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A Top-Down Approach: Tax Incentives and Their Effect on the Chinese Movie Industry



The overall Chinese economy seems to be slowing down. Certain aspects of the economy, however, are growing fast. Fueled by an expanding middle class and the State government's effort to transition from a manufacturing economy to a service one, the movie industry is growing at an extraordinary pace despite the downward pressure of the overall economy.

In fact, China is now the world's second-largest film market and its gross box office sales are likely to surpass those of the U.S. by the end of 2018.ⁱ In 2015, China's box office revenue reached the sum of 6.78 billion USD, recording an increase of 48.7% over 2014 and 349.1% over 2010.ⁱⁱ With box office revenue of 11 billion USD in 2015, the U.S. still occupies the top position, but it will not be for much longer given the inverse trend of American and Chinese movies and the potential presented by China's enormous population.

Although 2015 was a record year for American box office sales, the number of successful movies was unimpressive. “The takeaway is that we ha[d] a record year, but it was concentrated among fewer films. The top 10 films in 2014 represented 24 percent of the pie. The top 10 films [in 2015] represent[ed] 34 percent. There is no bottom anymore.” said Fox domestic distribution president Chris Aronson.ⁱⁱⁱ Apart from this, in 2014 the U.S. box office revenue registered a decrease of 5.13% over 2013. On the other side of the Pacific, the cultural and cinematographic movement has recorded a noteworthy development in recent years. Chinese films took an impressive 62% of the market in 2015. In the same year, Stephen Chow’s “The Mermaid” broke all-time records by becoming the first movie in mainland box office history to pass the 3 billion yuan mark.^{iv}

Further, there is room for many more screens in China. Despite being the country with the second most screens in the world, China’s 1.4 billion population is still underserved. In comparison, the U.S. has about 40,000 screens, which translates to roughly one per 8,000 inhabitants. In order to reach a similar level of density, the Chinese government has promoted a boom of screens and movie theaters construction. Consequently, cinema screens in China increased from 3,527 in 2007 to 31,627 in 2015. That is an average of 22 screens added every single day.^v Most of these screens were built in small cities and rural areas to catch up with metropolitan areas. As a result, per capita theater visits are also predicted to increase. Currently, a Chinese goes to movie theaters only 0.8 times a year on average, whereas an average American goes 3.22 times and an average South Korean goes 3.87 times per year.^{vi} Such data reveals that great potentials still exist in the Chinese movie industry.

The Film Industry Promotion Law

Even though domestic films were already performing strongly in China, the National People’s Congress issued a draft of the People’s Republic of China Film Industry Promotion Law (“Film Industry Promotion Law”) on November 6, 2015 to further boost China’s exploding film market and bridge the gap between domestic and foreign movies in technologies, capital, talents, and contents.

Concerning the lack of screens and movie theaters, the Congress has promised to increase support for rural film screenings, to continuously improve the capacity of film viewing in rural areas, and to provide the people with exceptional, quick and easy film viewing services.^{vii} The local governments are to pay to establish and improve service networks for such screening services.^{viii} In addition, local governments are required to “include the construction and reformation of movie theaters into the people’s economic and social development plans, culture industry development plans, overall land use plans and urban and rural overall construction plans.”^{ix}

The Film Industry Promotion Law is also aimed at encouraging “financial institutions to provide financial services to those engaged in film activities, (...) to support development of the film industry in terms of credit and other aspects,” as well as requiring “financial security institutions to provide financial guarantees for the film industry in accordance with law.”^x Moreover, the State mandates better capital, funding, financial and accounting systems to increase investment in the film industry, and declares to implement “tax incentive policies to promote the prosperous development of the film industry.”^{xi}

From 2009 to 2014: Previous Tax Measures

The Film Industry Promotion Law captured headlines worldwide. Nonetheless, what has been equally, if not more, important in fostering the growth of the Chinese movie industry is a series of tax incentives implemented since 2009.

