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## REGULATORY IMPACT ASSESSMENT FOR REFORM OF FILM TAX INCENTIVES

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### PROMOTING THE SUSTAINABLE PRODUCTION OF CULTURALLY BRITISH FILMS

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#### Introduction

**3.1** This final Regulatory Impact Assessment (RIA) updates the partial RIA published on 29 July 2005.

**3.2** In Budget 2005, the Government announced its intention to replace the current structure of tax relief with a new tax relief model. Introducing new relief for the production of qualifying UK films, and removing previous reliefs Section 42 of the Finance (No.2) Act 1992 and Section 48 of the Finance (No.2) Act 1997 (S42 and S48).

**3.3** A consultation document was published in July 2005, alongside draft legislation and explanatory notes. A further announcement on the value of the new reliefs was made at the Pre-Budget Report on 5 December 2005.

**3.4** Further information on film tax relief is available at <http://www.hmrc.gov.uk/films>.

#### Purpose and Intended Effect

##### *The Policy Objectives*

**3.5** The core aim of the new film tax relief is to promote the sustainable production of culturally British films. Within that, the new reliefs are designed to deliver a number of related objectives:

- promoting the production of films that might not otherwise be made; in particular, ensuring higher levels of support for low budget films;
- ensuring better value for money for taxpayers and for film producers through direct provision of benefit, without leakage of support, to filmmakers themselves;
- removing the need to access the relief through intermediaries to ensure easier, direct access to reliefs;
- removing distortions caused by the current reliefs by reducing avoidance risk and stabilising investment levels;
- ensuring greater flexibility for filmmakers in an increasingly global industry;
- ensuring sustainable production by creating closer links between Exchequer support for cultural film production and maintaining a critical mass of infrastructure, creative and technical expertise;
- ensuring better coherence by providing that the tax relief is targeted on its intended objective and directly influences decisions about the location of film making activity; and

- ensuring that the structure of the tax relief fits within the industry's financing model, but also encourages a behavioural shift towards more stable and sustained levels of investment.

### ***Background***

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

**3.7** While S42 ('large budget tax relief') was not time limited, S48 ('low budget tax relief') was introduced as a temporary measure, and was originally due to expire in 2000. It has since been extended on three occasions by Parliament and is now due to expire on 31 March 2006. Both reliefs aim to give support to the British film industry, but in recent years they have been the target of aggressive tax avoidance activity.

**3.8** In Budget 2005, the Chancellor announced that the current relief for low budget films, originally due to be replaced in July 2005, would be extended in recognition of the film industry's uncertainty about how the new relief would operate in practice. The Budget also announced a review of the current relief for large budget films, having concluded that it was no longer an effective means of delivering Government objectives for promoting a sustainable UK film industry.

**3.9** The outgoing films tax regime, as well as providing relief on film production costs, also allows relief on the acquisition of a film by third parties from a producer and has been the source of significant avoidance activity. The new film tax incentives are aimed directly at film production companies to ensure that the incentives are targeted where they are most effective in encouraging film production, whilst ensuring value for money for the British taxpayer.

### ***Rationale for Government Intervention***

#### ***Removing S42 and S48 and introducing new reliefs***

**3.10** The existing reliefs are an inefficient means of supporting the production of culturally British films and are particularly prone to leakage – allowing much of their value to go to financial intermediaries and other third parties, rather than film producers. Under the current arrangements, producers are forced to use complex sale and leaseback financial structures to access the benefits of the relief.

**3.11** S42 and S48, in addition to delivering an inefficient incentive, are also a rich source of tax-avoidance opportunities. Retaining the current reliefs would necessitate further and continuing anti-avoidance legislation, making the existing regime increasingly unstable and uncertain for film producers.

**3.12** The Government has stated its desire to continue support for film production in the UK, but considers that the existing arrangements deliver poor value for money for UK taxpayers and inefficient support for film producers. The new reliefs will deliver Exchequer assistance in a more efficient vehicle that better supports the sustainable production of culturally British films by targeting relief directly at producers.

### ***Outline of new scheme***

**3.13** The new reliefs will be provided directly to filmmakers themselves and will apply to films that are certified as culturally British, under a new test administered by the Department of Culture, Media and Sport (DCMS). Qualifying films must spend a minimum of 25% of their total production expenditure in the UK. Enhanced relief is available on up to 80% of the total qualifying production expenditure (comprising pre-production, principle photography and post-production).

**3.14** For qualifying films costing up to £20 million:

- An enhanced deduction of 100%; and
- A payable tax credit at a level of 25%.

**3.15** For all other qualifying films:

- An enhanced deduction of 80%; and
- A payable tax credit at a level of 20%.

