Update on UK Film Finance
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Introduction

The UK film industry is currently undergoing a change from the prior tax incentive structure for film, based on the total budget of a film, to a new tax relief based on the amount of spend in the UK. After a long period of uncertainty – even as to whether there would continue to be a UK fiscal incentive for film – which was very negative for production volume in 2005, volume in 2006 has increased as the nature and value of the new incentive has become clearer. The new incentive, like the immediately prior structure, applies to theatrical film only, and not to television. There is no likelihood that the incentive will ever apply to television, nor is there any meaningful constituency in the UK pushing for this.

There are still many uncertainties as to how the new incentive will actually work. The new incentive structure is yet to be approved by the European Commission, and the way in which the incentive will be 'cash-flowed' or 'discounted' is not completely clear. However, with regard to the interests of Canadian producers, there is no doubt that the new incentive will be less attractive for co-productions then the previous structure.

Current Activity

Films which started principal photography before April 1, 2006 and are completed by December 31. 2006 are the last films which will be able to take advantage of the sales leaseback structures afforded by Section 48 and Section 42 (which deals must be completed by October 1, 2007). Films entering production after April 1, 2006 qualify only for the new incentive.

In general, production volumes for this year are substantially up on last year. This is particularly the case with British originated films and inward investment films (films originating outside the UK, principally the US). However, after a flurry to commence co-productions prior to the April 1 deadline, there has been not so much co-production activity.

The new incentive structure is rather more complex than the predecessor structure. owever, in very approximate terms, its value can be summarised as:

- 25% of the amount of UK spend up to 80% of the budget (i.e. the maximum value is 20% of the budget) for films budgeted at £20 million or less
- 20% of the amount of UK spend up to 80% of the budget (i.e. the maximum value is 16% of the budget) for films budgeted at over £20 million.

In order to qualify for the incentive, the film needs to spend 25% of its budget in the UK – whether or not it is a co-production.

The value that is actually obtained by productions is likely to be less than the above. The benefit will be available through the filing of corporate tax forms. Thus, though one of the drivers of the new structure was to reduce the involvement of 'middle-men' in film finance, they are likely, in the near term, to have a substantial role based on the essential job of discounting this incentive.

The prior incentive structure required private investors in order to channel the benefit to productions. Thus 'middle-men' were an intrinsic part of the financing picture. However, this mechanism was felt to be highly inefficient – in that the loss of tax revenue to the Treasury far exceeded the benefit to the production sector. Accordingly, the new incentive was structured such that production companies could deal directly with Treasury to receive value for the benefit. However, this new mechanism does not accommodate the need for producers to use the benefit as part of their financing plan for production. Thus, middle-men will still have a role in cash-flowing the value of the benefit.

Currently, despite the substantial uncertainties involved, a number of entities have announced that they are in the business of cash-flowing the tax credit. In

some cases, entities are performing this function alongside equity investments they are making in projects. Given the risk involved, amounts offered are well below the 'face value' of the incentive.

Incentive Overview

The key elements are:

- a film needs to be intended for theatrical release
- the film must qualify as British or be an official co-production (see below)
- a film needs to spend at least 25% of its core expenditure (pre-production, principal, post but not development or distribution) in the UK to qualify for tax relief. This applies whether or not it is a co production
- UK spend is on goods and services consumed in the UK, so it includes amounts paid to non UK personnel for shooting in the UK
- tax relief is claimed on UK core expenditure up to a maximum of 80% of core expenditure, socalled qualifying expenditure
- the film can take 'enhanced deductions' of 100% of qualifying expenditure (80% for a film budgeted at over £20m) in addition to ordinary deductions
- OR the film can surrender deductions in exchange for a tax credit of 25% of losses surrendered up to a maximum of the qualifying expenditure amount (or a credit of 20% of losses surrendered for a film budgeted at over £20m).

The remainder of this paper discusses the structure of the incentive in detail.

Conditions

To be eligible for the relief the film must qualify as British under Schedule 1 of the 1985 Films Act, or as an official co-production – either a bilateral treaty or through the European Convention on Cinematographic Co-production. Schedule 1 now includes a cultural test that all films must pass (see below). It must also be intended for theatrical release and spend at least 25% of its core expenditure in the UK.

The relief can only be claimed by one company on any one film production. The claimant should be the film production company 'most directly engaged' (actively involved) in the pre-production, production, post-production and delivery of the film. This company must negotiate, perform or contract, the rights, goods and services for the production of the film. How Revenue and Customs (HMRC) determines the company 'most directly engaged' in the production is an area that is not completely clear.

