

Reform of film tax incentives :

Promoting the sustainable production of culturally British films

July 2005



HM TREASURY



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HM Treasury contacts

This document can be accessed from the Treasury Internet site at:

www.hm-treasury.gov.uk

For further information on the Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4861

E-mail: ceu.enquiries@hm-treasury.gov.uk

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INTRODUCTION

1.1 The Government recognises the important role that the British film industry plays in the representation and expression of British culture and national identity, and is committed to encouraging the enjoyment of film and promoting film production in the UK.

1.2 Government provides support to the film industry through a variety of means. One important plank of Government support is the fiscal incentives provided for film production through film tax reliefs.

1.3 There are currently two special tax incentives for film production in the UK. The Government reviewed the current tax incentive provided for small budget films last year and launched its proposals for a replacement in September 2004, based on a new film tax credit model. Following the Government's announced intention in December to review the tax relief used by large budget films, the Chancellor announced at Budget 2005 the Government's intention to reform that relief. The Chancellor also announced the extension of the current tax incentive for small budget films, to allow for formal consultation on draft legislative proposals across the entire film sector.

1.4 In line with the Chancellor's announcement, this consultation document takes forward the Government's commitment to consult formally on proposals for a new tax regime to incentivise the production of small and large budget films. It clarifies the core aim of tax reliefs as that of promoting the sustainable production of culturally British films.

1.5 The Government believes that the current reliefs must be reformed if they are to encourage stable and sustained investment in production of culturally British films while providing better value for money for the British taxpayer and the film-going public. The proposed replacement relief also reflects the need to comply with EU requirements on State aid in relation to cultural support, as set out most recently in guidance issued in March 2004. That guidance emphasises in particular the Commission's objection to requirements that a large part of a film's budget be spent in a particular country as a condition for any aid being given by that country.

1.6 The structure of this consultation document is as follows:

- Chapter Two clarifies the core aim and objectives for film tax incentives within the context of the Government's policy on film.
- Chapter Three sets out the case for reforming the current reliefs by considering the extent to which those Government objectives are addressed by the current film tax reliefs.
- Chapter Four sets out the reform objectives arising from the analysis contained in the previous chapter.
- Chapter Five then sets out proposals for the new film tax regime.

1.7 It is envisaged that the new film tax relief will be underpinned by a new cultural test that will ensure that film tax incentives are provided for culturally British film products. This document does not set out proposals for the new test: the Department for Culture, Media and Sport is launching consultation on the proposed new cultural test on the 29th July 2005, to run concurrently with this consultation on the replacement film tax relief.¹

1.8 Draft legislation is provided for illustrative purposes separately for comment, together with a partial Regulatory Impact Assessment and a summary of industry reactions to the proposals for a new small budget film tax credit and the review of the tax relief used by large budget films.

The consultation period begins today and will run until 21st October 2005.

Please ensure that your comments on this Consultation Document, and replies to the questions in it, reach us by 21st October 2005.

Comments and responses can be sent by email to:

films-team@hm-treasury.x.gsi.gov.uk

Comments and responses can also be sent by post to:

**David Hamp-Adams
Budget and Public Finances
HM Treasury, 1 Horse Guards Road
London, SW1A 2HQ
Fax: 020 7270 4861**

All comments received may be made public unless you specifically request otherwise. For comments received electronically, the general confidentiality disclaimers that often appear at the end of emails will be disregarded for the purposes of publishing comments unless an explicit request otherwise is made in the body of comment.

Paper copies of this document may be obtained, subject to availability, from the Public Enquiries Unit: public.enquiries.hm-treasury.gov.uk

¹ See website address http://www.culture.gov.uk/global/consultations/2005+current+consultations/culturaltest_britishfilm.htm

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FILM POLICY AND FILM TAX RELIEF OBJECTIVES

This Chapter clarifies the role that film tax incentives play within the overarching framework of Government policy on film. It describes the diverse aims and the range of Government support for film before going on to discuss the specific role of direct financial support for film production.

While grant funding and tax incentives share the same general aim, they have different but complementary roles. The core aim of tax relief is to promote the sustainable production of culturally British films.

The rest of the chapter then sets out what this core aim means in terms of specific objectives for film tax incentives.

GOVERNMENT FILM POLICY

2.1 The framework of Government support for the UK film industry reflects both the economic and cultural benefits that British films bring to the UK.

2.2 UK Film Council statistics demonstrate that the number of British film productions has almost quadrupled over the last ten years; with their total annual value rising from £240 million to £810 million. Examples of recent British film successes are *Vera Drake*, *Harry Potter and the Prisoner of Azkaban*, *Bridget Jones: the Edge of Reason*, *Bride and Prejudice* and *Valiant*. The UK film and video industry workforce has increased by 46% since 1994 and now employs roughly 47,000 people. In recent years, the UK has attracted a large amount of inward investment into the film industry, which has increased from £182m in 1994 to £548m in 2004. Though they are difficult to measure with any precision, there are also likely to be indirect economic benefits that spill over from film production to other UK industries such as tourism.

2.3 Cinematic film provides a universal and readily accessible medium for the expression and representation of British culture and national identity. Films can help reflect, explore and challenge our diverse history, cultural beliefs and shared values. In doing so, the best British films not only help us to reach a better shared understanding of Britain and its place in the world, but are also instrumental in spreading awareness and appreciation of British culture around the world. As such, British films are an important part of our cultural heritage and a significant channel for the continuing expression and dissemination of British culture.

2.4 The important role that film plays in British cultural life provides Government with a specific case for the forms of intervention that are made by Government to support the industry. The Government's commitment to promoting access and appreciation of British cinema and to ensuring a sustainable film-production capacity in the UK is clear through the support that it provides for film. The strategic body for film, the UK Film Council, was set up in 2000 with the aim of stimulating a competitive, successful and vibrant UK film industry and culture, and promoting the widest possible enjoyment and understanding of cinema throughout the nations and regions of the UK.

2.5 Government film policy has diverse objectives. These range from improving access to cinemas to raising skill levels within the industry. Support for the British film industry takes a number of forms reflecting the range of objectives.

2.6 The various means of support made available for films and film-related activity by the UK Film Council that are described below reflect the multiple objectives that underlie Government policy towards films.

UK Film Council – Indicative Annual Support for Film

Development Fund: £4 million a year to fund writers and stimulate cross fertilisation with the production sector.

New Cinema Fund: £5 million a year to support new talent and innovation on small budget films.

Premiere Fund: £8 million a year to stimulate entrepreneurship in the production sector by supporting commercially viable projects.

Distribution and Exhibition Fund: £15 million to fund distribution and exhibition of specialised and indigenous British film and increase accessibility to cinema for geographically remote audiences or disabled audiences including those with sensory impairments. Key to the strategy is the Digital Screen Network which is now being rolled out across the UK.

Skills and Training: £6.5 million per year is delegated to Skillset, the Sector Skills Council for the audiovisual industries in order to address training needs across the spectrum of film.

UK Film Council International: £1.7 million per year invested in supporting inward investment into the UK film sector and the export of UK films.

Nations and Regions: £8.5 million per year invested in the nine English regional screen agencies and three National agencies to support film and film-related activities across the UK.

British Film Institute: (bfi): £16 million per year invested in promoting an understanding and appreciation of Britain's film and television heritage and culture including support for the bfi National Film Theatre and the National Film and Television Archive.

First Light: £1 million a year to provide children between the ages of 5 and 18 with experience of film making.

2.7 A key objective of Government policy on film is to encourage stronger links between the distribution and production sectors in the UK film industry. At the request of the Minister for Creative Industries, the UK Film Council is currently undertaking a stocktake of film policy which will examine all non-tax policy instruments to see what more can be done to develop an integrated strategy for the future.

GOVERNMENT SUPPORT FOR FILM PRODUCTION

2.8 Like many countries, the UK provides direct financial support for the production of culturally British films. The main forms of direct financial support are:

- Grant in aid and lottery funding for film-making distributed through a number of organisations including the UK Film Council; and
- Tax incentives.

2.9 The common aim of both forms of financial support is to encourage stable and sustained production of culturally British films by way of direct subsidy or an incentive for specific behaviour. However, the two forms of Government financial support play different roles in how they achieve this aim, reflecting the different ways in which they operate.