Decree No. 31

Decree No. 31 of 2009 introduced exemptions of value added tax (“VAT”) and business tax (“BT”) for qualified enterprises in the film industry.^{xii} According to Article 1 of the decree, from January 1, 2009 to December 31, 2013, VAT and BT were exempt on income derived from the transfer of film copyrights,^{xiii} film distribution and box office revenue earned in rural areas.^{xiv}

In particular, a significant effort was made to support high-tech enterprises specialized in the cultural industry because of their importance in the digital economy. Article 5 of the decree stipulates that the BT of culture-focused high-tech companies “shall be collected at a reduced rate of 15%” and that “research and development costs incurred by cultural enterprises in developing all new technologies, products and techniques are allowed to be deducted from their taxable income in accordance with relevant taxation laws of the State.”^{xv} Other provisions introduced VAT rebate policies for exports of movies and completed TV programs,^{xvi} as well as tax reliefs on unmarketable works by considering them as property losses deductible for corporate income tax (“CIT”) purposes.^{xvii}

Order No. 86

In 2010, the State Administration of Taxation issued Order No. 86, which exempted cultural enterprises established before December 31, 2010 from CIT for three years from the date of their registration.^{xviii}

Decree No. 56

In 2014, Decree No. 56 of the Ministry of Finance extended for four more years (until December 31, 2018) the VAT and BT exemptions initially introduced by Decree No. 31. Furthermore, general VAT taxpayers that provide film-screening services in urban areas can adopt a simplified calculation method.^{xix}

Article 2 and Article 5 of Decree No.56 aimed at establishing special funds to support the production of films and the construction of movie theaters. The former requires the Central Treasury to arrange a special fund of 100 million yuan to promote the production of five to ten influential films dealing with special themes.^{xx} The latter is focused on bridging the gap between China’s rural areas and big metropolitan areas, such as Shanghai and Beijing, by introducing special funds to support the “construction of digital movie theaters in county-level cities, in central and western China as well as in the needy regions in eastern China.”^{xxi}

Decree No. 56 also strives to increase the degree of government investment in the movie industry and support financial assistance to film enterprises. Banking institutions are encouraged to create and expand the offering of financial products, such as lease loans, pledge financing of receivables, and equity pledge loans, that cater to the characteristics and needs of the film industry. At the same time, movie enterprises are spurred to go public by issuing corporate securities, set up collective trusts and offer other financing instruments.^{xxii}

Circular No. 85

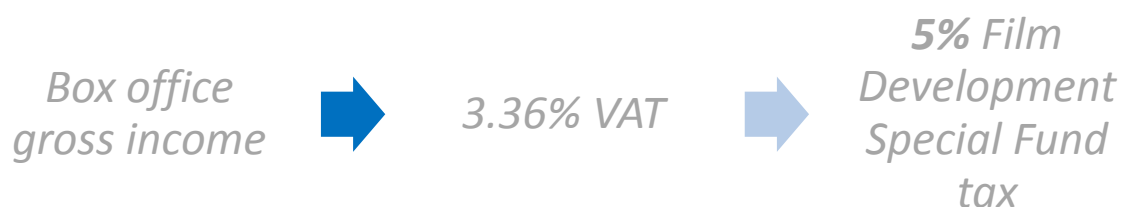
In 2014, the government issued Circular No. 85 to extend for another four years the reduced tax rate and tax deductions for high-tech companies initially introduced by Article 5 of Decree No. 31 in 2009.^{xxiii} The circular also introduced certain VAT exemptions on film production,

distribution and screening services provided outside China and rebates on the exportation of completed films.

