

Creative Sector Tax Reliefs—Treasury Proposals Elicit Detailed Responses as DCMS Consults on Cultural Tests

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Introduction

As tax compliance continues to dominate the headlines, most recently with the corporation tax liabilities of Amazon, Google and Starbucks being placed under the media's microscope, there has been further progress with the proposed tax reliefs for the creative sector (being the animation, high-end television and video games industries).

As previously reported,¹ HM Treasury set out the initial tax relief proposals, which had been outlined by the Chancellor at the 2012 Budget, in a consultation paper published on June 18, 2012. The consultation requested the industry's views on numerous aspects of the tax relief, and closed on September 10, 2012.

Since that consultation window closed, the Department for Culture, Media and Sport has also published three papers detailing consultations in respect of the cultural tests that will be included in the tax relief.

Treasury consultation

The Treasury is yet to release any further information such as the next steps towards drafting the reliefs, but is no doubt considering the responses received following the closure of the consultation on September 10. Several responses from advisors and industry bodies have been published, including those from the Producers Alliance of Cinema and Television ("Pact"), the British Screen Advisory Council ("BSAC"), the British Film Institute ("BFI"), the Association for UK Interactive Entertainment ("UKIE") and the Trade Association represented in the UK games industry ("TIGA") as well as advisors to the industry, such as Grant Thornton.

Generally the overall consensus seems to be that the proposed tax reliefs for the three industries is welcomed. In addition, the proposal to base the tax reliefs on the

Film Tax Relief model ("FTR") has been cautiously welcomed—the FTR scheme does not require significant administration by HM Revenue & Customs ("HMRC") but there will inevitably need to be slight adjustments to ensure that the proposals work in the three discrete industries in the creative sector.

Animation

In terms of the proposals to provide tax reliefs for the animation sector, responses have suggested that the proposed limitation, whereby if expenditure on animation makes up less than 75 per cent of the production costs the relief will not be available, could exclude a wide range of programming that would otherwise presumably be expected to qualify for the tax breaks. PACT and Animation UK have provided specific examples of programming to the Treasury in order to support this submission and, as a result, propose a threshold of 51 per cent of costs instead of the 75 per cent.

In addition, the proposed definition of animation as a "sequence of images in two or three dimensions created by recording still images or objects" sparked some debate. One comment queried how that would work when considering visual effects such as CGI where the term "frame" is used (and therefore whether a definition including "recording still images" would encapsulate CGI). The BSAC has asked that the definition of animation be consistent with the FTR where the definition of film does not include an express reference to "images in two or three dimensions" although both 3D and 2D films can claim relief.

The consultation paper's acknowledgement that the Government is targeting animation "intended for broadcast" has prompted several parties to suggest a need to carefully consider the definition of "broadcast" and in particular, to ensure such definition is future proofed so that, as technology changes and consumer behaviour adjusts, the ability of companies to claim the relief is not affected. For example, BSAC noted a recent Ofcom report which stated 5 per cent of UK households now have an internet connected smart TV. Whilst it is likely that the contents will currently be deemed a broadcast in the traditional sense, at some point in its exploitation cycle it is quite possible that the technology may be used by operators of on-demand distribution services and the definition of broadcast should allow for this adjustment.

In relation to the qualifying core expenditure and mixed content programmes, Grant Thornton has suggested that guidance should be given as to how costs would be apportioned in cases where elements of a budget could be attributed to both animation and live action elements. In addition, the BFI pointed out in its response that the production process for animation can

¹ Aredhel Darnley, "Treasury consults on creative sector tax reliefs" [2012] Ent. L.R. 23(7), 214–216.

often take longer than that of a film and, consequently, the Treasury should be taking into account this different model when considering multiple or repeat claims.

High-end television

The BSAC suggested that the definition of high-end TV should be less prescriptive than that offered in the consultation document (namely that the relief would apply to drama productions including comedy programmes, but excluding “advertising, discussion programmes, news or current affairs programmes, quiz shows, panel shows, variety shows, or similar entertainment”). BSAC’s submission is that it is unclear whether some types of documentary programmes would fall within the drama programmes genre such as drama-documentaries. Its recommendation is therefore to incorporate a definition that is:

“based around programmes that consist of scripted or narrated works with exclusions relating to news or current affairs discussion or chat shows, quiz or panel shows, live events, sporting events, variety shows or events or shows that require audience voting or which provide prizes to contestants or to general audience.”(hardly a short definition)

Turning to the Treasury’s proposal in respect of the monetary threshold (being £1m per hour of programme running time with an additional requirement that the programme has a running time of at least 30 minutes), BSAC suggests that the running time requirement be measured in “slot” time rather than running time, (it is understood that the TV coalition is to also argue for a “slot” time definition). Inevitably, this is an area that the High-End Television Tax Relief Working Group will focus on when working with the Treasury.

The BASC has disagreed with the Treasury’s initial proposal that only direct production costs should qualify towards the £1m per hour threshold to the extent that there is an implied intention to exclude expenditure on copyright acquisition. BSAC argues that this is generally accepted as a bona fide production cost which should be included.

