Treasury Consults on Creative Sector Tax Reliefs

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The animation, high-end TV and video game industries are the prospective beneficiaries of the Government's latest sector-specific tax break proposals. Following the success of the film tax relief ("FTR"), which in 2010–2011 provided £200 million of support to the British film industry by supporting over £1 billion of investment into 190 films, the "creative sectors" are next up to benefit from legislative tax reliefs. However, as is always the case with these initiatives, the devil is in the detail and, given the current sensitivity to "morally wrong" tax avoidance structures, the Government will be keen to ensure the reliefs are only available to those businesses that genuinely contribute to the UK economy. In a consultation paper, published on June 18, 2012, HM Treasury sets out the initial proposals in respect of these tax reliefs and requests industry's views on numerous questions. The consultation deadline is September 10, 2012.

Background

At the March 2012 Budget, George Osborne announced that the Government intends to introduce corporation tax reliefs for the animation, high-end television and video games industries from April 2013, subject to State aid approval. It is hoped these new reliefs will be among the most generous available in the world and will provide the necessary support for those three sectors to grow. The Government's ambition is to make the United Kingdom the technology centre of Europe and these corporation tax reliefs will be part of a package of measures to support technological innovation and to help the digital, creative and other high technology industries to grow.

Consultation

Some aspects of the consultation are particular to each of the three creative industries, whereas some aspects are applicable to all, including the initially proposed method of allowing the tax relief to be claimed.

In order to qualify, the claimant must be a UK incorporated company—sole traders and partnerships will not be entitled to the reliefs. In addition, it is worth noting that it is the corporate entity that benefits from the tax relief and not the investors in the corporate (albeit reducing the amount chargeable to tax in the corporate will inevitably be of benefit to its shareholders). The UK entity needs to be "directly involved" in the production of the programme or game—that is the company must be responsible for actually producing the content of the programme or game and be actively engaged in the decision making process to deliver the programme or game. The consultation seeks details of co-productions, for example where different companies both produce animated content for the same programme (as opposed to two companies co-financing the programme).

Broadly, it is proposed that the relief would give a qualifying entity an additional tax deduction, as is the case with FTR. That deduction would be based on "core expenditure", which would include all production costs integral to the production process, but would exclude those which were incurred on a purely speculative basis and which do not result in an end product. The legislative definition of core expenditure will be broadly similar to the definition used for the FTR, meaning all expenditure directly incurred in the production of the programme/game, excluding, for example, financing and advertising costs would qualify. Any grants or other public subsidies must also be netted off. At least 25 per cent of the core expenditure incurred by the company must relate to expenditure on goods or services that are used or consumed in the United Kingdom.

This expenditure can be deducted from the income received from the relevant activity in addition to the standard expenses that are deductible for tax purposes. This would either reduce the profits that are chargeable to tax (therefore resulting in a lower tax bill) or would result in the entity being loss making. A loss can then be surrendered to HM Revenue & Customs for a payable tax credit.

Whilst the levels of additional deduction and payable tax credit will be a decision for Ministers, the Government has stated that the aim is to introduce a relief of "similar generosity" to the FTR, where a limited budget film (one whose core expenditure is £20 million or less) enjoys an additional deduction of 100 per cent of relevant expenditure and the payable tax credit is 25 per cent of losses surrendered, with other more costly films enjoying rates of 80 per cent and 20 per cent respectively.

The Government is aware that a significant proportion of the costs of production will be incurred in advance of the finished product, for example in respect of an animated programme because of the long lead in time to production. Alternatively costs may be incurred speculatively, in the hope of a programme being commissioned for example. Whilst early stage costs aren't to be excluded, it will inevitably be necessary to include a rule to separate speculative expenditure that does not result in an end product from early stage expenditure on a project with an identifiable end product.