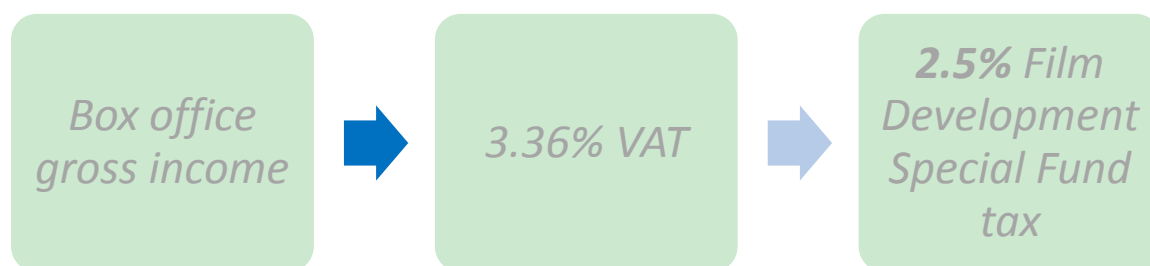
2016: A Special Rebate

In 2016, the Provincial Committee for the National Film Industry Development Special Fund issued Decision No. 3.^{xxiv} According to this decision, movie theaters which generate at least 2/3 of their revenues from the screening of Chinese movies will receive a 50% rebate on their payment of the Film Development Special Fund Tax.

Currently, movie theaters collect a 5% tax on all ticket sales which is paid into the “Film Development Special Fund” established by the State Administration of Press, Publication, Radio, Film and Television of the People’s Republic of China (SAPPRFT). To explain it better, a nationally-imposed VAT of 3.36% is first applied to the overall box office ticket sales. The 5% Film Development Special Fund tax is subsequently applied to the remaining amount, in order to subsidize the making of special-themed films and support the renovation/construction of movie theaters.^{xxv} After this further deduction, the net box office amount is allocated according to previous agreements between the theater (or theater chain) and the production/distribution company.^{xxvi}