Video games

Several entities have highlighted the difficulty of applying the FTR model to games in respect of the timing of production. For most games, there is no traditional end point and, whilst films have pre-production, principal photography and post-production stages, games cannot be so clearly split into separate states.

Similarly, the proposed definition of a video game may prove to be too restrictive. The UKIE contends that the term “video game” itself is perhaps no longer appropriate and gives the example of *Nightjar*, the recent smartphone game nominated for two BAFTA game awards in 2012, which uses only sound and no video. In any event, the UKIE is clear that a definition must include “software”.

The UKIE, along with Grant Thornton, suggests that the French definition suggested by the Treasury is outdated and contains numerous unnecessary points with most of the text concerning the delivery mechanism of the game, rather than the definition of the game itself. As a result, UKIE and TIGA have put forward alternative definitions of eligible games.

The Treasury’s proposal to exclude games which would be refused an age-rating certificate if reviewed against the United Kingdom’s video games classification regime is also a contentious area. Whilst it is generally agreed that games given a BBFC R18 rating should be specifically excluded from the scheme, there is a strong preference for games to have been rated under a recognised age-rating or approval system for the platform in order to receive tax relief. PEGI is legal age-rating system for physical releases in the United Kingdom and, being one of the high profile industry codes of conduct it has the confidence of both the industry and consumers, but crucially, has not yet been universally accepted.

In addition, there is inevitably a need to future proof the proposal as, for example, online and mobile games are not currently subject to classification. UKIE’s conversations with the industry have made clear that imposing an age-rating system on the social, mobile and browser based online markets through a tax relief system would not be acceptable to the majority of game businesses. It is suggested that guidance should be provided on what content would ultimately preclude a game from benefiting from tax relief and, for cases where an age-rating is not secured, the business itself should be required to make a declaration that there is no extreme or undesirable content in the game.

Throughout the proposals, and specifically in respect of the video games section, the need to make the claims simple and straightforward to administer was highlighted. This is not only in terms of considering at which point costs would start and cease to qualify for tax relief but also when considering the Treasury’s proposal that only costs incurred in producing a video game which is intended for commercial release. Grant Thornton believes this approach is still favourable to the “publisher commissioned” approach, as the industry frequently uses self/co-publishing. UKIE suggests that, if a financial threshold were put in place (as suggested in the consultation document), this would remove much of the concern in the area as very few independent developers who did not have external funding would spend more than £50,000 on any design work. In addition, this condition seems to be an attempt to adapt the phrase “intended for theatrical release” from the FTR but inevitably potentially disqualifies games which are released on initial free to play basis (and subsequently monetised either via in app purchases or advertising) as well as the wide range of games which are commissioned from developers by charities and semi-public bodies such as the Wellcome Trust and Channel 4.

Grant Thornton's discussions with the industry have given rise to their suggestion that a definitive list is produced that states the characteristics that are necessary to qualify. It is hoped that this tick-box approach would hopefully reduce the ambiguity and the time costs in establishing whether a qualifying video game has been produced.

Advertising

One theme common to the three proposed tax reliefs is the Treasury's intention to exclude from the regime any video games, animation and high-end television which includes advertising. The UKIE's response goes into some detail as to the difficulty in defining games whose primary purpose is the advertising of products. Inevitably, advertising is an increasingly important funding source for the games industry, especially when the game is launched in the mobile world. The advertising tends to take one of four different forms: in-game advertising (where adverts are shown at some point during the game (often in between levels)); branded virtual goods (such as a non-alterable part of the virtual world or a player's avatar wearing a branded item); sponsorship (i.e. where a brand pays to have itself associated with the game, perhaps by having its logo at the beginning of play); and brand commissioning (where a brand decides to create a game to raise awareness and commissions an entertainment developer to supply the game). The UKIE's view is that all of these advertising categories provide valuable sources of income to games businesses and, as such, should not be explicitly excluded on the basis they are funded by brands to increase awareness.

In addition, as UKIE points out, business models in the games industry are changing just as rapidly as the technology used to launch them and as a consequence, it is impossible to know how future games may be monetised and how advertising will be part of this.

More generally, the Institute of Practitioners in Advertising ("IPA") submitted a response to the consultations stating that it believed it is illogical when dealing with the creative industries to specifically exclude advertising materials. According to the IPA, advertising tends to be at the forefront of creative technological developments, which the tax relief is itself aimed at. In addition, ad agencies will often look to the same production companies that also specialise in animation and high-end television and therefore, without a flourishing ad industry, high-end created productions would not be able to draw on the current pool of highly skilled film crew, lighting companies, post-production houses, animators etc. As a result the IPA believes that the criteria for tax relief should be the *nature* of the creative work not the purpose for which it is intended.

Skills

The open question via the Treasury for any other issues to be raised has resulted in several bodies questioning the availability of effective skills and training strategies for the creative sectors that will be needed in order to extract the maximum benefit from the tax reliefs. Specifically, both the BSAC and the UKIE have highlighted concerns as to the size and strength of the existing skills base and whether this shortage would render the United Kingdom's talent pool insufficient to cope with the significant amount of additional production activity which is likely to be incentivised by the tax reliefs. The BASC stresses the importance of ensuring that comprehensive strategies are put in place to address these concerns and the UKIE proposes some mechanism to use a small part of the funds generated by the tax relief and to redirect them to support the recommendations of the Next Gen Skills campaign.