2.10 Grant funding for film production is allocated on a film-by-film basis and requires subjective judgment to be applied. Applications for grants are assessed on, among other things, whether the proposed films demonstrate qualities such as artistic merit, innovation or commercial potential. The grant funding mechanism plays a role in encouraging specific films to be produced with an eye to influencing the overall shape of film-making output. This may be important for ensuring, among other things, greater diversity and a channel for new talent that may be unable to raise the necessary finance in the absence of Government intervention.

2.11 Tax incentives, on the other hand, do not apply in such a selective manner. Instead, the tax system provides a general framework of eligibility, based on objective criteria, within which incentives are provided. As long as the eligibility criteria are met, any film can qualify for tax incentives without interference from Government in its cultural merit or how it is produced. Unlike grant funding, tax incentives do not seek to influence the specific qualitative outputs of individual films or specific production activities.

2.12 Grant funding and tax incentives therefore play different but complementary roles towards the same goal of addressing the cultural benefits that accrue from film production. To the extent that the development of creativity and cultural value may need to be channelled into particular projects, grants are more appropriate in targeting support at such specific objectives. On the other hand, tax incentives can play an important role in creating a favourable environment within which the market can determine what kind of cultural products are made, and how, with minimal distortions.

THE ROLE OF TAX INCENTIVES IN GOVERNMENT FILM POLICY

2.13 Tax incentives have a distinct role to play in supporting the overarching framework of Government film policy. The purpose of tax incentives is to provide support for British film production, with the aim of promoting the expression of British culture in accordance with the European Union's regulations on the provision of State aids to the cinematographic and audiovisual industries.²

Tax Relief as State aid for promoting culture

2.14 The new film tax relief is a form of support granted by the State with the aim of favouring the production of certain goods for which there is a market, and where there is a threat of distorting competition or affecting intra-Community trade. They are consequently a form of State aid and have to be notified and cleared by the European Commission.

2.15 Commission guidelines recognise the promotion of culture to be an exceptional reason for the granting of State aid. Therefore, in order to ensure that tax incentives are more clearly aimed at promoting culture, the current relevant test for a British film as set out in Schedule 1 of the Films Act 1985 will be reviewed. The Department for Culture, Media and Sport is launching a consultation on a new replacement test on 29th July 2005.³

Core aim of film tax relief

2.16 For the reasons set out above, the core aim of film tax reliefs is to **promote the sustainable production of culturally British films**, across the spectrum of indigenous and inward investment.

2.17 In addressing this core aim, film tax incentives operate within the wider context of Treasury objectives to promote fairness and efficiency in the tax system. The following key underlying objectives for film tax incentives flow from the core aim:

- Encouraging the production of films that might not otherwise be made;
- Promoting sustainability in British film production; and
- Maintaining a critical mass of UK infrastructure, creative and technical expertise, to facilitate the production of culturally British films.

Encouraging the production of films that might not otherwise be made

2.18 The high-risk and global nature of the film industry means that investment decisions tend to disadvantage films that have difficulty demonstrating clear commercial potential in advance. Tax incentives can help to tip the balance towards ensuring that such films actually get made.

2.19 In some cases, even where films are ultimately commercially unsuccessful they may have cultural significance. In other cases, once they are made, marginal projects can sometimes realise a commercial return that had not been originally envisaged.

² Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions on certain legal aspects relating to cinematographic and other audiovisual works (2002/C 43/04) (Cinema Communication) and Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions on the follow-up to the Cinema Communication (COM (2004) 171) <http://www.dti.gov.uk/ccp/stateaid/pdfs/cineavlegal2002.pdf>

³ See web address http://www.culture.gov.uk/global/consultations/2005+current+consultations/culturaltest_britishfilm.htm

Promoting sustainability in British film production

2.20 The continuing success of the UK film industry will depend on its ability to attract stable and sustainable levels of investment. This will help ensure a long-term flow of cultural benefits to audiences across the UK, in all their diversity.

2.21 Tax incentives can promote behaviour that contributes to a more sustainable and stable investment climate for film production by encouraging, wherever possible, film-makers to adopt a 'slate' approach towards the production of British films, instead of simply encouraging film production on a film-by-film basis.

2.22 The level and design of tax incentives must also reflect the aim of promoting competitiveness and sustainability rather than dependence. The decision on whether to base a film within the UK will not be wholly reliant on costs. The nature of the story told in the film, the suitability of local skills and infrastructure and the preferences of key stakeholders involved in the film will also play a part. The UK film industry enjoys international renown for the high quality of its production facilities, its creativity, its technological expertise, its capacity to innovate and the quality of its skills base. These qualities of the UK film industry represent attractions that may not be fully reflected in pure cost comparisons.

2.23 While the increasingly global nature of film production can lead to a downward pressure on costs, it also suggests that the competitiveness of the UK film industry will need to be secured increasingly on those qualities that have been instrumental in making it a centre of film-making excellence to date.

Maintaining a critical mass of UK infrastructure, creative and technical expertise, to facilitate the production of culturally British films

2.24 The supporting objective of maintaining a critical mass of production capacity within the UK is also necessary if culturally British films are to be produced on a regular and sustainable basis. This underpins the primary objective of ensuring the flow of cultural benefits from film production. Tax incentives must therefore balance the need to avoid unnecessary distortions to decisions about where film production is based, against the need to ensure a viable capacity across all the relevant sub-sectors involved at all stages of the production of a film, from development through to post-production and from creative capacity through to technical expertise.

CONCLUSION

2.25 The Government recognises the cultural and economic benefits arising from British films as part of its overall policy on culture and the creative industries. It provides support for films in a number of ways for diverse objectives. Film tax incentives occupy a specific role within the Government's framework for film policy. They complement the role of direct grants for film production in increasing the number of culturally British films that are produced. In doing so, their objective can be described as promoting the sustainable production of culturally British films.

2.26 The next Chapter evaluates the impact of the existing film tax reliefs in practice against wider government objectives as well as the objectives set out above.

3

REVIEW OF THE CURRENT FILM TAX RELIEFS

This Chapter examines the impact of the existing tax reliefs.

A description of the current reliefs and the way that their use has evolved is set out, followed by an analysis of the key weaknesses of the current reliefs in practice.

The main findings of the analysis, supplemented by a series of discussions with the film industry over the last year⁴, are that while the current reliefs have led to increased investment in UK film production, they have also not been as effective as they could be in meeting a number of Government objectives, including the specific objectives for tax incentives as set out in Chapter Two. In particular, continued avoidance activity has had adverse impacts on both the Exchequer and the industry. The findings suggest that the current reliefs could provide better value for money and that they could be reformed to more effectively incentivise investment in the UK film production industry and contribute to its competitiveness and sustainability.

CURRENT FILM TAX INCENTIVES AND THEIR USE

The Current Reliefs

3.1 Current UK law provides two special tax reliefs designed to incentivise film production; Section 42 Finance (No 2) Act 1992 (“S42”) and Section 48 Finance (No 2) Act 1997 (“S48”). S42 can be claimed for eligible production or acquisition expenditure on qualifying films of any size. S48 can be claimed for eligible production or acquisition expenditure on qualifying films that cost £15 million or less to make.

3.2 Both of these tax reliefs provide an accelerated deduction, for tax purposes, of eligible production or acquisition expenditure as follows:

- S42 allows eligible expenditure to be deducted over a minimum of three years; and
- S48 allows eligible expenditure to be deducted immediately upon completion or acquisition of the film.

3.3 Where Sections 42 and 48 do not apply, tax law enables deductions for film production expenditure to be spread over the income generating life of the film. Sections 42 and 48 are therefore designed to offer a cash flow incentive to film-makers by providing for an earlier set off of relevant costs associated with the production or acquisition of a film against taxable income than would otherwise be available.

3.4 In order to qualify for either of these reliefs, a film needs to be certified as a British film under Schedule 1 to the Films Act 1985, which includes access to certification via relevant bi-lateral and multi-lateral co-production treaties.

3.5 Once the qualifying criteria have been met and the film is certified, the expenditure is allowable regardless of which country it was incurred in.

⁴ See Annex A.

How the Reliefs are Currently Accessed

3.6 Superficially, S42 and S48 are relatively straightforward tax reliefs designed after a model that applies elsewhere in the tax system to address market failures by incentivising specific behaviours.⁵ However, in practice, the structures that are currently used by the industry to access the two film tax reliefs are far from straightforward.