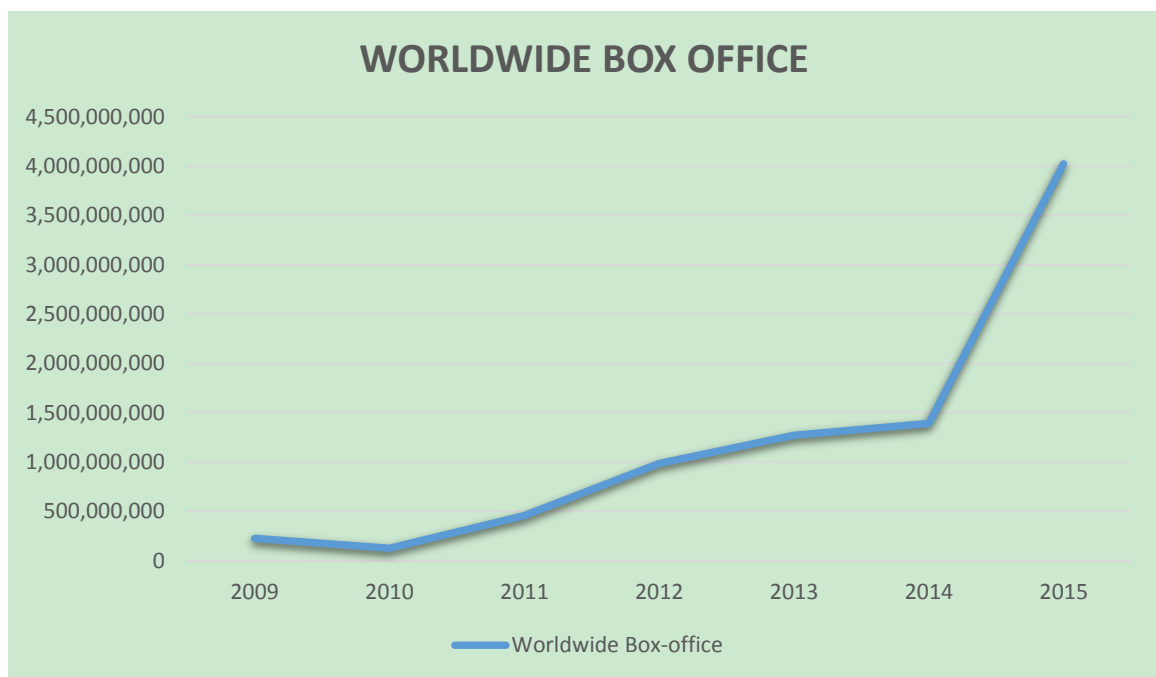
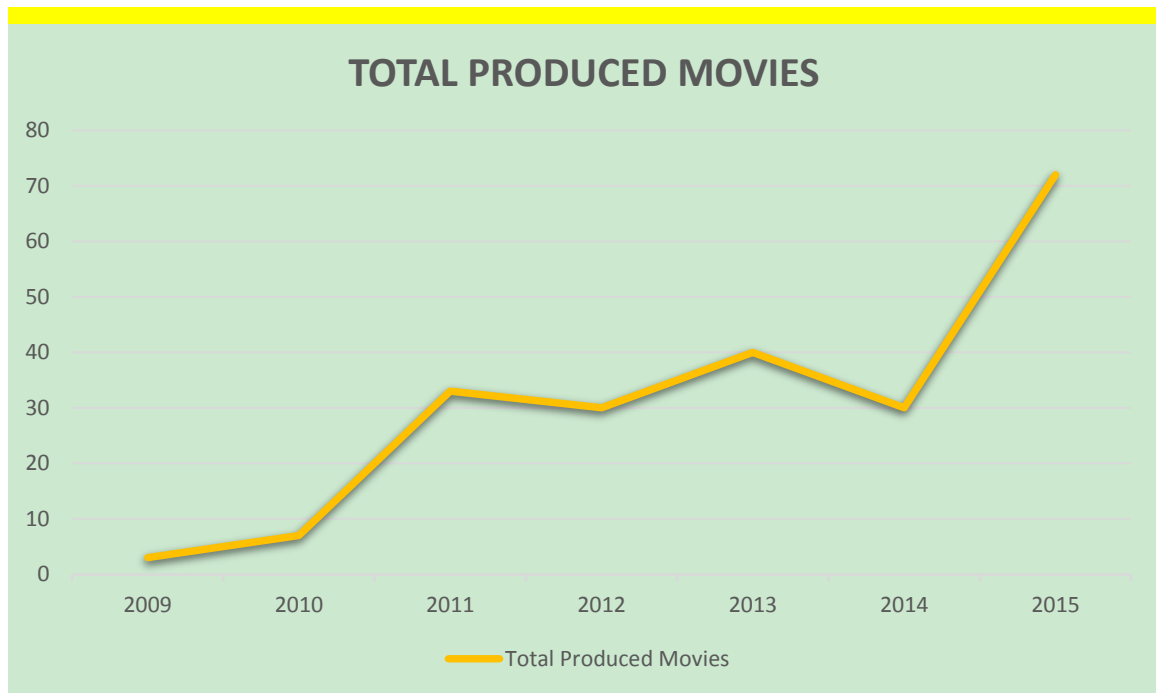
Thanks to the new tax rebate, theaters which meet the abovementioned requisite will be able to keep half of the 5% tax they usually pay on ticket sales. For instance, in the case of an after-VAT box office revenue of 1 million yuan, only 25,000 yuan (i.e. 2.5% of 1 million) must be paid as Film Development Special Fund Tax instead of 50,000 yuan (5% of 1 million).



To qualify for the rebate, Chinese cinemas must ensure that imported movies generate no more than 1/3 of the box office for the full year, as well as provide a certificate of clean regulatory record showing no history of box office under-reporting, fraud or other illegal activities.^{xxvii}

An Undeniable Impact

To what extent has the Chinese movie industry benefited from the abovementioned tax incentives? The graphs below show that there is a positive correlation between the tax incentives introduced between 2009 and 2015 and the upward trend of the Chinese movie industry, taking into consideration the total number of movies produced by Chinese companies and the corresponding worldwide income they generated.



Source: <http://www.the-numbers.com/China/movies#tab=year>

In 2011, two years after the first session of tax measures, 33 Chinese movies were produced, recording a rise of 371.43% over 2010. Throughout the same year, the worldwide box office generated by Chinese movies increased from 127 to 457 million USD. The tax measures of 2014 created a similar effect by increasing the number of movies produced by 140% and the worldwide income by 189.35% in merely one year's time.

