

The driving force of the Tax Relief System



The most significant feature of the Tax Relief System is that the Hungarian state has made corporate-tax paying domestic enterprises interested in providing financial support to films shot in Hungary. According to the provisions of the Act on Corporate Tax, such enterprises may reduce their tax base by the financial support they provide, moreover they may reduce their tax payable by the same amount.

Such double write-off of the support may result in so significant tax savings, that enterprises become financially interested in supporting film productions.

The following table illustrates the advantages of support for tax savings purposes with the example of two imaginary enterprises. Both companies in the example generated 1000 units of profit

before taxation, but the first company provides support to film production, and the other one does not.

This tax saving mechanism is the driving force of the system. The system is so efficient, that due to the incentive, the amount of capital intended to support film productions in Hungary many times exceeds the amount finally utilized within the limits of production capacity.

The upper limit of tax exemption is “twenty percent”, which is still acceptable by the central budget, which means that 20% of production costs incurred in Hungary are eligible for refund. It is important to stress that the amount of the “twenty percent”-saving exclusively depends on the amount spent, thus there is no upper limit to the refundable amount in the tax relief system.

	Taxpayer supporting film production	Taxpayer not supporting film production
Taxpayer's profit before taxation	1000	1000
Support for film production	100	0
Tax base	900	1000
Tax payable	$(900 \times 0.16) - 100 = 44$	$1000 \times 0.16 = 160$
Tax paid	144	160
Savings	16	

Year	Certificates of support (HUF) issued (20% of production costs incurred in Hungary)	pieces
2004	632 119 893	25
2005	2 824 580 273	167
2006	3 305 860 255	433
before 30 April 2007	972 704 066	139
Total	7 735 264 487	764

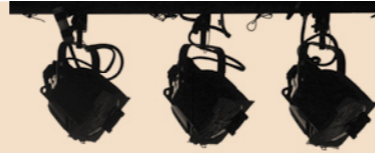


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The Creation and Most Important Elements of the Tax Relief System



I. The period of construction

This title gives an excellent summary of the events of the past few years in Hungary. Realizing that Hungarian motion picture art and professional standards may only be increased by developing the film-industry, Hungary launched fundamental reforms in the fields of film-industry and motion picture culture in 2003. Three years ago, in the spring of 2004, following several long years of preparation, the Hungarian Motion Picture Act was passed. It provided a legal framework to the reforms that stimulate the film industry, as a branch of the economy, and serve its prosperity. One of the priority objectives of the act was to improve the chaotic financial, production and distribution environment. Thus the tasks of the act were to create a simpler, more transparent, and operable professional environment which is able to absorb the increased state subsidy intended for the film industry. Furthermore, through a complex system of state instruments, it is to encourage establishing and maintaining connections with international film production by diverse support and efficient service provided to Hungarian productions, service jobs and other, foreign productions attracted to Hungary. The latter, the Hungarian Film Related Tax Relief System, which is one of the reform-measures defined in the act, was introduced with a dual purpose: to make Hungary one of the most attractive and competitive film production locations within Central Europe and to create new resources for the Hungarian film sector. Hungary intends to achieve this dual objective at the same time, providing exceptionally favorable conditions for all those who decide to shoot a film in Hungary.

Since the eighties, Hungary has gradually opened up for international relationships in the film industry. Low production costs, highly qualified experts, good infrastructure, attractive locations: these used to be the factors which convinced filmmakers seeking shooting and production facilities in the region to opt for Hungary. By the Millennium we had to realize, however, that these comparative advantages over other countries had melted away in the strong competition in Central-Eastern Europe. New instruments and new strategy were needed to improve our position and recover our status as one of the most attractive and most film-friendly environment. The most important element of this strategy is Hungary's new Film Related Tax Relief System.