3.7 In order to access the full cash flow advantage of an accelerated tax deduction, film-makers need to have sufficient taxable income (“taxable capacity”) to make use of the accelerated tax deductions.

3.8 Film-making is a high risk venture with little-to-no advance guarantee of any individual film’s success. Consequently, most producers are not able to anticipate income streams from their films that would be both timely and sufficient to ensure the taxable capacity necessary to benefit from the accelerated tax deductions. In many cases, film-makers would not therefore be able to anticipate with certainty any advantage from claiming Sections 42 or 48 and so would not be able to take account of the tax incentive benefit in decisions relating to the budget and location for the film.

3.9 The structures that have been developed over time to make use of the film tax reliefs reflect the problem with anticipating taxable capacity. Film-makers have sought to anticipate some level of tax assistance when preparing the budget for the film. For this reason, the use of sale and leaseback structures by film-makers to access the film tax reliefs has become widespread.

The Sale and Leaseback Model

3.10 Film sale and leaseback financing structures were developed to enable film-makers to utilise the tax relief immediately after the completion of a film by accessing the taxable capacity of third parties. A standard, or ‘plain vanilla’ sale and leaseback structure operates as follows:

Sale and Leaseback Model

- A production company sells a film as soon as it is completed to a third party, the purchase being funded partly by equity investment and partly by a bank loan. The third party then enters into a finance lease, usually for a period of 15 years, leasing back the rights to the original producer. The bulk of the sale proceeds that the film production company receives is put on deposit and is used, with the interest it generates, to cover the future lease payments whilst the remainder is set against the costs of producing the film.
- The sale and leaseback structure enables the third party - typically a partnership of high net worth individuals or a large corporate - to claim the benefit of the film tax reliefs against their own taxable income from other sources. Meanwhile, film-makers exchange the cash flow benefit offered by the film tax reliefs for an upfront payment which can be put towards the cost of making the film, the level of the payment being determined by the terms of the sale and leaseback agreement. In effect, the benefits provided by the film tax relief are shared between the film-makers and the third parties.

⁵ For example, accelerated capital allowances are provided as a cash flow benefit to encourage business investment in energy efficient assets and first year allowances are available to small and medium sized enterprises to encourage investment in capital assets.

3.11 These structures have been almost universally adopted by film-makers in the UK. Whilst the two film tax reliefs were not designed specifically to be used through sale and leaseback structures, it has proved difficult for film-makers to access the incentive effect of the current reliefs without them. It is in this context that the use of 'plain vanilla' structures within the industry has become common.

3.12 Through its role in facilitating industry access to the incentives offered by the film tax reliefs, sale and leaseback financing has assisted in the production of British films that would not otherwise have been made. However, the impact of sale and leaseback financing on the UK film industry and the tax reliefs themselves has been more wide-ranging. The most notable side effect of the industry adoption of sale and leaseback structures has been its link with increased levels of tax avoidance activity. The Government has been forced repeatedly to take action to protect the Exchequer from aggressive avoidance schemes over the life of the current film tax reliefs.

Tax Avoidance Activity **3.13** With any tax relief there will be those who seek to use it in a way that was not intended. However, the film tax reliefs have proved to be particularly attractive to those designing tax avoidance schemes over the years and there have been numerous occasions when Government has had to legislative action in order to protect the Exchequer against abuse of the film tax incentives.

Recent anti-avoidance legislation enacted in relation to film tax reliefs

FA 2000. Action to prevent multiple dipping of film reliefs by sale and leaseback of subsidiary rights in a film (s113 FA2000).

FA 2002. Restricted relief to Cinema films to prevent TV programmes claiming relief; (s99 FA 2002).

FA 2002. Restricted relief under Section 48 to actual payments made during film production; (s100 FA 2002).

FA 2002. Restricted Section 48 relief to the first acquisition from the producer to prevent sale and leaseback schemes claiming the relief more than once (s101 FA2002).

FA 2004. Action to prevent individuals who had used the film relief to defer their tax, from turning the deferral into an outright tax gain (s119 to 123 FA2004).

FA 2004. Action to prevent individuals acting in partnership avoiding tax by claiming losses greater than their contribution to the trade (s124 FA2004).

FA 2004. Action to prevent individuals deferring and avoiding tax by investing in film partnerships which did not use the tax relief for British films (s125 FA 2004).

FA 2004. Action to prevent individuals avoiding tax by using licence related losses followed by an exit (s126 to 130 FA 2004).

FA 2005. Action to prevent Section 42 and Section 48 tax relief being claimed more than once on the same film (Schedule 3 FA 2005).

FA 2005. Action to restrict relief under Section 42 to the actual production cost of the film (Sch. 3 FA2005).

FA 2005. Action to prevent companies and partnerships from using Sections 42 and 48 to defer tax for more than 15 years (ss60 - 65 FA2005).

FA 2005. Action to prevent groups of companies that had used Sections 42 or 48 from turning a tax deferral into an outright tax gain (ss 66 to 71 FA2005).

FA 2005. Action to prevent individuals acting in partnership from avoiding tax by claiming loss relief for amounts they have no real risk of losing (ss 73 to 79 FA2005).

3.14 The ability to transfer the benefit of film tax reliefs, through the sale and leaseback structure, has been the source of a major part of this avoidance activity since the attraction of sheltering other forms of economic activity increases the incentive for avoidance. Where a relief can be accessed to shelter higher marginal rates of tax, such as under the film tax partnerships that have used sale and leaseback structures, the incentive for the avoidance industry is even higher.

3.15 Recent evidence indicates that, whereas tax avoidance activity had previously been directed at S48 for the most part because of its more generous rate of accelerated tax deduction, over the last two years S42 has also been the target for increasing tax avoidance of the sort that it has proved necessary to combat in the past, primarily in relation to S48.

KEY WEAKNESSES OF THE CURRENT RELIEFS

Fairness and value for money

3.16 Whilst the current film tax reliefs have ensured the production of many valuable British films, the financing structures used to access them and the high levels of avoidance activity have affected their value for money for the taxpaying public, calling into question their fairness and effectiveness. The repeated use of tax avoidance schemes around the current film tax reliefs has also involved significant Exchequer costs and remains a clear Exchequer risk under the current reliefs. This has resulted in fluctuating and, at times, untenable levels of Exchequer cost over the years the reliefs have been in operation.

3.17 Part of the avoidance problem has been the opaque nature of sale and leaseback financing structures. Under sale and leaseback structures claims for film tax relief have been spread over the tax returns of numerous individual and corporate taxpayers rather than being made by the film-makers themselves. This makes monitoring of costs and take-up of the relief extremely difficult and slows down the process of identifying tax avoidance activity.

Leakage of value

3.18 However, the current reliefs are also less effective than they could be in achieving the goal of ensuring the production of culturally British films. As indicated in paragraph 3.10, under the sale and leaseback structures the cash flow benefit that film-makers were intended to receive is diluted. The share of Government support that is received by the industry is determined by market forces, such as the number of investors willing to enter into sale and leaseback transactions and assumptions about future levels of interest rates over a period of up to 15 years. The ability to transfer the benefit of film tax reliefs to high net worth individuals also distorts the film production cycle in the UK, as the market for sale and leaseback financing peaks towards the end of the tax year, with film projects forced to be designed around that deadline.

3.19 A strong message from indigenous producers in the discussions on S42 earlier this year was that sale and leaseback financing is highly complex, involving significant arrangement fees which serve to further reduce the level of incentive that is delivered to the policy target. The complexity of even the most basic sale and leaseback structures will have an impact on smaller, independent film-makers' ability to negotiate their share of the overall tax benefit with the sale and leaseback providers.

Incentives for investment in underlying infrastructure

3.20 As noted earlier, the two current film tax reliefs apply to all eligible expenditure, irrespective of the country in which the cost was incurred, provided the certification criteria have been met. Under co-production treaties, the level of minimum UK spend has at times been very low. The recent review of bi-lateral co-production treaties by the Department for Culture, Media and Sport also considered this issue.