Spend Requirements

A film needs to spend at least 25% of its core expenditure in the UK to qualify for the tax relief. Core expenditure is defined as production expenditure on film-making activities which includes preproduction, production and post-production phases but not development and distribution, which do not qualify for the incentive. With no definitive demarcation between what constitutes 'development' expenditure and what constitutes 'pre-production' expenditure, industry players are wary that this could lead to disagreements with HMRC on the amount of tax credit due and thereby delay the granting of rebate claims on individual projects.

UK expenditure, for the purposes of attracting the tax relief, includes the amount spent on all goods and services utilised in the UK regardless of their origin. For example, foreign performers' services performed in the UK would be considered

UK expenditure, however, payments for UK performers' services rendered abroad would not qualify as UK spend.

Calculating the Relief

There are two elements to the relief. These are the 'enhanced deductions' and the 'payable tax credit'. The relief is calculated on a percentage of the qualifying expenditure based on the size of the film's budget. Qualifying expenditure is the lesser of UK core expenditure and 80% of total core expenditure. To access the enhanced deductions, films with a core expenditure of £20m or less can claim 100% of the qualifying expenditure and films with a core expenditure over £20m can claim 80% of the qualifying expenditure. A portion or the entire amount of this enhanced deduction can be offset against income of the company.

Films can also choose to surrender all or a portion of this enhanced deduction for a payable tax credit. Films up to £20m can receive up to 25% of the total losses surrendered and films in excess of £20m can receive up to 20% of the total losses surrendered for films. Losses here include those that the production company is also able to claim under basic tax relief provisions up to a maximum of the qualifying expenditure.

Tax relief can be claimed at the end of each accounting period, which makes it more friendly to films with long production phases. Claims must be submitted with an accompanying DCMS certificate, attesting to a film's British status.

HMRC has the right to withhold payment of the tax credit should the company submitting the claim have a tax return under question, outstanding corporation tax payments, pay-as-you-earn (PAYE) contributions or National Insurance Contributions (NIC).

Discounting the Tax Credit

The deduction is unlikely to be helpful for most UK producers, since they tend not to have substantial corporate tax liabilities. Producers are most likely to access the payable tax credit and will be looking towards third parties to cash flow the tax credit. As mentioned, there are a number of entities that have already commenced, or are looking to commence, activities in this area.

The UK Producer's Association PACT is also currently lobbying financiers to agree to treat this credit as producer's equity on a project. Thus it would be recouped by the producer. This proposal is being considered by UK Film Council, BBC Films and Film Four.

Co-productions

Films which qualify as British under one of the UK's international co-production treaties or the European Convention for Cinematographic Co-production, are eligible to apply for the tax credit.

Co-productions also need to meet the minimum UK spend requirement of 25% and pass a cultural test. Limiting the tax relief to the UK spend has made it less attractive to co-productions than the previous sale and leaseback mechanism. With the tax credit only able to be claimed on the UK spend, this reduces the benefit for co-productions. The relief structure which favours only the company 'most actively engaged' in the production rules out any direct tax benefits for finance-only co-producers. In a situation with one co-producer providing the majority of production activities and being outside the UK tax structure, the UK based co-producer, though minor, should still be able to access the credit. If both the co-producers fall under the tax structure, only one company can claim the benefit.

Cultural Test

Schedule 1 has been amended, to include a cultural test which also applies to co-productions. The cultural test uses a points-based system. To qualify, productions need to obtain at least 16 of the 32 points available. The test is divided into three sections which focus on Cultural Content; Cultural Hubs and Cultural Practitioners. There are different factors for animation films and documentaries.

The first section considers the level of British culture included in the production, focusing on language, subject matter, the nationality or residential status of the principal characters and where the film is set. A maximum of four points can be gained. English language earns the production one point. The second section considers the extent to which the production uses UK based facilities. A film can score up to 15 points in this section. The third section analyses the nationality of the individuals involved in the production. There are up to 13 points to be gained in this section. Points can be gained for utilising the services of residents of the EEC.

It appears that this aspect has been the main reason for the delay on the approval by the European Commission presently vetting the scheme for State Aid approval. It has expressed concerns about the validity of the cultural test to "meet the requirements of the communication that aid be directed to a cultural production and that the production is cultural according to verifiable national criteria."[1] A European Commission spokesperson has indicated that a decision should be reached by the end of 2006[2].

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[1] Michelle Sutton, member of EC competition cabinet, quoted in Screen International "UK tax credit stranded as Europe ponders approval. Oct. 19, 2006

[2] Jonathan Todd, European Commission Spokesman on Competition, quoted in Screen International "We hope to issue a decision before the end of the year, assuming the UK authorities provide us with the elements which address the Commission's concerns." October 26, 2006

Other Mechanisms

While the tax relief is the key incentive to attract financiers to UK productions, there are some other investment instruments being explored by producers to attract finance to films, notably Enterprise Investment Schemes (EIS) and Venture Capital Trust Schemes (VCT). It is not clear that either of these have yet been successfully used for film investments.