The Tax Relief System encourages foreign film producers to come and produce films in Hungary as they can reduce the production costs of their films on the one hand, while it also creates extra resources for co-productions and Hungarian films on the other. Through the Tax Relief System, the available financial resource - which is defined as direct state subsidy in the Motion Picture Act and not to be confused with direct subsidy provided by different film funds - is 20% of film production costs incurred in Hungary. The source for indirect subsidy is the profit before taxation of Hungarian economic enterprises, which intend to reduce their tax payable by supporting Hungarian film production.

II.

The long term objective of the Tax Relief System, i.e. to strengthen the Hungarian audiovisual industry, is probably the most convincing factor for those who intend to take advantage of the benefits of the system, namely that the only risk they take lies within their own field of operation, and that the system works reliably, predictably and profitably. What else could prove the reliability of the Tax Relief System better than showing why it is worth for Hungary and its central budget to calculate with lost tax revenue, and why it is worth for Hungarian taxpaying enterprises to support domestic film production?

In the case of "films produced on order" the client himself is to be made interested in bringing the production to Hungary and in trusting local agents of the industry with its implementation. Therefore, it is the client, for whom an attractive shooting and production environment should be established in Hungary. In line with the above, the act has introduced reimbursement as a form of granting advantages. Its basic principle is that clients ordering service jobs are entitled to reimbursement calculated against their confirmed direct film production expenses incurred in Hungary. Expenses incurred in Hungary, i.e. "direct costs" of the given film production actually spent and certified by the Film Office, are eligible for the twenty percent reimbursement. Since budget allocations covering reimbursement may not appear as direct and immediately binding cost-items in the central budget, the state subsidy, therefore, will be indirectly realized through granting tax-exemptions to the Hungarian taxpayer who, in turn, will reimburse the Client. (Thus the budget encumbrance does

not appear upon the payment of reimbursement but later as freeing of income when the taxpayer, who is actually financing and executing the reimbursement, enforces his tax exemptions.) At this point, however, the Hungarian central budget not only has to face lost tax-revenues, but it also will also see extra income generated by the improved operation of the Hungarian film industry, which would not appear without the tax relief system. This interest of the state is what makes the system, besides its cultural and other positive effects, viable in itself and sustainable in the long run. This strict fiscal interest ensures your piece of mind as an investor.

In the case of "films produced not on order", potential co-producers need to be encouraged to plan and carry out more and more productions with Hungarian participation, i.e. to invest to a greater extent in cinematographic works shot in Hungary. To launch and maintain the system, corporate sponsors who invest in the creation of such cinematographic works financially are also entitled to reduce their corporate tax by 20% of the total "direct film production costs" incurred in Hungary.

III. Other Participants in the System

Taxpayers wishing to utilize the tax exemption opportunity may enter the system not only through making a direct, bilateral connection with a given production, but also through an opportunity providing an indirect way to realize their tax savings through film industry tax exemptions. A way for that is to introduce capital market instruments and other mechanisms that collect financial resources of different sizes intended for this purpose and forward them towards the end points of utilization, i.e. the film productions. It may be more convenient for professionals working in the film industry to receive a certain share of funding through these agents, using the latter's' expertise. These agents have appeared in Hungary over the past three years, and their activity has had a positive effect on the operation of the system. It is important to stress that one of the most important principles of the Tax Relief System is that it strives for simplicity, i.e. the system may be utilized independently with using the participants' own resources. Whether and to what extent a production uses other services of these agents (bank connections, expertise in procedures, exploring pre-financing options) is the decision of the clients and producers.

IV. Tax benefits for development

For agents, producers and other professional service providers of the film industry, the new Tax Relief System offers an unequivocal opportunity for professional improvement. A growth in the number of clients may bring about improved infrastructure. The new system encourages investments into the film production infrastructure with tax benefits in order to make the development induced by the Tax Relief System effective

in the long run and to optimize the exploitation of the system. Further benefits are available when purchasing special film industry devices or developing infrastructure (purchasing film industry apparatus, cameras, lighting equipment, etc., or constructing permanent sets, studios etc.). These encourage investments through applying more favorable depreciation keys and considering investments as tax base reduction items.