The sharp increases in 2015 were illustrative of how important the tax incentives leading up to that year had been. The continuous tax incentives since 2009 have built faith and predictability for Chinese movie companies. In fact, these initiatives are no longer perceived as

isolated and provisional, but rather as part of a long-term plan aimed at promoting the domestic movie industry.

Conclusion

It is evident that the aggressive tax incentives have boosted the Chinese movie industry. These incentives have had a significant impact on two different levels. The measures ranging from 2009 to 2014 aimed to improve the quantity and the quality of Chinese films. These incentives provided financial support to movie, high-tech and cultural enterprises in order to promote the domestic film industry. The year 2016, however, has represented a turning point. The Chinese government introduced tax incentives to help local cinemas and theaters. By acting in this way, the focus was switched from movie producers and distributors to theater operators.

In that sense, the government's strategy can be expressed as "from the top (movie enterprises) to the bottom (customers)." So far, the growth of the Chinese film industry has concentrated on the quantity and the quality of movies, without affecting to a noticeable extent the average number of theater visits per capita. A new series of tax incentives may pave the way to a cinema construction boom and to attracting more citizens to the cinemas. When this new stage of the government's plan succeeds, China's movie industry will finally become a real gold mine.

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ⁱ Rob Cain, *China's Movie Industry is Growing Faster Than Any Other Country's Anywhere, Any Time, Ever*, Forbes (June 26, 2015), <http://www.forbes.com/sites/robcairn/2015/06/26/chinas-movie-industry-is-growing-faster-than-any-other-countrys-anywhere-any-time-ever/#1c74d8695051>.

ⁱⁱ Patrick Brzeski, *China to Reward Cinemas for Favoring Local Films Over Hollywood Imports*, The Hollywood Reporter (March 27, 2016), <http://www.hollywoodreporter.com/news/china-reward-cinemas-favoring-local-878541>.

ⁱⁱⁱ Pamela McClintock, *Box Office 2015: How Revenue (Narrowly) Hit a Record \$11B in the U.S.*, The Hollywood Reporter (December 29, 2015), <http://www.hollywoodreporter.com/news/box-office-2015-how-revenue-851167>.

^{iv} Patrick Brzeski, *China Box Office Grows Astonishing 48.7 Percent in 2015, Hits \$ 6.78 Billion*, The Hollywood Reporter (December 31, 2015), <http://www.hollywoodreporter.com/news/china-box-office-grows-astonishing-851629>.

^v Tang Yue, *Holiday Upsurge Leads to Record-breaking Box-office Revenues in 1Q*, China Daily (April 4, 2016), http://www.chinadaily.com.cn/china/2016-04/04/content_24264686.htm.

^{vi} Patrick Brzeski, *supra* note 4.

^{vii} Article 30 of the People's Republic of China Film Industry Promotion Law (Draft).

^{viii} *Id.*

^{ix} Article 39, *Id.*

^x Article 40, *Id.*

^{xi} Article 38, *Id.*

^{xii} Decree No. 31 of 2009 ("Supporting the Development of Cultural Enterprises Taxation Policies Provisions"; March 27, 2009).

^{xiii} This provision about copyrights represents the key of China's movie industry future growth. Nowadays, domestic films still rely almost exclusively on box office sales for recoupment of costs and profit-making. In general, when the ratio of a film's total cost of production to gross box office takings reaches 1:2.5, the film can recoup costs. In Hollywood, on the other hand, the box office on average accounts for approximately only 20-30% of a film's total revenue. In fact, the majority of the revenue comes from transfer or licensing of various exclusive rights in the film's copyright, and from the development of related consumer products and merchandising.

^{xiv} Article 1 of Decree No. 31 of 2009 reads: "Competent administrative authorities for broadcasting, movie and television media (including those at the Central, provincial, prefectural and county levels), in accordance with their respective functions and authorities, shall approve engagement by film corporations (including their member enterprises) in movie production, distribution and projection, movie studios, and other movie enterprises shall be exempted from value-added tax and business tax for their income obtained from the sales of movie copies, transfer of movie copyright, movie circulation and screening movies in rural areas."