3.21 Provided it is consistent with the Government's aim of encouraging the sustainable production of culturally British films, tax incentives should allow the market to determine which films are made and how they are made. This fits with the current ability to claim film tax incentives under the industry practice of making co-productions, where the artistic needs of specific films can sometimes be best addressed by locating production in more than one territory. However, the application of the current film tax reliefs to worldwide expenditure can act as a disincentive to spend money in the UK, particularly where incentives from other jurisdictions are available, since producers get no additional marginal relief from spending beyond a minimum threshold in the UK. This has the effect of weakening the link between supporting cultural products and maintaining the industry's infrastructure.

3.22 The fact that the current reliefs apply to worldwide expenditure can also have an undesirable distortive effect on decisions about where to base a film. In some cases it can encourage 'relief tourism' where film-makers seek to meet only the bare requirements of certification, thereby obtaining the maximum level of tax relief in the UK and then situating the remainder of the production work overseas to access film incentives in other jurisdictions.

3.23 At best this means one of the key supporting objective of film tax reliefs, that of maintaining a critical mass of infrastructure, is not sufficiently targeted by the current tax reliefs because Government support is spread across film production in the UK and overseas. At worst, where 'relief tourism' is the motivating factor rather than any artistic requirements, relief for worldwide expenditure provides an incentive to restrict the level of production work carried out in the UK to the minimum that is required to qualify for UK tax reliefs.

Market distortions

3.24 Tax avoidance activity has also created a certain amount of unwelcome market distortion. Whilst a key objective of tax reliefs is to facilitate the operation of the market in as non-distortionary a manner as possible, the potential for avoidance has led to the production of poor quality products made solely for the purpose of claiming accelerated tax relief to shelter other economic activities from tax.

Uncertainty and instability

3.25 The high level of avoidance activity over the years has had a negative impact on the benefits provided by the film tax reliefs, because it has resulted in higher levels of support than is intended, and because it has generated uncertainty about Government commitment to providing continuing support.

3.26 Industry contributions to the review of S42 earlier this year suggested that:

- The industry had become reliant on, or at least expected, a level of support inflated by the tax avoidance schemes which were closed down by action taken by the Government in the 2004 Pre-Budget Report;
- The complexity of financing structures made the objectives of the film tax reliefs unclear and blurred the line between normal financing and tax avoidance schemes; and
- The constant modification of legislation, to close new tax avoidance schemes, created uncertainty as to Government intentions and the level of its commitment to supporting the industry.

3.27 At best, this may have generated further confusion about what is and is not an acceptable sale and leaseback financing structure and at worst this may have led to a perception that the UK is “closed for business” as a location for film production activity.

Sustainability 3.28 The sale and leaseback financing structures that have been developed to access the film tax reliefs mean that the reliefs deviate in practice from the normal principle that relief should be given in relation to production activity. Film financiers use the relief to shelter their other economic activity from tax and the structures that are used generally ensure that film-makers can benefit from the maximum level of relief even where none of the future income earned from exploiting their films arises in the UK. This means that profits from successful British films are rarely retained in the UK for investment in future production.

3.29 Whilst it is not an objective of Government to require film-makers to exploit their films in the UK, the film tax reliefs should promote sustainable production of culturally British films by encouraging, wherever possible, film-makers to adopt a slate approach to film production in the UK. The structure of the current film tax reliefs does not encourage film-makers to take decisions about where to base their films across a slate of films, since it allows the maximum level of tax benefit to be accessed on a film, without any need to set off deductions against future film-related taxable income. Under the sale and leaseback structures, there is nothing to discourage indigenous film-makers or inward investors from accessing tax reliefs purely on an individual project basis. As such, whilst the current reliefs incentivise the production of individual films, they do not encourage sustainable, ongoing production of culturally British films.

SUMMARY

3.30 In summary, the review of the existing tax reliefs, based on discussions with the industry, has provided evidence of the weaknesses of the reliefs on several fronts with adverse impacts on both the Exchequer and the industry. The analysis in this chapter provides the basis for the objectives for reform set out in the next chapter, and explains the design of the proposed relief set out in Chapter 5.

4

OBJECTIVES FOR THE REFORM OF THE FILM TAX RELIEFS

As Chapter Three has set out, the current film tax reliefs are subject to a number of weaknesses both operationally and in terms of their fit with Government objectives for film tax incentives as set out in Chapter Two.

Building on the analysis in Chapter Three, this Chapter provides a brief summary of the reform objectives and thinking behind the proposed new relief.

4.1 In reviewing both film tax reliefs and in discussions with the industry, we have taken the opportunity to set out the core aim of film tax incentives and the objectives that they support. The core aim of film tax reliefs is to **promote the sustainable production of culturally British films**.

4.2 The proposals on which the Government is inviting comments are designed to address the problems and weaknesses identified in Chapter 3 in relation to the existing film tax reliefs.

4.3 The following objectives for reform inform the design features of the new proposals.

- Promoting the production of films that might not otherwise be made; in particular ensuring higher levels of support for small budget films.
- Ensuring better value for money for taxpayers and for film producers through direct provision of benefit, without leakage of support, to film-makers themselves.
- Removing the need to access the relief through intermediaries to ensure easier, direct access to the reliefs.
- Removing distortions caused by the current reliefs by reducing avoidance risk and stabilising investment levels.
- Ensuring, where consistent with other objectives, greater flexibility for film-makers in an increasingly global industry.
- Ensuring sustainable production by creating closer links between Exchequer support for cultural production and maintaining a critical mass of infrastructure, creative and technical expertise.
- Promoting stable, sustained investment by encouraging film-makers to retain and reinvest profits in UK film production, on a slate basis, and therefore contributing to a more self-financing, and more sustainable, level of tax relief.
- Ensuring better coherence by providing that the tax relief is targeted on its intended objective and directly influences decisions about the costs and income of the film industry.

5

THE PROPOSED NEW RELIEF

This chapter sets out proposals for replacing the current reliefs with a new film tax relief designed in accordance with the objectives for reform set out in Chapter 4.

The proposed new relief is based on the tax credit model that was launched in September 2004 as a proposal for a new small budget film tax credit. This new relief reflects the desire for a single coherent regime applicable to all films following industry comments last year on the tax credit model and earlier this year on S42. Different levels of payable credits and enhancements are envisaged for different films.

In summary, the proposed new relief would:

- be provided directly to film-makers themselves;
- apply to films that are certified as culturally British films, under a new test that the Department for Culture, Media and Sport is consulting on from 29th July 2005;
- be provided on qualifying UK production expenditure where a minimum UK spend threshold of up to 40% has been met, and subject to a maximum of 80% of the total qualifying production expenditure in order to comply with EU State aid rules;
- allow a payable tax credit at a level of 30% for films that cost up to £20 million;
- allow a payable credit at a level of 25% for other qualifying films;
- provide an enhanced deduction of 50% for films that cost up to £20 million; and
- provide an enhanced deduction of 25% for other qualifying films.

This chapter sets out the detail of the proposals and areas of design where comments and views from stakeholders are invited. The relevant sections of this chapter can be cross-referenced with the illustrative draft legislation published today.

The illustrative draft legislation is intended to demonstrate the basis of the legislation that would be required to introduce the proposed new relief. This chapter also sets out for consultation with stakeholders some issues that are not addressed in the illustrative draft legislation, but would ultimately need to be included at a later stage.

THE PROPOSED NEW RELIEF

5.1 The new film tax relief would be aimed directly at companies making films in the UK. It is intended to enable producers to make immediate use of tax relief as their films begin to be capable of generating taxable income. In accordance with the objectives for film tax incentives, the relief is also intended to encourage producers to use UK facilities and support the UK film infrastructure. While the new relief would build on the same foundations as the current reliefs (see the explanation of the current tax position in Chapter 3 and 5.2 below), it would represent a State aid (see paragraph 2.14) and the design takes account of this. The new relief would enable producers to:

- Write off expenditure for tax purposes more quickly than they could otherwise;

- Access additional relief, as an enhancement, based on their qualifying UK expenditure; and
- Surrender losses arising from qualifying UK expenditure, but not the enhancement, in return for a payable tax credit.

5.2 Where this treatment does not apply, capital expenditure on the production of a film would still be treated under current legislation (Sections 40A and 40B Finance (No 2) Act 1992) as revenue expenditure to be spread over the life of the film, with the proceeds of sale or exploitation treated as revenue receipts as they are due.