Tax benefits for development, which are not defined in the Motion Picture Act but in paragraph (1) section 22/B and Schedules 1-2 of the Act on Corporate Tax, are as follows:

1. Any taxpayer may apply a 50% devaluation key in the case of acquiring equipment or assets serving specific film making purposes, therefore by reducing their tax base - by half the price of the acquired equipment - their corporate tax payable also decreases.
2. Any taxpayer may apply a 15% devaluation key in the case of constructing buildings serving specific film making purposes, therefore by reducing their tax base - by half of the construction costs of the constructed film industry building - their corporate tax payable also decreases.
3. Should any taxpayer's investment or purchase falling under any of the above categories - qualifying as motion picture investment serving film production - exceed HUF100 million in present value, further tax exemptions are available. To exploit the above opportunity, the taxpayer carrying out the investment may reduce its tax by 30-50% - depending on the region of the country in which it carries out the investment. (Budapest: 35%, Pest county: 40%, West-Transdanubia: 45%, rest of the country: 50%.)

V. Studios

The introduction of the new system has provided an excellent opportunity for Hungarian film professionals. It is hardly possible to build an industry, renew infrastructure, train experts and carry out developments overnight. The viability of the system, however, is demonstrated by the fact that over the past three years two flagship-studios of Hungarian film industry have opened.



Brief Summary of the Operation of the Tax Relief System



I.

If you simply do not wish to spend more than absolutely necessary, then most likely you are one of those producers who wish to have their film produced, in whole or in part, in Hungary. You will order a service from a Hungarian film production company, thus, according to the Tax Relief System you qualify as a Client, and your production as a “film produced on order”, or a so-called “production service”. The above is defined in the Tax Relief System as follows: films produced on order are productions made by foreign film producers in Hungary with the involvement of an assigned Hungarian film production company. In this case - though usually the total budget of the film is available - the aim of the foreign producer is to decrease production costs by using the Tax Relief System.

In this case the client, i.e. the foreign producer, receives the refund directly, transferred to it by a given Hungarian taxpaying enterprise.

If you need financial resources because the total financing of your film may only be provided for by using the Tax Relief System and by exploiting other Hungarian resources, then most likely you will produce your film in co-production: according to the Tax

Relief System this is a film produced not on order, a co-production co-produced with a Hungarian filmmaker. The second model supports films, the total budget of which cannot be provided by the producers, therefore, they wish to involve other sources, too. In this case, the support is given to the Hungarian producer (co-producer) by a Hungarian taxpaying enterprise.

The Tax Relief System distinguishes between these two types of productions based on the different shares the Hungarian participants hold in the rights of the film. However, there is no significant difference between the two types of productions from the point of the extent and availability of tax relief. In both cases what exclusively matters is the amount of costs spent on film production and incurred in Hungary, the 20% of which amount shall - without further conditions and following the certifying procedure of the Film Office - be automatically refunded.

II.

In the case of films produced on order, the parties shall have contractual obligations towards each other. The Hungarian film producing company shall register itself and the cinematographic work at the Film Office in advance, and under the contract concluded with the foreign producer, it shall order and provide

	DIRECT HUNGARIAN COSTS (EUR)					
	piece 2004.		piece 2005.		piece 2006.	
under 40.000.-EUR	0	0	0	0	1	25 092
40.001-400.000.-EUR	3	363 620	5	1 214 075	6	1 243 083
400.001-2.000.000.-EUR	3	2 341 755	5	6 689 224	7	8 443 349
above 2.000.000.-EUR	1	4 345 114	2	35 894 227	2	17 770 349
SERVICE JOBS	7	7 050 489	12	43 797 526	16	27 481 872
under 40.000.-EUR	0	0	0	0	0	0
40.001-400.000.-EUR	8	1 290 592	7	1 586 357	8	1 453 273
400.001-2.000.000.-EUR	2	1 458 476	4	4 452 725	4	3 804 536
above 2.000.000.-EUR	1	2 141 118	5	14 631 090	1	9 034 267
CO-PRODUCTIONS	11	4 890 185	16	20 670 172	13	14 292 076
under 40.000.-EUR	39	804 683	45	860 577	123	2 606 426
40.001-400.000.-EUR	16	2 974 797	25	3 834 678	78	10 322 137
400.001-2.000.000.-EUR	13	10 319 008	14	12 377 755	30	29 889 292
above 2.000.000.-EUR	0	0	1	2 831 519	3	11 939 161
HUNGARIAN FILMS	68	14 098 487	85	19 904 529	234	54 757 016
TOTAL	86	26 039 161	113	84 372 227	263	96 530 964