^{xv} Article 5, *Id.*

^{xvi} Article 3, *Id.*: "Exports of books, newspapers, periodicals, audio-video products, electronic publications, movies and completed TV programs shall be eligible for the value-added tax export rebate policy in accordance with applicable provisions."

^{xvii} Article 6, *Id.*: "In the case of unmarketable publications of publishers and distributors, e.g. paper books which have been unmarketable for over five years (including the year of publication, hereinafter the same), audio-video products, electronic publications, and screen sheets (inclusive of micro-reproductions) which have been unmarketable for over two years, paper periodicals, wall calendars and New-Year paintings that have been unmarketable for over one year, the actual value of such products may be deducted as property loss before being taxed. If unmarketable publications deducted as property loss before the imposition of tax are sold in a subsequent year, such sales income shall be included in the taxable income of the year of disposition").

^{xviii} Order No. 86 of the State Administration of Taxation ("Issues Related to Policies on Enterprise Income Tax of Newly Established Cultural Enterprises Notice"; March 2, 2010) states as follows: "The General Administration of Customs and the State Administration of Taxation on Several Taxation Policies for Supporting the Development of Cultural Enterprises (Decree No.31 of 2009), and Article 1 of the Notice of the Ministry of Finance, the General Administration of Customs and the State Administration of Taxation on Certain Issues Related to Taxation Policies on Supporting Culture Industry Development During Trial Reform of the Cultural System (Decree No. 2 of 2005), government-encouraged cultural enterprises newly established before December 31, 2008, shall be exempt from paying enterprise income tax for three years from the date of industrial and commercial

registration, and the preferential policy shall expire on December 31, 2010 in accordance with the provisions of Article 8 of the Notice of the Ministry of Finance.”

^{xix} Article 4 of Decree No. 56 of the Ministry of Finance (“Film Industry Development Economic Policies Support Notice”; May 31, 2014): “The following incomes shall be exempted from value-added tax (“VAT”) during the period from January 1, 2014 to December 31, 2018: incomes obtained by film production enterprises from the sales of film copies (including digital copies) and the transfer of copyrights; film distribution incomes obtained by film distribution enterprises; and, incomes obtained by film screening enterprises from screening films in rural areas. Film screening services provided in urban areas by general taxpayers may, pursuant to prevailing policies, be subject to VAT according to simplified taxation methods.”

^{xx} Article 2, *Id.*: “The Central Treasury shall continue to set aside special funds for quality films to promote the creation and production of films. Specifically, an amount of RMB 100 million shall be arranged annually to support five to ten influential films touching on key themes that will be selected upon application for approval on a case-by-case basis.”

^{xxi} Article 5, *Id.*: “The Central Treasury shall set aside subsidies under the special funds for the development of the film industry to prioritize support for the construction of digital movie theaters in county-level cities in central and western China as well as in the needy regions in eastern China. Local finance departments shall, according to local economic development realities, make reasonable funding arrangements to promote the balanced development of the construction of digital movie theaters in county-level cities.”

^{xxii} Article 7, *Id.*

^{xxiii} Article 4 of Circular No. 85 of the State Administration of Taxation (“The Circular on Several Issues Concerning Tax Policies for Continuously Supporting the Development of Cultural Enterprises”, November 27, 2014).

^{xxiv} Decision No. 3 of the Provincial Committee for the National Film Industry Development Special Fund (“Notice on Rewarding Outstanding Theaters for Performing Domestic Film”; March 3, 2016).

^{xxv} Robert Cain, *How China’s Movie Distribution System Works*, Chinafilmbiz (November 9, 2012), <https://chinafilmbiz.com/2012/11/07/how-chinas-movie-distribution-system-works-part-1/>.

^{xxvi} In relation with these agreements, in 2012 SAPPRFT announced that the production/distribution party may receive no less than 43% of the box office, while the theater operators receive no greater than 50%.

^{xxvii} Patrick Frater, *China to Boost Local Films with Tax Break*, Variety (March 28, 2016), <http://variety.com/2016/film/asia/china-to-boost-local-films-with-tax-break-1201740838/>.