5.3 The rest of this chapter explains how the proposed relief would work. The following issues are addressed in the illustrative draft legislation and the associated draft Explanatory Notes and are covered in the rest of this chapter:

- The persons who would be eligible for the relief
- The films that would qualify
- Minimum UK spend test
- Accelerated relief for qualifying UK production expenditure
- Defining qualifying UK production expenditure
- Calculating and utilising the enhanced deduction
- Surrendering losses for the payable tax credit.

Other issues not included in the skeleton draft legislation but which would need to be considered before the design of the scheme is finalised, are then set out.

The persons who would be eligible for the relief

5.4 The proposed new relief would be available to film production companies within the charge to Corporation Tax. It would apply to producers of eligible films that are genuinely intended for theatrical release. Unlike the current reliefs, the new relief would not be available to subsequent acquirers. These conditions are set out at paragraph 1 of the Schedule in the draft legislation.

5.5 The proposed definition of the producer of a film (at paragraph 3 of the Schedule to the draft legislation) is the company that incurs all of the production expenditure on the film and owns the original master version, including all rights in it, at the time the film is completed. This is intended to ensure that the relief would be available only to the company that actually makes, and has the rights to exploit, the film. **Comments are requested on whether the definition of a producer will achieve the aim of only making the relief available to the appropriate person.**

The films that would qualify

5.6 Only films that fulfil the conditions of a new test to determine eligibility, would qualify for the new relief. The proposed new test is intended to better identify films as culturally British products in line with the EU Commission's guidance on State aid. The Department for Culture, Media and Sport is publishing on the 29th of July details of the proposed new test on their website⁶ and asking for comments as part of this consultation on the proposals for a new relief. The draft legislation (paragraph 4 of the draft Schedule) contains a power to define an eligible film in regulations.

⁶ http://www.culture.gov.uk/global/consultations/2005+current+consultations/culturaltest_britishfilm.htm

Minimum UK spend 5.7 As set out in Chapter 2, a supporting objective of film tax incentives is to help maintain a critical mass of infrastructure, facilities and talent within the UK in a manner that supports the sustainable production of culturally British films. This means encouraging viable capacity across all the relevant sub-sectors involved at all stages of the production of a film. The new relief would therefore ensure that films that pass the new cultural test would only qualify for the new relief if a minimum proportion of the production expenditure were spent on UK goods and services. It is envisaged that the minimum proportion of production expenditure in the UK will be set at a suitable level but no higher than 40%. As with the new cultural test, it is envisaged that the test of minimum UK expenditure would be set out in regulations using a power of the sort illustrated by paragraph 4 of the draft Schedule. **Views are sought on an appropriate level of minimum UK expenditure that would ensure the new reliefs address the objective of maintaining a critical mass of infrastructure in the UK.**

Maximum threshold 5.8 The proposals for the new relief would allow qualifying UK production expenditure to be deducted when a company completes a film and is able to exploit it. The draft legislation (in particular paragraphs 13 and 14 of the draft Schedule) illustrate how this might be achieved. However, film-making often cannot be constrained by national boundaries, and the reduction of the current minimum spending threshold of 70% to a lower level as proposed above reflects the need for flexibility in this regard. It is not intended that the new relief should unnecessarily disadvantage those producers who need to incur some of their expenditure outside the UK in order to meet the requirements of the film. In line with the EU Commission's recommendations⁷, the maximum level of relief would therefore be available even where up to 20% of the relevant production expenditure was incurred outside the UK. The illustrative draft legislation achieves this by defining "qualifying UK production expenditure" (paragraph 7 of the draft Schedule) as the amount of UK production expenditure, subject to a maximum of 80% of the total relevant production expenditure on the film.

Acceleration deduction for qualifying production expenditure 5.9 The degree to which tax relief for film production expenditure can currently be accelerated depends on whether relief is available under S42 or S48 (see paragraph 3.2). The new relief would enable qualifying UK production expenditure to be deducted when the company completes the film and begins to trade (see paragraph 8 of the draft Schedule) irrespective of whether the film qualifies as a small budget or other qualifying film. This is in contrast to the current rules for those films eligible for relief under S42 which are required to write off their expenditure over three years. Qualifying UK production expenditure would be available to be set against film income (see paragraph 11 of the draft Schedule), or to be surrendered immediately for a payable tax credit (as described at paragraph 5.14 below). Other production expenditure would still be deductible under the normal rules for film expenditure (see paragraph 5.2 above).

Defining qualifying UK production expenditure 5.10 Qualifying UK production expenditure relates both to the minimum UK spend test and to the calculation of UK production expenditure eligible for the new relief. Under the current regime, Sections 42 and 48 do not apply to all expenditure incurred by a production company. In response to comments made on the proposals for a new relief for small budget British films (see Annex A), it is envisaged that there would be a statutory definition of eligible production expenditure, to ensure that the current treatment is translated into the new relief rules in a way that provides greater clarity for film-makers.

⁷ Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions on Certain Legal Aspects Relating to the Cinematographic and other Audiovisual Works (2001)

5.11 Clause 1 of the draft legislation illustrates how this might begin to be done. It defines production expenditure in accordance with generally accepted accounting practice and provides for certain types of expenditure to be added and excluded to arrive at qualifying expenditure. The statutory exclusions would put beyond doubt that, in calculating production expenditure for the purposes of the relief, only genuine costs actually paid for goods or services qualify. Items that have commonly been included in expenditure as part of tax avoidance schemes, such as interest and financing costs, deferrals, participations and reinvestments, are excluded from the new tax relief and would instead receive normal tax treatment. These issues are addressed in the draft legislation at draft Clause 4, and Part 3 of the draft Schedule. **Views are sought on expenditure to be included and excluded in a definition of production expenditure for tax relief purposes.**

5.12 The type of expenditure that represents spending in the UK is important both for the minimum spend test (see 5.11 above) and also for the purposes of calculating the relief available. A statutory definition would provide certainty and make it easier for film production companies to claim the tax relief. A statutory definition would identify the use of UK:

- Infrastructure,
- Services, and
- Talent.

5.13 Tests would be needed to identify such expenditure. Paragraph 7(2) of the Schedule sets out proposals for the start of such a test. **Comments are requested on this point.**

Calculating and utilising the enhanced deduction

5.14 Under the new relief, in addition to the ability to deduct qualifying UK production expenditure, the production company would be eligible for an enhanced deduction. This deduction would only be available to set against film income. In other words, it would not be capable of being surrendered for a payable tax credit. Although it is not reflected in the draft legislation, it is envisaged that the value of the enhancement would be 50% of the qualifying UK production expenditure for films with a production cost of £20m or less, and 25% for other films. The enhanced deduction would effectively enable the film production company to make profits tax free and therefore would encourage companies to make profitable films that contribute to the wider sustainability of film production in the UK. Paragraphs 5.22-5.25 below look at how loss relief might be used in other ways to encourage the sustainable production of UK films.

Surrendering losses for the payable tax credit.

5.15 In cases where the deductions for qualifying UK production expenditure create or augment a loss, the producer would be able to surrender all, or part, of the loss for a payable tax credit as an alternative to setting the loss against film income. Where the expenditure is incurred in an accounting period prior to the commencement of trading, the film production company would be able to elect for a treatment that would still allow a tax credit to be claimed. A mechanism along these lines is illustrated at paragraph 13 of the draft Schedule.

5.16 As with the levels of enhancement for qualifying expenditure (paragraph 5.14 above), it is envisaged that different levels of payable tax credit would apply depending on whether or not the film has a total production expenditure of less, or more, than £20m. For small budget qualifying films with total production expenditure of £20m or less, the tax credit payable rate would be 30% of the surrendered loss and for other qualifying films the proposed level would be 25% of the surrendered loss.

5.17 The loss that would be available for surrender would be the lesser of the loss computed for tax purposes, and the qualifying production expenditure deducted in the period. This would limit the payable tax credit to the portion of loss relating to the actual qualifying UK production expenditure. The payable tax credit would not, therefore, apply to the enhancement. The production company would have the flexibility to be able to choose how much of this loss is surrendered and the remainder would still be available for set off against film income and for utilisation as described in paragraphs 5.22-5.25 below.