The cultural test

Crucially, in each case, to qualify for the relief, the animation, high-end TV programme or video game must be "culturally British". It is on these cultural grounds that the European Commission will need to grant State aid approval and this is something that the Government is planning to obtain throughout 2012. It is intended that a consultation on the cultural tests applicable to each industry will be released in the autumn of this year. The FTR includes a "culturally British" requirement already and it is possible that, as has been the case for the tax reliefs themselves, the cultural tests applicable to the creative sectors will mirror those applicable to the film industry. The BFI's cultural tests award points if the film is set in the United Kingdom, the lead characters are British citizens and British residents, if the studio is in the United Kingodm, if the key individuals (director, script writer, lead actors etc) are British and so on. It is expected that a similar point scoring system will operate in respect of the creative sectors tax reliefs.

Animation

The first of the three creative sectors that are targeted in the consultation is the animation industry. Aardman Animations, the studio behind Bafta-winning Wallace & Gromit, has welcomed the proposed tax credit, with the head of broadcast publicly recognising there has been a "dramatic decline on UK TV of home produced animation" and hoping that the tax credits will give UK animation "a shot at reversing that trend".

The consultation proposes numerous questions in respect of the animation aspect of the tax relief. The first of these is in relation to the definition of animation. The Government faces the task of drafting a definition which works in the legislation, is recognised in the animation industry and is in line with State aid guidelines. The current proposal is to define animation as:

> "a sequence of images in 2 or 3 dimensions created recording still images or objects, one frame at a time with incremental changes in position, form or appearance between frames to create the impression of movement."

In addition, the Government is targeting animation that is intended for broadcast and therefore the scope of the relief will exclude specific categories, such as animation produced for advertising purposes, news or weather, game shows, and animation programmes which are pornographic in content.

As some productions are not entirely made up of animated content alone, it is proposed that the relief is limited to productions where expenditure on animation makes up the vast majority (i.e. 75 per cent or more) of the costs. It is hoped that this will be a relatively straightforward factor to ascertain and would be easier to administer than requiring a minimum number of minutes of animated content per production or that the main character is animated etc.

High-end television

For the purposes of the consultation, the term "high-end television" broadly means high quality television drama costing £1 million or more per hour of programme running time.

This aspect of the relief has been introduced following growing evidence that a number of UK high-end TV productions are being made overseas or, in the case of marginally commercially unviable productions, not being made at all despite their potential. The relief is not intended to subsidise existing TV production activity taking place within the United Kingdom but to attract new investment and the creation of cultural products that would not otherwise be made in the United Kingdom.

The Government is seeking views on how to define high-end television and is intending for the relief to apply to programmes intended for broadcast that are dramatic productions, including comedy programmes. Drama for these purposes does not include advertising, discussion programmes, news or current affairs programmes, quiz shows, panel shows, variety shows or similar entertainment. The monetary threshold of £1 million per hour of programme running time is intended to align with the way the industry operates and, provided that the definition is kept relatively simple, it is hoped this will not be too burdensome to administer.

In order to safeguard against manipulation of costs, it is proposed that the £1 million threshold refers only to direct production costs, which corresponds to the way the FTR threshold is calculated and avoids the potential risk of an "all in budget costs" definition which could include costs not directly related to the making of the programme (for example expenditure on raising finance, advertising, marketing costs). The definition proposed is in line with treatment in other jurisdictions offering similar reliefs. For example, Quebec uses an "all in" spend approach which corresponds generally to eligible salary costs and costs directly attributable to the completion of the production. The consultation paper proposes that £1 million production expenditure per hour running time is the running time excluding any commercial breaks, and that the programme must have a running time of at least 30 minutes.

Left Bank Pictures, which shot just one day out of two series of *Strike Back* in the United Kingdom (which cost around £2.2 million per hour long episode) has confirmed that, had there been a tax incentive, it is likely the company would have shot a third of the two series in the United Kingdom instead of South Africa and Hungary. The Government will be hoping that other production companies will take the same approach.

