

TAX AVOIDANCE USING FILM AND PARTNERSHIP RELIEFS

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Part I of this note includes details of the proposed additional legislation to make the accelerated deductions claimed under the film tax reliefs clearer and easier to enforce – see paragraph 7.

I DOUBLE CLAIMS FOR FILM TAX RELIEF

1. Relief for expenditure on the production or acquisition of a film can be claimed by certain persons under section 42 of the Finance (No.2) Act 1992 (“section 42”) or, for “low budget films”, under section 48 of the Finance (No.2) Act 1997 (“section 48”). This legislation has been used in tax avoidance schemes which seek to achieve the benefit of a tax deferral twice (or more) on the same film. The government proposes to introduce legislation in the next Finance Bill which will have effect from 2 December 2004 to counter these schemes.
2. At the same time the opportunity will be taken to simplify and align one aspect of section 42 with section 48 for films which start principal photography on or after 2 December 2004.

Background

3. The reliefs were intended to cater for sales and acquisitions of films which involve a receipt which is set against a deduction. However schemes have been devised which seek:
 - to defer the receipt to the person selling the film, so giving two deductions which defer tax; or
 - shelter the receipt permanently, so giving rise to *both* a tax deferral *and* a permanent tax gain.

Details of the proposed legislation

4. The government proposes to introduce legislation in the next Finance Bill to provide that relief under section 42 and section 48 can be obtained only once on

any film; and to limit entitlement to relief under section 42 to the total production costs (as is already provided for in relation to relief under section 48).

5. The legislation will provide that relief under section 42 and section 48 is available to a person in respect of expenditure on the production or acquisition of a film only if any previous owners of the film have not claimed, and have elected not to claim, relief under those sections in respect of the film.
6. The legislation will provide for a person who has incurred expenditure on the production or acquisition of a film to elect not to claim relief by giving notice to the Inland Revenue that they have not claimed relief under section 42 or section 48 in relation to a film; for that notice to be irrevocable; and for that person to cease to be entitled to relief in relation to that film. It will also require that person to inform any other person who acquires or has acquired the film from them of their election; and of any elections by earlier owners they know of.
7. This provision will apply in relation to any production or acquisition expenditure incurred on or after 2 December 2004, unless there was an unconditional obligation to incur that expenditure under a contract entered into before 2 December 2004 or the film is currently in production (that is, principal photography on a film started before 2 December 2004 but the film was not completed by that date).
8. For films currently in production, there will be provisions with similar effect to those in section 101 Finance Act 2002 for low budget films to limit relief under section 42 in relation to an acquisition of a film on or after 2 December 2004. That is, relief will be limited to expenditure on the acquisition of the film by the producer, or a person acquiring it directly from the producer, and will not be available in relation to any subsequent acquisition (or in relation to any acquisition by the producer or a person acquiring it from the producer other than the first).
9. The government also proposes to introduce legislation in the next Finance Bill to align an aspect of section 42 with section 48. Legislation will also be introduced to provide that relief under section 42 in respect of a film will be limited to the total production expenditure on the film. "Total production expenditure" will be defined for this purpose as it is in section 48 in relation to relief under that section which already has this rule.
10. The provision described in paragraph 9 will apply in relation to production or acquisition expenditure on films which start principal photography on or after 2 December 2004, unless there was an unconditional obligation to incur that expenditure under a contract entered into before 2 December 2004.
11. For the purpose of paragraphs 7 and 10 a condition which relates only to the Secretary of State certifying under Schedule 1 to the Films Act 1985 that the film qualifies for the purposes of section 40D will be disregarded.

II RESTRICTING FILM TAX DEFERRAL TO 15 YEARS

12. The government also proposes to introduce legislation in the next Finance Bill which will have effect from 2 December 2004 to counter arrangements which use film tax reliefs to defer tax beyond 15 years.

Background

13. Film tax relief is commonly accessed by film-makers through licensing, leasing or similar arrangements with companies or with individuals in partnership. Typically, the company or partnership (the “investor”) will pay to produce or acquire a film, and then licence or lease this film back to a producer or distributor for a specified period. Usually the investor will be guaranteed a minimum amount of licence fees or lease rental payments spread over the period of the licence or lease.
14. The investor obtains accelerated relief for the cost of the film under section 42 or section 48. They then pay tax in later years on the fees or rental income. This works as a tax deferral for the investor – in effect pushing back the time that tax is paid in return for an investment in a film.
15. The longer the period that tax is deferred, the more valuable this is to the investor. The Inland Revenue has routinely accepted deferral for up to 15 years. But a number of schemes have recently emerged which seek longer periods.