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services and other items required for production, and shall also provide undertaken services in Hungary.

The Hungarian taxpayer undertakes in the contract that after the completion of the production in Hungary (or one of its phases) and following the issue of a tax certificate by the Film Office, it shall pay 20% of film production costs incurred in Hungary to the foreign client.

The Hungarian taxpayer providing the support may be involved in the arrangement by both the Hungarian and the foreign producer.

In the case of films produced not on order the role of the Hungarian partner, and that of the Film Office - the latter of which supervises state funds for the film industry - becomes more important.

In the case of these productions, the Film Office, as the government agency responsible for the regulatory tasks defined in the Motion Picture Act and for the operation of the film related tax relief system, first registers the Hungarian film producer and the cinematographic works applying for funding in the framework of the tax relief system, then examines and certifies Hungarian production costs and issues the tax relief certificate.

Furthermore, the Film Office passes a decision on the status of the production (Hungarian or co-production status) in a separate procedure, which status is an eligibility condition when applying for direct state subsidy.

By determining the funding intensity index, the Film Office declares the rate of production costs for which a given production may receive direct state subsidy. If this rate is exceeded, the office shall reduce the amount of tax relief by the excess amount, which procedure, from the point of system operation, stresses the obligation of accurate planning and that of providing reliable information flow between the partners.

Films produced on order (production service)

1. Client orders 100 units worth of production services from a Hungarian production company registered at the Film Office.
2. The Client, the production company and the Hungarian taxpayer intending to claim tax exemption (either directly or through a defined instrument - for example the fund collecting such sources) shall sign a trilateral contract in which the taxpayer undertakes that, following the receipt of the tax relief certificate from the Film Office, it shall pay Client 20% of latter's direct film production costs related to a given production and incurred in Hungary as financial support.

3. The production company shall spend 70 units out of its 100 units total budget on direct film production costs in Hungary.
4. The Film Office will then examine the 70-unit expenditure and issue a tax relief certificate to the production company verifying the costs. The certificate shall provide for an exemption not exceeding 20% of the 70 units, that is 14 units in this example.
5. Upon receipt of the certificate, the taxpayer shall pay 14 units of support to the Client.
6. In possession of both the statement about having paid the support and the certificate of the Film Office, taxpayer may reduce its tax paying obligation by 16.24 units (as both its tax base and its tax payable may be reduced by 14, i.e. $14 \times 0.16 + 14 = 16.24$ units, that sum is saved by the taxpayer, which equals the lost tax revenue of the state, i.e. the amount of the indirect state subsidy).
7. For the taxpayer, this arrangement is financially favorable since by covering 14 units worth of expense in the film industry it shall save 16.24 units in tax-relief.
8. The central budget balance is also positive, since 70 units worth of film industry spending generates 16.8 units in tax revenues, while the lost tax revenue caused by the tax relief system is only 16.24 units.

Co-productions (films produced not on order)

1. The sponsor (taxpayer) - usually directly - gets in touch with a film producer registered at the Film Office, and concludes a contract with latter to finance 20% of film production costs (tax-

payer's investment in the production shall be 14 units for easier comparison with the previous arrangement).