Other Issues 5.18 As noted at the start of this chapter, the draft legislation is indicative and not intended to be comprehensive. In particular it does not deal with:

- all the anti-avoidance measures that would be necessary to ensure the efficient delivery of relief to the intended recipients only;
- how losses could be best utilised to encourage the development of the UK film industry;
- arrangements for managing the transition from the current position to the new relief; and
- other changes needed to simplify and clarify the remaining film tax legislation.

ANTI-AVOIDANCE RULES

5.19 As indicated in Chapter 4, a primary aim of reforming the film tax reliefs is to prevent further avoidance activity, as this affects their value for money to taxpayers and has an adverse effect on sustainable investment in the UK film industry. The draft legislation does not contain all the safeguards likely to be needed to ensure that the relief delivers support to the appropriate film production companies and not to those seeking to use film making as a way to shelter other economic activity from tax. While Clause 1 and paragraph 21 of the draft schedule contain broad anti-avoidance rules it is quite likely that these would not appear as drafted in the final draft legislation. It is likely that the design of the proposed relief will be further modified in light of consultation and that, in addition to rules of the sort proposed, other specific anti-avoidance rules would also need to be introduced. The paragraph provides a clear indication of the Government's intention to include firm and wide-ranging anti-avoidance provisions to prevent the new relief from being abused.

5.20 On the basis of the previous exploitation of the current film reliefs, the areas where anti avoidance rules are likely to be most appropriate are to:

- ensure the relief can only be accessed by genuine film producers, and not third party intermediaries and financiers, by carefully defining what is meant by a “producer” for the purposes of the tax relief (see paragraph 5.4 – 5.5);
- prevent the inflation of production costs, for example through the inclusion of reinvestments and similar deductions (see paragraph 5.11);
- prevent avoidance of tax through sales of films, or of any rights in films, for less than their full market value; and
- ensure that companies cannot avoid tax by turning the accelerated relief and the payable tax credit into an outright tax advantage.

5.21 However, this list may not be comprehensive and any further areas of avoidance would need to be addressed as appropriate.

FLEXIBLE LOSSES TO ENCOURAGE SUSTAINABLE FILM PRODUCTION

Availability against income from film

5.22 As indicated in Chapter 2, the aim of the film tax incentives is to encourage the sustainable production of culturally British films. It is therefore not intended that the new relief would be diluted by allowing access through economic activity not related to film production. However, it is possible that the proposals set out in the September 2004 Technical Note are more restrictive than necessary in this regard. The September 2004 proposals envisaged that film losses would only be available against income from the same film. This would reduce the impact of the tax relief in encouraging film-makers to adopt a slate approach to film production in the UK. Consequently it is now envisaged that film losses arising from the new relief would be available against income from film exploitation generally. **Comments are requested on this proposal.**

Maximising tax claims

5.23 Under the new relief, where companies surrender losses to claim a payable tax credit, they not would be prevented from revisiting this decision. It is possible that, subsequent to making a claim for a payable tax credit, a company might decide that it would be better served by using the amount claimed as losses against film profits. It is envisaged that the normal taxation machinery will provide suitable flexibility to enable them to do this.

5.24 The new film relief would be claimed by companies submitting their Corporation Tax returns. A company would have 12 months to do this from the end of the accounting period in which it completes the film, and a further 12 months after that in which it can amend its return. After surrendering losses or claiming relief a company may, therefore, within the normal period for amending its return, choose to amend its return if it feels that this is more advantageous. In relation to the proposed new relief, losses surrendered for a payable tax credit would be capable of reinstatement, and the tax position unwound, by amendment of the claim and repayment of any credit that the company no longer wished to claim. **Comments are requested on whether this process would, in practice, enable film production companies to revisit decisions in the appropriate circumstances.**

Availability within a wider film group **5.25** The proposals would enable film production companies to surrender losses for a payable tax credit, removing the need to enter into arrangements with financiers to enable them to utilise the losses in return for lower financing costs or to utilise losses against film income. However, film production is inherently risky and profits and losses from films could be pooled in order to reduce volatility and to encourage film-makers to adopt a slate-of-films approach to film production in the UK. Whilst losses arising from the film reliefs would not be fully available to be surrendered using the normal Group and Consortium relief mechanisms, it is envisaged that they would be capable of being surrendered to other companies to the extent that they can be set against profits from exploiting films. Allowing them to be offset against film-related economic activity would be in keeping with the objective of encouraging more sustainable investment. **Comments are requested on this proposal.**

COMMENCEMENT AND TRANSITION

5.26 The draft legislation does not deal with the way in which the new relief would be brought into effect. The date upon which the new scheme could start will depend on the EU Commission's approval (see paragraph 2.14). FA 2005 has already provided that S48 F(No 2)A 1997 and the equivalent provisions in ITTOIA 2005, s139 and s 140, will not apply to any film with a first date of principal photography on or after 1 April 2006. Films started before that date will be able to receive relief under S48 provided they are completed before 1 January 2007 and, in the case of relief for acquisition expenditure, provided the film is acquired before 1 October 2007. A seamless transition between the current reliefs and the new relief is envisaged with no gap in relief.

5.27 In addition to introducing the new relief, the draft legislation sets out a number of provisions that would apply to the film reliefs in general. It is envisaged that these provisions should apply from 1 April 2006. However, the commencement for the statutory definition of "production expenditure" in clause 1 would be more detailed. It is inevitable that some films will have production straddling the envisaged 1 April 2006 commencement date. In order to avoid producers of such films from having to work with two, possibly different, definitions of "production expenditure", it is therefore envisaged that in such circumstances the new statutory definition would only apply to such films that are completed on or after 1st January 2007. The new definition would not therefore apply to production expenditure on films that commence principal photography before 1st April 2006 and which are completed before 1st January 2007. **Views on whether these proposals for commencement are practicable and on how any new definition of production expenditure should be introduced, are requested.**

PROPOSAL TO RATIONALISE THE LEGISLATIVE FRAMEWORK

5.28 The following Sections are rarely used in practice:

- Sections 40D F(No 2)A 1992 and 143 ITTOIA 2005 (which allow companies, partnerships and sole traders to elect that film expenditure be treated under the capital allowances rules); and
- Sections 41 F(No. 2)A 1992 and 137 ITTOIA 2005 (which provide relief for preliminary expenditure).

5.29 It may therefore be appropriate to repeal these Sections as part of the proposed reform of film tax reliefs. **Comments are requested on this proposal.**

6

QUESTIONS FOR CONSULTATION

6.1 The Government would welcome the views of all stakeholders both on the questions raised in this consultation document and on the draft legislation provided today.

6.2 A number of specific questions are asked in Chapter 5 of this consultation document which describes the main features of the proposed new tax relief. A full list of these questions is reproduced in full below.

- Does the proposed definition of a producer provide an effective means of ensuring that the tax relief is available to the appropriate person? (paragraph 5.5)
- What would be an appropriate level of minimum UK expenditure to achieve the objective of maintaining a critical mass of infrastructure and viable capacity across relevant sub-sectors involved at all stages of the production of a film within the UK? (paragraph 5.7)
- What items should be excluded or included in defining production expenditure for the purposes of the tax relief? (paragraph 5.11)
- Is the proposed test for determining what constitutes spending in the UK an effective one? (paragraph 5.13)
- How should film losses be made available only against income from film exploitation? (paragraph 5.22)
- Would the proposal for reinstating losses previously surrendered for a payable credit enable film production companies to revisit their decisions in practice? (paragraph 5.24)
- How should losses arising from the film reliefs be set against the profits from exploiting other films? (paragraph 5.25)
- Do you agree that films already in production when the new tax relief is introduced should not be subject to the proposed statutory definition of production expenditure? (paragraph 5.27)
- Do you agree that Sections 40D 41 of Finance (No. 2) Act 1992, together with their income tax equivalents in Sections 143 and 137 of ITTOIA 2005, should be repealed? (paragraph 5.29)

INDUSTRY COMMENTS AND GOVERNMENT RESPONSE ON CURRENT FILM TAX RELIEFS

SMALL BUDGET TAX RELIEF

The Government introduced a new tax relief for small budget British films in Section 48 of the Finance (No 2) Act 1997. The relief allows the total production costs of qualifying films with a total budget of £15 million or less to be written off immediately against taxable profits.