Details of the proposed legislation

16. The provisions will apply to any person carrying on a trade which includes the exploitation of a film, or any person who intends to carry on such a trade, who, on or after 2 December 2004, enters into an agreement that guarantees an amount of income arising from exploitation of that film or amends or extends an existing agreement.
17. The provisions will apply where:
 - the person carrying on the trade claims, or has claimed, relief for expenditure incurred on the production or acquisition of the film under section 42 or section 48 and
 - the agreement specifies that any amount of income guaranteed under that agreement will arise more than 15 years after the time that the agreement is made.
18. Provision will then be made with the effect that, when such an agreement is made:
 - the relief (that is, the amount which a person is entitled to deduct on making a claim under section 42 in respect of any expenditure incurred on the production or acquisition of a film) will be restricted. The restricted

deduction will be the expenditure claimed multiplied by 15 divided by N, where N is the period, in years, for which income is guaranteed to arise under the agreement;

- the difference between the amount of expenditure in respect of which a claim is made and the (restricted) deduction will be excluded from allocation under section 40B Finance Act 1992 until 15 years and 1 day after the date the agreement is made; and
- any excess relief already claimed will be recovered.

19. The legislation will also provide for:

- an agreement to be treated as guaranteeing a person an amount of income if the agreement, or any part of it, is designed to secure the receipt by that person of an amount (or at least that amount) of income;
- an agreement which is conditional upon a future event is to be treated as entered into at the earlier of the time it becomes unconditional and the time income first arises under the agreement;
- an agreement (the “later agreement”) which is made on or after 2 December 2004 and which guarantees a person an amount of income from exploitation of a film which succeeds, rescinds and replaces, amends or is in addition to any agreement already made, and which guarantees income to a time later than any earlier agreement, to be treated as an extension to the earlier agreement, with effect from when the later agreement is made. That is, for the purposes of any subsequent claims, and for excess relief, it will be as if the first agreement had run to that later time;
- a partnership which carries on the trade to be treated as having claimed any relief under section 42 or section 48 actually claimed by a previous partnership who carried on the trade if the trade has not been discontinued.

20. There will be excess relief if:

- starting with the relief actually claimed under section 42 and section 48 (which may have been restricted relief)
- subtracting the maximum relief which could have been claimed if the agreement (or later agreement) had been in place when the person was first entitled to claim and claims had been restricted accordingly
- adding any amount of excess relief charged on the occasion of any previous agreement or amendment to an agreement

the result is greater than zero.

21. Excess relief will be

- treated as a trading receipt of the trade in the period of account in which the agreement or later agreement is made; and
- treated as expenditure incurred, for the purposes of section 40B, 15 years and 1 day after the date the agreement is made;

so relief for expenditure is deferred rather than lost permanently.

III AVOIDANCE USING “EXITS” BY COMPANIES THAT HAVE ACCESSED FILM TAX RELIEF

22. Some groups of companies are making use of schemes ("exit schemes") intended to convert the deferral of tax offered by special tax reliefs for films into a permanent tax advantage. The government proposes to introduce legislation in the next Finance Bill, with effect from 2 December 2004, to counter these schemes. A measure was introduced to prevent exits by individuals at sections 119 to 123 of the 2004 Finance Act.

Background

23. Legislation provides for capital expenditure on the production or acquisition of the master version of a film to be treated as revenue expenditure. It also provides detailed rules as to when that expenditure may be relieved for tax purposes. The main provisions are sections 40A to 43 Finance (No.2) Act 1992 and section 48 Finance (No.2) Act 1997.

24. Financing in the film industry often relies on an early sale of a film and its lease back to the producer. This allows film makers early access to the benefit of the tax reliefs. The lessor gets an accelerated tax deduction followed by taxable income from the lease or other payments.

25. However, in some cases the accelerated relief is used effectively (for example, by way of group relief within a group) and then the rights to the future income are transferred out of the group so in effect the deferred tax is not paid.