2. In line with the co-production agreement, the production company shall produce the film, and out of its total budget shall spend at least 70 units on direct film production costs in Hungary. Certainly, the financial share of the Hungarian co-producer in production costs does not necessarily correspond with the direct film production costs incurred in Hungary, so if either exceeds the other, actual costs shall serve as a basis for tax relief calculation.
3. The Film Office will then examine the 70-unit expenditure and issue a tax relief certificate to the production company verifying the costs.
4. In possession of both the statement on having paid the contractual financial support to the production and the certificate of the Film Office, taxpayer may reduce both its tax base by 14 units and its tax payable by further 14 units.
5. The central budget balance is also positive, since 70 units worth of film industry spending generates 16.8 units in tax revenues, while the lost tax revenue caused by the tax relief system is only 16.24 units.

The rule that tax relief may only be obtained if the production is registered in the registration and qualification system of the Film Office that records productions and industry participants (as defined in the Motion Picture Act), applies to all of the above arrangements. A description of administrative procedures follows.



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Unit 8

The Role and Procedures of NFOH



I. The Film Office in General

The Film Office is a central administrative body established according to the Motion Picture Act. By the foundation of the National Film Office in June 2004, Hungary joined the group of countries in which central administration of the film industry is carried out by a separate government organization - which is independent of the funding system. The tasks of the National Film Office, set forth by the Motion Picture Act, include:

- ▶ registration of motion picture organizations applying for direct or indirect state subsidy, constant monitoring of the registry, sanctioning (disclosing) those who violate the rules of the system;
- ▶ total financial auditing of cinematographic works financed by public funds;
- ▶ controlling and supervising the operation of the Tax Relief System, issuing tax relief certificates for investors of film productions;
- ▶ registering cinematographic works to be produced, certifying „direct film production costs” which determine the amount of tax relief (declaring eligibility and rate of funding);
- ▶ managing film related databases, collecting and providing statistical data concerning the film industry and making them available to both Hungarian and foreign institutes;
- ▶ certifying the domestic share of film productions, granting the „Hungarian film” and “co-production film with Hungarian participation” status, issuing a film’s certificate of origin;
- ▶ implementing the European Convention on Cinematographic Co-Production of the Council of Europe;
- ▶ rating cinematographic works to be distributed, in accordance with categories set forth by law;
- ▶ monitoring the proper display of classification signs, imposing fines;
- ▶ registering “art” movie theatres, and their regular monitoring;
- ▶ rating „art” category films;
- ▶ concerning the implementation of bi- and multilateral co-production conventions, the Film Office is the competent authority.

It is important to stress that the Film Office is not a national funding agency, its exclusive task concerning the Tax Relief System is monitoring and supervising its operation. If a production complies with all requirements of relevant legislation, the Film Office is obliged to issue the tax relief certificate.

Since the general administrative reform in 2006, the Film Office has been operating as an independent directorate of the National Office of Cultural Heritage, nevertheless, this measure of administration rationalization left the office’s tasks and professional status intact. It still plays a key role in the above fields as a motion picture authority.

The Film Office employs 10 civil servants at the moment. Its head office is in Budapest. Its overseeing body is the Ministry of Education and Culture.

The Film Office, as part of the Hungarian administration, operates according to latter’s rules, although its procedures are set forth by separate legislation. Clients of the Film Office are obliged to pay a fixed rate of administration service fee. The given procedure shall start upon filling in the forms available on our website and submitting them to the Film Office. The relevant legislation sets deadlines for our procedures, which are usually 30 days. Film Office procedures are concluded by decisions. Before a decision becomes effective and if you disagree, you may take the case to second instance, i.e. appeal to the Minister of Education and Culture.

II. General Information on Procedures

In the following section a summary of the most important elements of Film Office procedures follow, which are of significance when using the Tax Relief System.

Closely linked to one another, Film Office procedures help you in exploiting the Tax Relief System. Should you become a client of the Film Office, you or your Hungarian partner will have to initiate a row of procedures that logically follow one another.

We wish to describe the whole process through a list of Film Office procedures.