DCMS consultations

The DCMS has now issued three consultation papers to seek views on the proposed tests to identify culturally British video games, high-end television and animation which might be considered eligible for the new tax relief. This requirement is in line with EU rules on State Aid and therefore the final design of the cultural test will be dependent upon input from the consultation and the European Union itself.

The three consultation papers are hugely similar and all have a closing date of October 29, 2012. In terms of animation and high-end television, it is expected that any applications for the new tax relief will need to qualify as British either under the new cultural test or as an official co-production. Six of the United Kingdom's bilateral treaties (namely with Australia, Canada, France, Israel, New Zealand and the occupied Palestinian territories) have provisions within the agreements to jointly make TV co-productions.

In addition, the DCMS has been working with the relevant stakeholders (particularly the imaginatively named Animation Tax Relief Working Group, Video Games Tax Relief Working Group and High-End Television Tax Relief Working Group) in order to design the relevant cultural tests. As with the FTR, points will be awarded in respect of the cultural content of the production, the cultural contribution, cultural hubs and cultural practitioners. The high-end TV and animation tests require the productions to achieve 16 points out of a possible 31, with the video games cultural test being passed if 16 points out of 30 are scored.

The cultural content points will be awarded if the United Kingdom or EEA is used as a setting. Interestingly, animation and video games will meet this criterion if the setting is a "fictionalised" representation of the United Kingdom/EEA or set in a location/world that cannot be determined. The video game and animation tests also have an additional limb in the cultural contents section, namely that the artistic costs (which would cover the

personal costs for the producer, assistant producer, artistic director etc) represent more than 50 per cent of the production budget. Additional points are available if the lead characters are British citizens or residents (or of a nationality/species that cannot be determined in the case of animation or games) and if the narrative and animation dialogue is mainly in English or of a European story.

Cultural contribution points are available if the production contributes to or reflects British cultural heritage as well as if contemporary social and cultural issues of disability, ethnic diversity and social exclusion are explored. In addition, the video game test awards points if the game itself incorporates clear British technological or creative innovation such as innovations in game play, graphics, user interface, AI or online/multi-player functionality, whereas the tests for high-end TV and animation reward productions whose portrayal of British culture comes as a result of the makers' creative approach.

The third section, "cultural hubs", will reward the use of the United Kingdom's facilities with points being awarded for the use of location shooting, studio shooting, development, special effects, music etc. It is anticipated that that section will mirror the version used in the cultural test for the FTR.

The final section of "cultural practitioners" will measure the use of personnel with creative input into the cultural value of the production with points awarded for the use of United Kingdom or EEA national residents in key roles as identified by the DCMS. The guidance for high-end television would look at the director, scriptwriter, producer, composer, lead actors and other key staff whereas the video games tests will take into consideration the lead programmer, lead designer, scriptwriter, manager etc.

The plan is for all three tests to be administered by the BFI, which is currently responsible for administering the cultural tests applicable for the FTR. However, the DCMS is happy to take the industry's views on this proposal, as indeed it is on all other aspects of the papers. In particular, specific queries have been raised in terms of high-end television where, unlike a film

production, a TV series may not go into production with a fixed direction for the storyline and the DCMS has asked how that will be taken into account when assessing the cultural test. Equally, if the cultural test application is to be considered at the stage of a pilot episode, the DCMS has requested consideration as to circumstances where points that have been awarded at that time are no longer met once the series is commissioned.

Conclusion

It is clear the FTR is going to continue to play a major part in the shaping of the creative sectors' tax relief. The Treasury has not yet released any further information on the formulation of the reliefs but, given the recent publication of the cultural tests, it is likely the industries will be continue to be busy liaising with the Government as to how best to structure the final drafts of the reliefs. As always, it will be interesting to see how flexible the different Government departments are in responding to industry's views, particularly in respect of the formulation of the tax relief which resulted in several lengthy responses being published.

Perhaps the key overriding aspect remains the rate of relief and how this will be used to ensure that the United Kingdom is competitive compared to numerous other jurisdictions which are already offering similar incentives. Indeed, Grant Thornton's suggestion that the rate of relief should be 25 per cent of qualifying expenditure (giving an effective rate of 20 per cent as this would only be available and up to 80 per cent of budget) is a direct response to the benefits offered in other jurisdictions, particularly in respect of high-end television. As the BSAC highlighted in its response, Ireland currently offers a benefit of 28 per cent of qualifying spend, while foreign producers can receive a 16 per cent credit from the Canadian federal government on top of provincial credits (for example, in Ontario, a tax credit can be claimed on 25 per cent of eligible labour expenditure). The Abu Dhabi Film Commission is shortly to introduce a tax relief worth 30 per cent on film and TV productions, so the Treasury will need to ensure the final UK proposals are not only acceptable domestically but internationally competitive.