The relief was first introduced as a temporary measure which applied to production and acquisition expenditure incurred before 2 July 2000. It was subsequently extended twice, in 1999 and 2001, to apply to costs incurred before 2 July 2005.

In the 2004 Budget, the Chancellor of the Exchequer announced that the small budget film tax relief would be replaced on expiry with a new relief that would go directly to film makers. Details of how the relief would operate were announced by the Paymaster General on 21 September 2004.

Under the terms of the tax relief, film makers would be entitled to a deduction of 150% of total production expenditure to offset against income when computing business profits. They would be able to surrender any losses, up to a limit of 100% of total production expenditure, to HM Revenue and Customs for a cash payment equal to 20% of the amount of the loss surrendered.

HM Revenue and Customs published a technical note on the same day and invited comments on the proposals from the film industry. A period of informal consultation took place in late 2004. The main points raised in these representations are summarised below.

- 1. The way in which the Government intends the relief to operate should be clarified to provide film makers sufficient certainty to allow effective planning for future productions.*

The Government recognised that the industry were unclear about how the new relief would operate in practice and decided that the introduction of the new small budget relief should be delayed until 2006. This decision was announced in the 2005 Budget and enacted in the subsequent Finance Act.

- 2. Film producers should be allowed to surrender losses at the rate of 30% for a payment equal to 20% of total production expenditure.*

The Government was not convinced of the need for a change in the design of the relief to enable producers to maximise its benefit. However, the proposed structure of the new relief has developed to take account of other factors, including factors related to obtaining State aid clearance.

- 3. The definition of production expenditure should be widened to include participations, deferrals, print and advertising, reinvestments, financing, business overheads and other costs.*

The Government does not accept there is any justification for widening the definition of production expenditure for the purposes of the tax relief from that set out in the September technical note. The relief is provided only on costs directly incurred on film

production, rather than on incidental or other indirect costs, in order to ensure it is effectively targeted at activities that relate to Government objectives for film.

3. *Film production companies should be able to enter into distribution agreements which spread the recognition of income for tax purposes over a period of 15 years.*

This would be contrary to the Government's aim of providing support directly to film producers. Tax deferral and other arrangements designed to share the relief with third parties would only give support indirectly, thereby diluting the benefit which producers receive.

4. *The relief should be made available to partnerships, providing them the opportunity to use the relief to offset tax liability on their other income.*

The Government remains committed to the principle that the tax relief should go directly to film producers. This reflects the current practice, whereby films are produced by companies specially set up for that purpose. Experience has demonstrated that allowing partnerships and other third parties to access the reliefs both reduces the benefit to the producer and introduces scope for abuse.

5. *Film producers should be able to claim tax relief without having to submit a tax return.*

The film tax relief needs to operate in a way that is consistent with the wider tax system. Therefore, relief can only be provided once HM Revenue and Customs are in a position to process a relevant tax return.

6. *A precise definition of what constitutes eligible production expenditure is needed to provide certainty for producers and ensure fairness of treatment.*

The Government proposes that there should be an explicit definition of eligible production expenditure within the legislation for the new tax relief.

7. *A producer should get the same level of benefit from the tax relief whether or not the film is retained and exploited from the UK.*

The Government considers that the decision whether or not to retain rights to a film in the UK should be an entirely commercial one. It also considers that where a producer has benefited from accelerated tax relief, an enhanced deduction or a payable credit, the company should not be able to avoid its future tax liability.

8. *The new relief should not affect the ability of individuals to make use of other tax incentives designed to encourage investment, such as the Enterprise Investment Scheme and Venture Capital Trusts.*

The Government recognises the need for genuine investment in film production as in any other type of business. The new film relief is therefore designed to work alongside other investment incentives and does not restrict investors' ability to access them.

LARGE BUDGET TAX RELIEF

The current tax relief for films was introduced in Section 42 of the Finance (No 2) Act 1992. It allows expenditure on the production or acquisition of qualifying films to be written off against taxable profits over a minimum of three years.

In the Pre-Budget Report of 2 December 2004, the Chancellor introduced a number of measures to end the abuse of the tax reliefs for films to ensure that they operated as intended. At the same time, he also announced that the Government would consult with the industry to review the large budget tax relief.

This review was taken forward on a short time scale to the end of January 2005. Its main conclusion was that Section 42 no longer provided an effective means of delivering the Government's objectives for supporting a sustainable film industry. In particular, the widespread use of sale and leaseback structures to access the relief had made it inefficient and open to abuse, whilst the cost of avoidance activity meant that providing support had become untenable and had helped to contribute to a sense of instability within the industry.

The main points raised by the industry, other than those made previously as part of the discussions on the proposals for a new small budget relief, are summarised below.

1. *Above all, the film industry needs certainty regarding the status of tax reliefs to allow them to plan for future film production.*

The Government fully recognises that the lead-in times for film production mean that producers need as much advance certainty as possible regarding tax reliefs. It was for this reason that the Government announced that it would continue to support British films through the tax system and that it would consult formally on the proposals for the new reliefs before an orderly transition to the new reliefs in 2006.

2. *It is imperative that any replacement tax relief is robust enough to ensure it is not subject to further abuse.*

It is a fundamental principle that the new relief should not be vulnerable to the types of abuse film reliefs have suffered in the past, and which have given rise to instability and uncertainty in the industry. The Government intends to include firm anti-avoidance provisions in the legislation to ensure there is no recurrence of such abuse.

3. *There should be a short-term enhancement to return the value of relief to the level achieved before Government action in the Pre Budget Report.*

The Government's action at the Pre Budget Report was an entirely appropriate response to counter abuses of film tax relief.

4. *Successive actions by the Government to close down avoidance schemes has created uncertainty and damaged the attractiveness of the UK as a location for film production.*

The Government has no option but to close down tax avoidance schemes as it becomes aware of them. Otherwise, the relief would not be affordable and the principle of fairness to other taxpayers would be undermined. The reform of the tax reliefs is aimed at removing the risk of avoidance activity, in order to ensure that tax incentives promote stable investment based on certainty of what is available for film-makers through the tax system.

5. *Film production companies need a tax relief that they can use to underwrite costs in the 'bottom line' of the production budget.*

Film tax reliefs, as with any other tax reliefs, provide deductions for expenditure that can be claimed in computing profits and losses for tax purposes. The Government recognises that future income from a film may be uncertain, and for this reason is proposing that producers should have the option to surrender losses for a cash credit if they wish.

6. *The design of large budget tax relief should take into account the value of incentives offered by other countries to ensure that the UK remains internationally competitive as a location for film production.*

The proposed tax relief compares favourably with those provided in other countries. In addition, the decision to make films in the UK rather than elsewhere is not determined solely by tax incentives. There are several other important factors that affect these decisions, such as the wide range of world-class film making facilities and skills available in the UK.

Contributors	
AFM Lighting	The Musicians Union
Archer Street Media	NBC/Universal
Artem	Olswang
Baker Tilly	PACT
BECTU	Panavision
The British Screen Advisory Council	Paramount Pictures
The British Society of Cinematographers	Pinewood/Shepperton
Cinesite	The Production Guild of Great Britain
Denton Wide Sapte	Richards Butler
Ealing Studios	The Royal Bank of Scotland
Ernst and Young	Scion Films
Film London	Signature Media
Fox Pictures	SJ Berwin
Framestore CFC	Sony Pictures
FTVR Equity	Tenon Media
HSBC	The UK Film Council
Ingenious Media	UK Post
Lee and Thompson	Viacom International
MGM	The Walt Disney Company
Miramax	Warner Bros
The Motion Picture Association of America	Wiggin and Company
	Working Title Films

B

PARTIAL REGULATORY IMPACT ASSESSMENT

OBJECTIVE

The aim of film tax relief is to provide the support necessary to ensure the sustainable production of culturally British films. It provides an incentive to film producers to support this aim by encouraging investment in the UK film infrastructure and the skills whose maintenance is essential for the sustainable production of culturally British films.

BACKGROUND

There are currently two special tax incentives available for the production of films in the UK. The first was introduced by Section 42 of the Finance (No 2) Act 1992 and the second, available for qualifying films with total expenditure of £15 million or less, by Section 48 of the Finance (No 2) Act 1997. Whilst Section 42 ('large budget tax relief') was not time limited, Section 48 ('small budget tax relief') was introduced as a temporary measure and was originally due to expire in 2000, but has since been extended on three occasions by Parliament.