1. In the procedure of applying for registration at the Film Office, you or your Hungarian partner, as a motion picture organization, will become eligible for indirect state subsidy. The National Film Office registers professional motion picture organizations and

natural persons applying for state subsidy, as well as Hungarian enterprises participating in the production of motion pictures produced on order. Registration requests shall be submitted to the National Film Office, prior to applying for state subsidy, by filling in a form physically or electronically. The registration fee shall be paid upon filing the request.

2. As stated above, there are specific requirements for productions the Hungarian producer of which wish to apply for direct state subsidy under the Tax Relief System. If you come to Hungary not as a co-producer, but as a Client, your partner will not have to initiate a procedure of certifying the share of Hungarian participation, the so-called film categorization procedure. Neither are you obliged to do so if you do not wish to apply for direct state support for your film produced with Hungarian participation.

Otherwise, a film categorization procedure will have to be initiated, as, in line with legal requirements, the Film Office registers those cinematographic works in preparation or under production which receive support, in order to establish eligibility for direct state subsidy. Registered Hungarian film producing companies or producers, i.e. companies in the registry of the Film Office, shall ask for the categorization of the production 45 days preceding the shooting in Hungary (attach documents, schedules, certificates defined by law must be attached) and the categorization fee upon filing the request shall be paid. You may initiate categorization by filling in and submitting the proper forms physically or electronically on the Film Office website. For productions spending less than HUF 25 million, the law prescribes simplified procedures.

3. The next phase is Production phase, i.e. carrying out production work in Hungary. During this phase, usually following the beginning of shooting, the cinematographic work must be registered. The registration process, at the moment, is not bound by an initiation deadline, i.e. you can initiate it any time. Its significance is that when the producers or filmmakers are already in possession of the most important parameters of the production (budget figures supported by certificates of financing, production plan, agreements, etc.), they shall register these parameters at the Film Office. The Film Office shall carry out an auditing process of the created cinematographic work in view of the registered data. Registration is a process in which producers or filmmakers themselves draw up a plan,

which shall serve as a basis for verification by the Film Office. Further significance of the registration becomes apparent if the decision of the Film Office includes the sum of direct film production costs. Following the inspection of the budget plan and based on submitted certifications, documents, plans and the legislative regulations, the Film Office issues a preliminary declaration of the sum eligible for the 20% tax relief certificate. The declaration of eligibility and rate of funding concerning the sum in the tax relief certificate shall prevail for those who take on any financing responsibility concerning this sum (insurance companies, pre-financers, sponsors, banks, credit institutions, etc.)

4. Film Office auditing of the cinematographic work shall be carried out upon demand. It makes production financing easier that the production process in Hungary may be broken up into quarters, and following the completion of individual phases you may ask for the issue of tax certificates quarterly, for costs incurred in the given phase. After production in Hungary (or a 3-calendar-month phase thereof) has been finished and upon the request of the producers or filmmakers, the Film Office reviews the accounting of the production and within the 30-day deadline provided by law, issues the tax relief certificate.

5. Five days prior to the issue of the tax relief certificate, the production company must report the name of the sponsor (taxpayer) to the Office, for whom the certificate shall be issued. The tax relief certificate declares the sum equaling 20% of film production costs incurred in Hungary.

6. Generally, only following the receipt of the tax certificate does the Hungarian taxpayer comply with its contractual obligations - i.e. paying the support set forth by its agreement with the foreign or Hungarian producer - and transfers the sum defined in the tax certificate to its partner. Sponsors shall only transfer the financial support set forth by their contract at this point, as only the certificate guarantees that they shall receive tax relief on the financial support they provided. As for the sponsors only the tax relief certificate verifying production costs and issued by the Film Office guarantees tax-savings, producers and film-makers may have to explore pre-financing possibilities to overcome problems in cash-flow. Although this is the most common solution, the system does not exclude sponsors providing support in advance at their own risk.

	2004	2005	2006
SERVICE JOBS	7 050 489	43 797 526	27 481 872
CO-PRODUCTIONS	4 890 185	20 670 172	14 292 076
HUNGARIAN FILMS	14 098 487	19 904 529	54 757 016