There will remain a limited amount of equity funding for UK film – what is often referred to as GAAP funds, since the only tax advantage is the ordinary Generally Accepted Accounting Principles deductions. However, there has not been any indication of the growth of 'hedge funds', as has happened in the US – though mostly for the majors' productions. This is seen as unlikely to be a viable model in the UK since there are few UK production companies with the track record required to interest potential investors.

Conclusion

Tax incentives are seen as necessary to encourage British filmmaking, support co-productions and increase the ability of UK industry to attract inward investment. Subject to the hammering out of definitions for a few key terms by the HMRC and increasing familiarity with all the permutations of the new tax credits, overall, there is cautious optimism for UK film production, subject to the approval of tax relief by the European Commission.

Relevant links:

Department of Culture, Media and Sport – new film tax relief summary

http://www.culture.gov.uk/what_we_do/Creative_industries/film/tax_relief.htm

UK Finance Act 2006- html version – Office of the Public Sector – July 2006

http://www.opsi.gov.uk/acts/acts2006/20060025.htm

Office of the Public Sector -UK Finance Act 2006 - Chapter 3 – Detailed Tax Relief

http://www.opsi.gov.uk/acts/acts2006/60025--f.htm#31

Department of Culture, Media and Sport - UK Co-Production Agreements

http://www.culture.gov.uk/what_we_do/Creative_industries/film/co-production_agreements.htm

Department of Culture, Media and Sport - Schedule 1 with Cultural Test) - Mar 31 2006

http://www.culture.gov.uk/NR/rdonlyres/3E9AA19B-6792-48C5-A13F-4634F6EA6980/0/filmsorder2006.pdf

Applying for the DCMS Certificate for 'British' films (DCMS website)

http://www.culture.gov.uk/what_we_do/Creative_industries/film/british_film_certificates.htm

HMRC - Tax Relief (updated October 4, 2006)

http://www.hmrc.gov.uk/films/index.htm

HMRC - Claiming Tax Relief Draft Guidance (updated October 4, 2006)

http://www.hmrc.gov.uk/films/draft-guidance/tax-relief.pdf

HMRC- Claiming Losses Draft Guidance (updated October 4, 2006)

http://www.hmrc.gov.uk/films/draft-guidance/loss-relief.pdf

PACT

http://www.pact.co.uk/

UK Film Council

http://www.ukfilmcouncil.org.uk/

BBC Films

http://www.bbc.co.uk/bbcfilms/

Film Four

http://www.filmfour.co.uk/

European Commission

http://ec.europa.eu/index_en.htm

Glossary

Basic tax relief
The normal operating deductions that a production company can claim against its total tax liability. This is available to both film and television productions and is open to all productions in the UK (regardless of it being considered 'British' or destined for theatrical release).

British film
Any film that passes the cultural test outlined in Schedule of the 1985 UK films Act.. Co-productions (under international and EC treaties) are eligible.

Core expenditure
Production expenditure on film-making activities in the pre-production (after a project is greenlit), production and post production phases. Core expenditure does not include development and distribution costs.

Cultural test
The test added to Schedule 1 of the 1985 Films Act, which is used to ascertain whether a film qualifies as British for the purposes of the relief. It also applies to co-productions. It consists of three sections which analyse the levels of cultural content (story, language etc) use of the UK as a cultural hub(use of UK locations/ facilities) and use of cultural practitioners (UK/EU/EEC cast and crew).

Enhanced deductions
The percentage of the qualifying expenditure that a company can claim as an additional tax deduction beyond basic corporate tax deductions. This is the additional tax benefit (or "film tax relief") that is the special treatment awarded to qualifying British film productions intended for theatrical release.

Film production company
The company that is most actively involved with the production of the film. This company must be involved in a substantial proportion of the decision-making processes of the film.

Losses surrendered
The enhanced deductions (and a certain amount of the basic deduction under certain circumstances) up to the amount of qualifying expenditure (see below) can be claimed by the production company in their annual tax returns. Alternatively these losses can be surrendered for a payable tax credit.

Qualifying expenditure
This is the proportion of UK (spend) core expenditure that is eligible for tax deduction by the film company. This is the lesser of UK spend or 80% of total core expenditure. Films with a budget of £20m or less may be able to claim 100% of UK spend on pre-production, production and post production activities. Films with a budget of over £20m can claim 80%.

Tax credit (payable)
The proportion of the enhanced tax deduction that can be exchanged for a payable credit. Films with a budget of £20m or less can receive 25% of the total losses surrendered (for a maximum of 20% of the core expenditure if all core expenditure is UK spend). Films over £20m can receive 20% of the total losses surrendered (or a maximum of 16% of core expenditure if all core expenditure is UK spend).