Video games

The European video games industry is facing growing international competition from Asia and North America in particular. Given the current technological changes and increasing market opportunities, the Government is keen to ensure that the United Kingdom's excellent track record in high quality video games design continues. The tax relief in respect of video games would need to take into account the fact that a significant proportion of the video games sector is currently based on a production process with games produced on a physical medium (e.g. a disc) for playing on a console. However, increasingly games are being created for digital distribution only, with the rise of Facebook and other online providers benefiting from the phenomenally popular use of smartphones, tablets and the like, and the relief will need to cater for the creation of those games as well.

Two alternative models to the FTR-esque relief have been considered for video games: first, a model structured like the United Kingdom's existing R&D tax credit and secondly the video games tax credit model as available in France. The first would operate by requiring companies to identify all relevant qualifying expenditure, which would involve companies being required to keep separate expenditure for all qualifying and non-qualifying games as well as requiring the income from all qualifying games to be pooled. The French model calculates the tax credit by directly applying a rate to the "expenditure on conception and creation". The tax credit is then set off against the corporation tax payable or, where there is a loss, is repaid. The UK model of course entitles the production company to an additional deduction in computing its profits or losses and the UK Government therefore considers that the proposed FTC model is, on balance, likely to benefit a wider range of companies in the United Kingdom.

Inevitably there is a need to define a video game and the proposal is to adopt the French tax relief definition:

> "leisure software made available to the public on a physical, medium or online and incorporating elements of artistic and technological creation; the latter cover not only PC and console video games but also mobile games, on-line games for one of more players, educational or edutainment software and, provided that they incorporate sufficient interactivity and creativity, cultural CD-ROMs."

However, as with animation, there will be no relief available for video games whose primary purpose is gambling, advertising or one which would be refused an age rating certificate.

The tax reliefs will be provided for the costs of developing the game, but not for the costs of code debugging or maintenance after the game has reached a certain developmental stage such as "open beta" (which refers to a stage in a game's development where the game has been released to the public and almost all the bugs and problems have been worked out in the earlier development stages). However, where there has been genuine further development, for example building expansion packs and additional features, tax relief may be available for those associated costs.

The French video games tax credit has a threshold to entry of €150,000 of development costs, the rationale being to exclude games not intended for large scale marketing. The Government's initial scoping work has suggested a threshold to entry of £50,000 and the Government is seeking feedback as to that conclusion.

Procedure

An entity will be required to claim the relief on its tax return. HM Revenue & Customs will operate a non-statutory clearance system for these reliefs in response to applications from businesses. However, where a company claims tax relief under one creative sector relief, it will not be able to claim relief under another creative sector tax relief. For example, animated films intended for theatrical release that meet the qualifying criteria of the FTR will continue to be eligible for support under the FTR scheme, but will not be able to claim relief under the animation tax relief as well. It will be a decision for the corporate to decide which is the appropriate relief to claim.

Reaction

Those in the affected industries have welcomed the news that the Government is now actively pursuing the opportunity to make a corporation tax relief available. It was to be expected that the creative sector reliefs would be based heavily on the existing FTR which, over the last six years, has worked well within the film industry. The Government expects that, by 2016/17, the new animation relief should have a value of £15 million a year and the new video games relief should have a value of £25 million a year (there is no figure yet given for the new high-end television relief as it is not known how many companies will benefit from the relief). The consultation is inevitably the first step of several that will need to be taken in order to implement such tax reliefs, not least the cultural test. Details of the cultural test will not be known until the autumn when a separate consultation is released, and that will inevitably trigger further debate in the industries.

However, it's not all positive. The proposed thresholds to entry of £50,000 for video games and £1 million per hour of programme running time for high-end television will inevitably result in smaller businesses missing out on these tax breaks. In industries where start-up costs can be prohibitive, further increasing the competitive advantage of those larger entities will surely dishearten those outside the scope of the tax breaks. Having said that, with other jurisdictions already offering tax breaks, the UK Government needed to act to ensure it is not left behind. The call for evidence that concludes the consultation paper stretches to almost four pages demonstrating the complexity of drafting the legislative provisions as well as obtaining State aid approval.