## **Consultation**

### ***Within Government***

**3.16** HM Treasury, HM Revenue & Customs (HMRC), DCMS and The UK Film Council have worked together closely on these proposals from the outset.

### ***Public Consultation***

**3.17** HM Treasury and HMRC have been consulting with the film industry and other interested parties on the reform of film tax relief since September 2004, when consultation began on a new low-budget film tax relief to replace the S48 tax relief. Full consultation on a replacement structure for both S42 and S48 was announced in Budget 2005 and formal consultation began with the publication of a consultation document, draft legislation and explanatory notes on 29 July 2005.

**3.18** Over the 12-week consultation period, HM Treasury, HMRC and DCMS held a series of formal and informal consultative meetings with the industry and other related parties. 52 written responses were received and several respondents have continued to engage in informal discussions on the detail of the new relief. The Government has welcomed the comments received during this consultative period.

## **Options**

### ***1. Make S48 permanent and leave S42 in place***

**3.19** A continuation of the current reliefs was considered and rejected by HM Treasury in a review last year. The current reliefs have succeeded in increasing investment in UK film production, but while an extension of the current reliefs would maintain support for film production, the review found overwhelming evidence to support reform of the existing reliefs.

**3.20** The main findings of the analysis, supplemented by a series of discussions with the film industry, were that the existing film tax reliefs were not effective in meeting the Government's objectives for film policy. The existing reliefs provide poor value-for-

money for the taxpaying public: they are inefficient and a large proportion of their value leaks to financial intermediaries. In addition, they have provided a rich source of tax avoidance opportunities, in part due to the opaque sale and leaseback structures required by film producers to access the value of the relief. Extending the current reliefs would require significant resource within HMRC to monitor and tackle the avoidance risk effectively.

**3.21** Tax avoidance activity through the existing reliefs has also created a certain amount of unwelcome market distortion. While 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 tax 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.

**3.22** Finally, the application of the current reliefs to worldwide expenditure can also have a distortive effect. It can actually act as a disincentive to spend money in the UK, particularly where incentives from other jurisdictions are available. To achieve the Government's objectives, any film tax relief must reverse this situation.

## ***2. Allow S48 to expire and leave S42 in place***

**3.23** This option would mean that S42 would be the only tax incentive available to any qualifying film. In view of the conclusions on option 1 (above) this would fail to meet the Government's objective to support film production.

## ***3. Extend the grant system***

**3.24** There are a number of reasons why support for films is not supplied entirely through direct subsidy. The Government's strategy is to provide support through a combination of direct subsidy and support through tax reliefs.

**3.25** Grant funding for film production is allocated on a film-by-film basis and requires subjective judgement to be applied. The grant funding mechanism plays an important role in encouraging specific films to be produced. Particularly, where the film production market would not otherwise support the production of a film. Grant funding is therefore most successful in promoting the production of less commercial films.

**3.26** However, while direct subsidy can be useful in encouraging activity that the market would not otherwise perform, the direct involvement of Government is not always suitable. Tax relief has the advantage of directing Government support entirely within a market-based mechanism, allowing the market to make objective decisions about film production while influencing decisions at the margins.

**3.27** In this way, tax relief is well suited to allowing film production companies to capture the wider spill over benefits to society that stem from the production of culturally British films. While grants can only support a small, targeted number of films, tax relief can provide support for a much wider number of films at lower administrative cost, allowing the production of culturally British films that, without tax relief, would be marginally unviable and promoting the sustainability of the British film industry

#### ***4. Remove all tax relief for film production***

**3.28** Film production is a global industry, with location decisions influenced, amongst other factors, by the generosity of state support. The availability of Government support is therefore an important factor in investment decisions, particularly where it can reduce the costs of producing in a high-cost environment such as the UK.

**3.29** While the end of film tax relief would have the immediate benefit of removing a key source of avoidance and uncertainty in the tax system, it would also carry a significant social and cultural cost. In the absence of any enhanced tax relief, film production companies would not be able to capture any of the wider spillover benefits to society that stem from their production of culturally British films. Given this, films of significant cultural value but that might be marginally commercially unviable would not be made in the absence of tax relief.

**3.30** Beyond this, the removal of all tax relief would have significant impacts on sustainability of a critical mass of film production infrastructure in the UK. This is especially so given the global nature of the film industry, with location decisions influenced, amongst other factors, by the generosity of state support. In the absence of UK tax relief, cost savings abroad from cheaper labour and from similar tax incentives may encourage UK film producers to produce films outside the UK and there would be an associated drop in inward investment.

**3.31** The loss of tax incentives would therefore place in jeopardy the UK's 'critical mass' of key film production infrastructure and skills and would discourage the production of culturally British films in the UK. As a further consequence, film producers may seek to rely more heavily on alternative sources of public subsidy, including lottery funding.