Details of proposed legislation

26. The legislation will apply, with effect on and after 2 December 2004, to any company (the "film rights company") that:

- is a 75% subsidiary, as defined by section 838(1)(a) of the Income and Corporation Taxes Act 1988 ("ICTA"), of the principal company of a group; and

- owns rights under an agreement (the “film rights agreement”) to a guaranteed amount of income arising from a film on which relief has at any time been claimed (either by the film rights company or another company) for production or acquisition expenditure under section 42 or section 48.
27. The legislation will provide that an agreement guarantees a company an amount of income if the agreement, or any part of it, is designed to secure the receipt by the company of that amount (or at least that amount) of income.
28. The legislation will also provide that for this purpose the principal company of a group is the company of which the film rights company is a 75% subsidiary and:
- to which the film rights company would be able to surrender trading losses (were it to incur such losses) by way of a group claim to group relief under section 402 of ICTA; and
 - which is not itself a 75% subsidiary of any other company to which the film rights company could surrender trading losses by such a claim to group relief.
29. The legislation will then provide that where a film rights company ceases to be a 75% subsidiary of the company which, immediately prior to the cessation, was the principal company of the group (“exits”):
- its accounting period for the purposes of corporation tax ceases, and a new one begins;
 - the film rights company will be required to bring into account in the accounting period which ends immediately prior to its exit, a trading receipt, as if it was a receipt of income in respect of the film rights, equal to the film rights value; and
 - the film rights company will be deemed for the accounting period immediately following the exit to have trading losses brought forward under section 393(1) of ICTA from the preceding accounting period equal to the film rights value (in addition to any other losses brought forward).
30. The legislation will provide for the film rights value of a film to be found from the future receipts from the film rights agreement which would (before any deduction) count as income for tax purposes, computing the value in accordance with generally accepted accounting practice.
31. The legislation will also provide that if:
- a film rights company disposes of any rights under an agreement to a guaranteed amount of income arising from a film, whether alone or as part of a larger disposal;

- that disposal is to a person that is not a 75% subsidiary of the group principal company; and
- the trading income received by the company for the disposal of the rights to income from the film is less than the film rights value,

then

- the film rights company will be required to bring into account in the accounting period in which the disposal is made, as a trading receipt in respect of the film, the amount by which the film rights value exceeds the amount actually received as trading income for the disposal (“the rights shortfall”); and
 - if the person acquiring the rights to income from the film is a company, it will be entitled to deduct as an expense of its trade an amount equal to the rights shortfall.
32. The amounts received as trading income by the film rights company will include for this purpose any consideration for the disposal of the rights to income from the film which are treated for tax purposes as trading income other than amounts so treated solely by virtue of the new provisions.
 33. Where the film rights company or any branch of that company ceases to be within the charge to corporation tax it will be deemed to have received an amount of trading income equal to the film rights value.
 34. These provisions will have effect in relation to exits (see paragraph 29) and disposals (see paragraph 31) on or after 2 December 2004.

IV. INDIVIDUALS IN PARTNERSHIP: RESTRICTION OF LOSS RELIEF

35. Various recent schemes seek to avoid legislation which restricts the amount of loss relief that can be claimed by individuals who are trading in partnership. The government proposes to introduce legislation in the next Finance Bill which will have effect from 2 December 2004 to prevent partners obtaining sideways loss relief in excess of their capital contributions to the trade for which they are and remain fully at risk. The Inland Revenue will continue to challenge schemes which do not succeed on the basis of the current law.

Background

36. Where individuals incur trading losses from a trade they carry on (alone or in partnership) they may be able to set the losses against other income and capital gains. But limited partners, members of a limited liability partnership and other partners who on average spend less than 10 hours per week actively carrying on the trade are broadly restricted to relief which is no more than the capital they

actually contribute to the trade. Some seek to avoid these restrictions by, for example, the use of limited or non-recourse loans to provide an amount which counts as capital contributed but which is not in practice at risk in the way of ordinary capital.

Details of the proposed legislation

37. First, the legislation will provide additional restrictions on the amount of trading losses that some partners can set against their other income or gains.
38. The additional provisions will apply to the amounts a relevant partner may claim as relief for trading losses under:
 - section 380 ICTA 1988 – relief for trading losses against general income of the same or the preceding year of assessment
 - section 381 ICTA 1988 – relief for trading losses incurred in the early years of trade
 - section 72 Finance Act 1991 – trading losses relieved against capital gains.

These are collectively referred to below as “relevant loss relief”.