In the 2004 Budget, the Chancellor announced that the small budget tax relief would be replaced when it expired in July 2005 with a new relief aimed at support for filmmakers. Further details were provided in an HMRC Technical Note on 21st September 2004.

At the Pre-Budget Report in December 2004, the Chancellor announced a review of large budget tax relief, and invited comments from relevant parties. This review was carried out in January 2005 the Chancellor announced in the 2005 Budget that the large budget relief would be replaced by a tax credit model. At the same time, the Government decided to extend the existing small budget relief until 31 March 2006

The intention is that the new relief be introduced with effect from 1 April 2006 following formal consultation on draft legislation. This timetable would be subject to obtaining clearance from the European Commission that the relief is consistent with the rules for providing State aid for the production of cultural products.

THE NEED FOR GOVERNMENT INTERVENTION

Cinematic film provides a universal and readily accessible medium for the expression and representation of British culture and national identity. Where cultural contribution goes beyond providing entertainment in this sense, the social benefits often fail to be captured in the transactions that people undertake in the market. In this regard culturally British films can be regarded as merit goods that the market often fails to provide at the optimum level.

The social benefits that attach to cultural production suggest that there is a public interest in ensuring greater supply than the market would otherwise provide. Without Government intervention, a richer, more diverse and more representative range of voices may not emerge, resulting in a more impoverished and limited range of choices for the public. The aim of support is to address the market failure in the supply of culturally British films by way of an incentive for specific behaviour – the production of culturally British films.

OPTIONS

There are four main options for the future of film tax relief and they are considered below.

Option 1 – Do nothing: allow Section 48 to expire and leave Section 42 in place

This option would mean that Section 42 would be the only tax incentive available to any qualifying film. In light of the conclusions of the review of Section 42 summarised in Annex A above, leaving large budget film tax relief as it stands would not address the Government's intention to support the sustainable production of culturally British films.

Option 2 – Make Section 48 permanent and leave Section 42 in place

Leaving the current tax reliefs to run in their current form would not address the Government's concerns at the weaknesses identified in the reviews of Sections 42 and 48.

Option 3 – Abolish tax reliefs and replace with direct grants to producers

There are currently a number of grant-based schemes in place for film production, primarily those funded by the national lottery. Whilst these are of great importance to the film industry, they are by nature selective and reach a limited number of films. A detailed consideration is required on a film-by-film basis due to the inherent difficulty of identifying films with the potential to be commercially successful.

As discussed in Chapter 2, tax incentives work in a different way to direct subsidies. Unlike grant funding, tax incentives do not seek to influence the specific qualitative outputs of the domestic industry. Tax incentives play an important role in facilitating a favourable environment within which the market can determine what kind of cultural products are made, with minimal distortions.

Option 4 – Replace both existing reliefs with a new model targeted at producers

The proposed new relief would be targeted directly and exclusively at film production companies who are within the charge to UK Corporation Tax. It would give them an immediate write-off of up to 80% of eligible production costs against the income that arises from the film. It would also allow producers of small budget films with total production costs of £20m or less to surrender any losses that arise for a cash payment of 30%, whilst providing an enhanced deduction of 50% of eligible production costs which can be utilised and carried forward to set against income. It would allow producers of other qualifying films to surrender any losses that arise for a cash payment of 25%, whilst providing an enhanced deduction of 25% of eligible production costs which can be utilised and carried forward to set against income.

Introducing a relief that cannot be accessed by third parties would ensure that the full benefit be delivered to producers. It would also stop the deliberate abuse that the film

reliefs have suffered from in the past and which have made the costs of providing support to the industry unsustainable.

The new tax relief would be restricted to expenditure that is incurred on filming activity within the UK. This would provide a direct incentive for both indigenous and overseas film producers to make full use of the production infrastructure in the UK, thereby ensuring the stable investment necessary for the sustainable production of culturally British films.

The films qualifying for the new tax relief would be determined in part by the application of a new test to ensure that films are genuinely culturally British. This test would be administered in a similar way to the current certification process based on the 1985 Films Act. This would meet the requirements of the State aid rules for support to film production and provide a sound basis for making a formal application to the Commission.

CONCLUSION

The proposed new tax relief provides the most effective vehicle for supporting UK film production in a way that ensures that the relief is not vulnerable to abuse whilst encouraging genuine investment in film production infrastructure. The introduction of a new test to ensure only culturally British films will benefit from the relief will also increase the likelihood of obtaining speedy approval from the Commission.

SECTORS AND GROUPS AFFECTED

The new relief is targeted directly at the UK film production sector. There are currently between 4,000 and 5,000 UK companies either directly involved in film production or who provide the necessary services to film producers (such as studio facilities, sound, lighting, post production and special effects). All of these businesses would be directly affected by the new tax relief.

Indirectly affected would be the film financing sectors, in particular banks lending money to producers, and those sectors which market and exploit films once they are completed. **We would welcome the views of the film financing, marketing and other associated sectors on the extent to which they would be affected by the new film tax relief.**

BENEFITS

Film production companies would benefit through a reduction in the amount of corporation tax they would otherwise be liable to pay. Those companies not making a profit would benefit by being able to cash in losses for a payable receipt. Since the relief would be targeted directly at producers, they would no longer need to enter into complex and costly arrangements with third parties to access tax relief. Additionally, because the benefit would not be shared with third parties, a greater proportion would go directly to the film producer. By ensuring the direct targeting of support to film production, there would be more effective encouragement of those activities that contribute to the Government's objective of promoting the sustainable production of culturally British films.

Since the reliefs provide direct support to film production activity, and prevent intermediaries from accessing tax relief for purposes for which they were not intended,

Exchequer funds will be less open to risk of misuse thereby providing greater value for money to the general taxpayer.

COSTS

Policy costs

None identified. Any costs associated with introducing the relevant legislation and with revising guidance for HMRC inspectors would be absorbed within general activities.

Implementation and compliance costs

Once the new tax relief is implemented, film production companies would be required to make a formal application to determine whether the film fulfils the criteria of the cultural test. However, in order to qualify for the current tax reliefs, producers already need to have their films formally certified as British. Responsibility for the new test, would, as currently, lie with the Department for Culture, Media and Sport. The process is likely to be no more burdensome than the certification process currently in place and the Department for Culture, Media and Sport will be consulting on the new test in parallel with the consultation on the new tax relief.

The amount of relief which individual films are entitled to would be administered as part of HM Revenue and Customs' normal examination of the company's corporation tax return and would use the same information that is currently required. **We would welcome the views of the film industry on whether the new tests for qualifying for film tax relief would bring any significant additional administrative costs as part of the consultation process.**

Since production companies already record expenditure in detail for the purposes of budgetary control, obtaining bank finance and obtaining completion bonds and have to present the information to the Department for Culture, Media and Sport to obtain British certification, there would not be any significant additional compliance requirements or set-up costs under the new tax relief.

EXCHEQUER EFFECTS IMPACTS

The new relief has been designed to be broadly cost neutral when the costs of providing the current tax reliefs are taken into account.

COMPETITION ASSESSMENT

There would be no impact on competition from the reliefs. However, officials are working with the European Commission to ensure that the reliefs comply with European competition guidelines on State aid.

MONITORING AND EVALUATION

The film tax reliefs would be kept under continuous review. Data on claims for film tax relief would be collected through the corporate tax self-assessment system. This information would allow estimates of the take-up and cost of the relief to be produced on a regular basis, enabling continuous monitoring of the performance of the policy.

This information would also be linked with data held by the Department for Culture, Media and Sport and the UK Film Council and from other sources on the distribution

and performance of British films at the box office and through other channels. This would allow the performance of the relief against its wider objectives to be assessed and a judgement made about the effectiveness of the relief given in light of its costs.

The time lag between companies incurring production expenditure and filing their tax return means that the first results from the monitoring exercise would be delayed. The evaluation would likewise depend on the time taken for films to secure distribution and for box office outcomes to become available.

Contact Point:

David Hamp-Adams

Budget and Public Finances

HM Treasury, 1 Horse Guards Road

London, SW1A 2HQ

0207 2706102