#### ***5. Replace both existing reliefs with a new model targeted at producers***

**3.32** The chosen option is therefore to introduce a reformed system of film tax reliefs, targeting support directly to producers. The new reliefs will provide more generous relief, with the minimum of leakage to third parties. In conjunction with a new cultural test, they will incentivise the production of culturally British films, contributing towards a 'critical mass' of key infrastructure and skills and safeguarding the sustainable production of culturally British films.

### **Costs and Benefits**

#### ***Sectors and Groups Affected***

##### ***Film Makers and Film Practitioners***

**3.33** The new film tax reliefs will be claimed directly by the film production company, without the need for complex sale and leaseback financial structures. With no leakage to third parties, the reliefs will deliver more generous support to film production, with a lower overall cost to the Exchequer.

**3.34** The new reliefs will support a wide range of activities encompassing the full range of film production, including pre-production, principle photography and post-production. They will provide an additional incentive to perform activities that, at

present, are often not performed in the UK because of cost constraints. They will also be more effective in building a critical mass of film production infrastructure, supporting a wider range of creative and technical skills in the UK.

**3.35** The relief makes no distinction between inward investors or indigenous producers, but the relief will be maximised when 80% of the total spend on a film is spent in the UK, incentivising the use of UK facilities and creative skills in filmmaking.

### ***Individuals and Partnerships***

**3.36** The new relief will only be available to film production companies. Individuals and partnerships will no longer be able to get relief for film acquisition costs for tax purposes. Film producers are free to form a film production company to benefit from the new reliefs. It is not therefore anticipated that a restriction to film production companies will negatively impact film production.

### ***Co-Producers***

**3.37** The new reliefs will apply across the board to both wholly UK-based productions and co-productions with other countries. There is no explicit distinction. At present, the arrangements permit tax relief on the worldwide spend for a co-production. In many cases, this incentivises film production abroad, and does not reconcile with the Government's objective to create a critical mass of infrastructure and skills within the UK. The structure of the new reliefs means that films of this type will naturally receive less Government support than under the previous relief. Furthermore, it is an explicit objective of the new relief to encourage a behavioural shift to bring future film production activity to the UK.

**3.38** The Government does however recognise the cultural and economic benefits of co-productions and has taken steps to ensure that genuine co-production activity can continue to benefit from the new reliefs. Film producers are required to spend a minimum of 25% of the film's total budget in the UK. This threshold has been set to permit bi-lateral and multi-lateral film production to continue with tax relief – while excluding film production that only uses a minimal amount of UK skills and infrastructure. There are also additional avenues for Government support, including lottery funding.

### ***Financiers***

**3.39** The new proposals are designed specifically to exclude financiers and other intermediaries from accessing incentives intended for film production. They will therefore be unable to exploit opportunities for tax avoidance using film reliefs.

### ***Voluntary Organisations and Charities***

**3.40** No related impacts on these organisations have been identified.

### ***Equality Impacts including Race and Northern Ireland***

**3.41** No adverse equality impacts have been identified.

**3.42** As a tax-based incentive the new reliefs are available across the UK, including Northern Ireland. No specific impact in Northern Ireland is anticipated.

## *Human Rights Issues*

**3.43** None have been identified.

## **Benefits**

**3.44** The benefits of removing the S42 and S48 reliefs and replacing them with a new regime are numerous. They can be broadly summarised as:

- Better-targeted support, directly to filmmakers, with the minimum of leakage to financial intermediaries and other third parties. This will permit more generous levels of support for film production and a lower overall cost to the Exchequer.
- In conjunction with the new 'cultural test', administered by DCMS, the new reliefs give more effective support for the sustainable production of culturally British films.
- Increased levels of investment, from both domestic and foreign investors, fostering a sustainable market for film production in the UK with an incentive to retain the profits of filmmaking in the UK – and creating a critical mass in infrastructure and creative and technical skills.
- A reduction in films tax relief-related tax avoidance, bringing with it an associated reduction in the need for anti-avoidance legislation and greater stability in the films-relief structure.

## **Costs**

### *Exchequer*

**3.45** The new film tax relief is estimated to cost £20 million in 2006-07 rising to around £120 million a year thereafter. Taking account of the savings from expected costs of the film tax reliefs being replaced, the total Exchequer effect is estimated to be +£30 million in 2006-07, -£20 million in 2007-08 and +£20 million in 2008-09.