39. A relevant partner for this purpose will be an individual who, on or after 2 December 2004, is:
 - a limited partner (as defined in Section 117 ICTA 1988)
 - a member of a limited liability partnership
 - a general partner who does not spend a significant amount of time in running the trade (as defined in Section 118ZE and 118ZH ICTA 1988).
40. The provisions will apply to:
 - any individual who becomes a relevant partner on or after 2 Dec 2004 in respect of all trading losses that are allocated to him by the partnership of which he is a relevant partner; and
 - any individual who was a relevant partner on and before 2 Dec 2004 in respect of all trading losses that are allocated to him by the partnership of which he is a relevant partner, less that partner’s share of the pre-commencement trading losses.
41. For this purpose:

- the pre-commencement trading losses of the partnership will be the trading losses (if any) arising for any period (starting with the end of the last period of account of the partnership or the date that trading commenced if later) up to 1 December 2004, and will be computed as if that date were the end of a period of account
 - the relevant partner's share of the pre-commencement losses will be the share of those losses specified in the partnership agreement existing at that date.
42. The provisions will ensure that a relevant partner's contribution to a trade, as it applies in s117(3), s118ZC(2) and s118ZG(1) ICTA 1988, will exclude any part of the amounts contributed to the extent that an agreement or arrangement exists under which the cost of providing those amounts is or could be borne by another person. Note that "another person" could be any partnership, whether or not the relevant partner is a partner of that partnership.
43. For the purposes of these provisions any individual who claims, or has claimed, relevant loss relief in respect of any period in which he or she was a relevant partner of a partnership, will be treated as if he or she were still a relevant partner, even if he or she has ceased to be so, and whether or not that partnership has ceased to exist or to carry on a trade; and all references to a relevant partner in this note should be read accordingly.
44. Provision will also be made to deal with circumstances where, at any time on or after 2 December 2004 (the "later time") after a relevant partner has made a capital contribution to a trade, the cost of providing any part (the relevant part) of the relevant partner's capital contribution to the trade, is borne by another person. The following rules will apply:
- where the relevant partner has not received relevant loss relief (either because no claim to relevant loss relief has been made or such a claim has been made and the claim can be amended) then the relevant partner's capital contribution to the trade will exclude the relevant part;
 - where the relevant partner has benefited from relevant loss relief then a reduced capital contribution to the trade ("reduced contribution") will be calculated by excluding the relevant part from the relevant partner's capital contribution to the trade. The relevant partner will then be deemed to have received an amount of income, chargeable to tax under Case VI Schedule D, at the *later time* equal to the amount by which the relevant loss relief exceeds the reduced contribution.
45. If a relevant partner borrowed (by any form of credit) in order to enable the partner to make a capital contribution to the trade and, if over any period of five years, the costs incurred by the relevant partner on that loan (or any loan that replaces that loan or is used to repay that loan) are not substantially the same as

the costs on a loan on ordinary commercial terms, then a part, equal to the outstanding amount of that loan, will be deemed to have been borne by another person at a *later time*. A later time for this purpose is the end of the period of five years referred to above. But this will not apply where a partner has not borne the ordinary commercial costs of that loan on account of his inability to pay.,

46. Second, further provisions will be made, in addition to those introduced in the Finance Act 2004, for individuals who have made film related losses (as referred to in section 119(1)(a) of that Act) sustained by them in a trade carried on in partnership.
47. These provisions will apply to contributions made on or after 2 December 2004 and to agreements and arrangements made after that date in respect of contributions made earlier. They will provide that:
 - an individual's capital contribution to the trade (as defined in section 121 Finance Act) will exclude any amount to the extent that an agreement or arrangement exists under which the cost of providing those amounts is or could be borne by another person;
 - where an individual borrowed (by any form of credit) in order to enable the individual to make a capital contribution to the trade and, over any period of five years, the costs incurred by the individual on that loan (or any loan that replaces that loan, or is used to repay that loan) are not substantially the same as the costs on a loan on ordinary commercial terms, then a part, equal to the outstanding amount of that loan, will be deemed to have been borne by another person at the end of the period of five years. But this will not apply where an individual has not borne the ordinary commercial costs of that loan on account of his inability to pay.
48. The proposed legislation will not have effect in relation to any part of an individual's capital contribution to the trade which is borne by another person in the normal course of that individual's domestic, family or personal relationships.

References in this note to a "film" should be read to include a tape or disc unless the context requires otherwise.

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