### *Administrative Costs*

**3.46** Claims for the new relief and for the payable tax credit will be embedded in the computation of taxable profits or losses. Discussions with the industry confirm that film-makers maintain and organise records in a way that facilitates extraction of information (for instance that expenditure relates to services performed in the UK) needed to make the claim. This minimises the additional administrative costs to business in claiming this valuable relief.

**3.47** The new reliefs will be similar in operation to enhanced reliefs and payable tax credits available for expenditure on qualifying Research & Development. This provides an administrative model, and existing processes, that will minimise additional costs for HMRC. It is envisaged that necessary modifications to forms and guidance will be handled within the normal baseline for the annual review and updating of these forms and systems.

### ***Social Impacts and Influences***

**3.48** The new tax relief is available for the costs of producing culturally British films. We anticipate beneficial social impacts through the production of a higher volume of films reflecting the UK's diverse history, cultural beliefs and shared values.

### ***Environmental Impacts***

**3.49** No direct impacts have been identified.

### **Small Firms Impact Test**

**3.50** The new reliefs apply to all film production companies, regardless of size. Analysis shows that the standard model of film production is to bring packages of creative and technical skills together to work together on a particular project. Most films are therefore made through a special purpose vehicle, which is used once for a particular film. On this basis, no specific or disproportionate impact on smaller firms is anticipated.

### **Competition Assessment**

**3.51** Analysis shows the new regime will not have any adverse impact on competition within the film industry. It is designed to apply equally to all qualifying film production companies.

**3.52** The proposed relief has been formally notified to the European Commission to ensure that it meets the criteria for a State Aid and is fully compatible with the Commission's rules on competition within the European Union.

### **Enforcement, Sanctions and Monitoring**

#### ***Enforcement***

**3.53** The new rules will be enforced as part of HMRC's existing processes for ensuring compliance with the tax system. Claims for the new relief will be embedded in the normal return of Corporation Tax profits or losses, and claim for payable tax credits. It is expected that the majority of claims will be by companies specially set to produce a named film in line with normal industry practice. Such returns including film related claims will be channelled to designated officers familiar with the industry and the specialist legislation. These specialist officers will form a virtual network able to exchange information and best practice and will be led by experienced officers in HMRC's Large Business Service working with the media sector.

#### ***Sanctions***

**3.54** The new relief enables ongoing projects to access relief on the basis that their plans for film production will be followed across a number of accounting periods. While there will be mechanisms to allow adjustment of relief and payable tax credits, including their recovery where conditions are breached, the current sanctions and penalties in the existing tax regime will apply equally to the new film tax reliefs. There are no additional sanctions for the new reliefs.

### ***Monitoring and Evaluation***

**3.55** Claims for the new film tax relief will be identified in the production company's self-assessment tax return. This information will allow claims for relief and the associated costs to be monitored on a regular basis. The new film tax relief will also be evaluated over time to assess its performance against its wider objectives, and so allow a judgement to be formed on the effectiveness of the relief in light of its costs.

### ***Implementation and Delivery Plan***

**3.56** Discussions with the industry indicate that conventional management information systems used by the industry will provide the necessary information to enable claims for the new relief to be made as part of the normal process of submitting the statutory Corporation Tax return. The records needed to support claims to the new relief and if appropriate to the payable tax credit will be the same as are currently required to support the computation of profits and management records supporting the location of the services supplied required to identify expenditure on services within the UK for calculation of the enhancement.

**3.57** The new relief is a State aid and, subject to the Commission's approval the new regime will apply to new films, those beginning principle photography after 1 April 2006 where the theoretical earliest date for the return would be 9 months thereafter and, in practice returns for the initial accounting period for which the new relief will be available are expected up to 12 months after that. Draft public guidance on the operation of the new legislation will be made available by October 2006, 3 months before the deadline for the earliest statutory return of film production company within the new relief.

### ***Post-Implementation Review***

**3.58** In due course HMRC will undertake a review of the figures in this RIA in Standard Cost Methodology terms, and a separate compliance cost review will take place within 12 to 24 months following implementation.

### ***Summary and Recommendation***

**3.59** In summary, the new film tax reliefs will be a more effective, efficient and valuable replacement for the current reliefs. They will target support directly to film producers, with less leakage to financiers and other third-parties and substantially fewer tax avoidance opportunities. They will permit a more generous and stable regime with less overall Exchequer cost.

**3.60** In conjunction with the new cultural test, administered by DCMS, the new reliefs will provide a valuable incentive for the sustainable production of culturally British films, providing the necessary support to ensure a critical mass in key infrastructure and skills in film production in the UK.

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## REGULATORY IMPACT ASSESSMENT

### Reform of Film Tax Incentives: Promoting the Sustainable Production of Culturally British Films

#### Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

Dawn Primarolo  
Paymaster General

Dated: 15 March 2006