

SUMMARY OF THE NEW UK FILM TAX RELIEF AND THE NEW CULTURAL TEST

A NEW TAX RELIEF

1. Introduction

On 1 January 2007 the legislation in the Finance Act 2006 ("**Finance Act**") relating to the new tax credit for the British film industry finally came into force. Replacing both section 48 and section 42, the new regime is intended to deliver the tax benefit more efficiently by making it available directly to the film makers and by removing the need to access the relief through intermediaries, thereby reducing leakage. It is also intended by the Government to assist in the building of a sustainable local production industry and to maintain a critical mass of infrastructure to support that industry.

The new relief is available for films commencing principal photography on or after 1 January 2007. As there was a hiatus between the ending of the old reliefs and the introduction of the new relief there are transitional provisions for those films which commenced principal photography before 1 January 2007 and are not completed by that date and these are outlined in more detail below.

2. Details of the new tax relief

2.1 Only available to film production companies ("FPC")

The new relief is only available to FPCs within the charge to UK corporation tax – it is claimed through the company's corporation tax return. Partnerships or individuals will not be able to claim relief.

An FPC is the company responsible for the pre-production, principal photography and post-production of the film and for delivery of the completed film. However for films that began principal photography before 1 April 2006 the FPC does not need to be responsible for, or actively involved in, the pre-production of the film.

The FPC must have an active involvement in production planning and the decision making process during these various stages of production and directly negotiate, contract and pay for rights, goods and services in relation to the film. This does not mean that the FPC must be directly responsible for every aspect of every one of these activities nor that it cannot commission a third party to undertake some of these activities on its behalf. However, it cannot entirely relinquish its involvement in any activities. A company whose participation in a film is restricted to providing or arranging finance for film production activity will not qualify for the tax relief. Importantly, there is no requirement for the FPC to own the master negative or other film rights.

In relation to qualifying co-productions (ie a film that is treated as a British film by virtue of being produced pursuant to an international co-production treaty between the UK and one or more other states) ("**Qualifying Co-Production**"), the requirements which a company must meet to be treated as an FPC are relaxed. A UK co-producer is not required to meet all the conditions for an FPC set out above and instead is only required to make an effective creative, technical and artistic contribution to the film. In other words, financial only co-producers will not be able to claim tax relief.

There can only be one FPC in relation to a film. If there is more than one company within the charge to UK corporation tax (including through a UK branch of a foreign company) that is involved in all aspects of the production process, then it is the company that is most directly involved in those activities that qualifies as the FPC.

2.2 Only available to films intended for theatrical release

As with section 48 and section 42, the relief is only available for films that are genuinely intended for theatrical release. Theatrical release means exhibition to the paying public at the commercial cinema and a film is only regarded as intended for theatrical release if it is intended that a significant proportion of the earnings of the film should be obtained by such exhibition. For the condition to be met, the intention to theatrically release the film must be held at the end of each accounting period of the FPC during which filmmaking activities are carried on. If at the end of an accounting period the film is not intended for theatrical release, the condition is not met for that period or any subsequent accounting period but the FPC is still entitled to relief in the earlier accounting periods for which the condition was met. A film does not need to actually be theatrically released in order to access the credit and HM Revenue & Customs ("**HMRC**") has issued guidance as to when a film will be regarded as being intended for theatrical release. It will be so regarded where it meets the following conditions:

- the film is a full length or "short" feature film of a type commonly shown at cinemas;
- the film is made in a format suitable for theatrical showing at the commercial cinema;
- it can be demonstrated, at the end of the relevant accounting period, that there was an intention to seek a contract to present the film in the cinema;
- the income from the theatrical release is not negligible in terms of the film's total anticipated income.

2.3 Only available to British Films

To qualify for the new tax relief, a film must be certified as a British film either under Schedule 1 to the Films Act 1985 or as a Qualifying Co-Production. Schedule 1 was revised with effect from 1 April 2006 to include a new cultural test (the "**First Cultural Test**") and this cultural test was further revised with effect from 1 January 2007 (the "**Final Cultural Test**"). Further details of the cultural tests and the revised Schedule 1 are set out in the second section of this note.

On 1 April 2007 UK Film Council ("**UKFC**") replaced the Department for Media, Culture and Sport ("**DCMS**") as the entity responsible for certifying whether a film is British. All applications for films that started principal photography on or after 1 January 2007 should now be sent directly to UKFC and marked for the attention of the Certification Unit. However for films that started principal photography prior to 1 January 2007, applications should still be sent to the DCMS.

2.4 Minimum UK expenditure requirement

For a film to qualify for the new tax relief, not less than 25% of the core expenditure incurred by the FPC or, in the case of a Qualifying Co-Production, all the co-producers must be UK expenditure.

2.5 Only available on core expenditure which is UK expenditure

Unlike section 48 and section 42 which could be claimed in respect of the whole budget of a film (subject to certain exclusions) the relief can only be claimed on so much of the FPC's core expenditure that is UK expenditure up to a maximum of 80% of the FPC's core expenditure (the "**Qualifying Expenditure**"). As the tax relief is calculated on the basis of the FPC's core expenditure, the maximum amount of core expenditure which will qualify for relief in the case of a Qualifying Co-Production, is 80% of the core expenditure incurred by the UK co-producer only (assuming the UK co-producer qualifies as the FPC). It will be essential that the UK co-producer incurs the costs of all services provided in the UK to ensure that it obtains the maximum benefit.

2.6 Meaning of core expenditure and UK expenditure

"Core expenditure" means expenditure on activities involved in pre-production, principal photography and post-production of a film but excludes expenditure on development and distribution and also the costs of raising and servicing finance. HMRC has provided guidance on how to distinguish between development and pre-production expenditure. Development expenditure is speculative in nature and undertaken with the aim of determining whether a film is a commercially feasible project. Pre-production expenditure is in essence purposive and is incurred on those activities undertaken in the knowledge that a decision has been taken for the film to go ahead.

The exclusion of development costs from core expenditure initially caused concern amongst the UK production community who felt that certain costs incurred during development, such as script costs, should properly attract the new tax relief. However, the "used and consumed" test (see below) has partially allayed these concerns in that it can permit a portion of the costs of acquisition of a script to qualify for the relief.

HMRC has also confirmed that the cost of acquiring any underlying rights, such as the right to use a story or a book as the basis of a film can also qualify as core expenditure but expenditure on wider rights beyond what is needed to make the film, for example the right to use and exploit characters which appear in the story or book or other ancillary rights, will not. However, while the actual purchase of the rights necessary to make a film is core expenditure, a payment for an option over such rights is not as it is speculative development expenditure.

Deferments and participations will qualify as core expenditure if they are the subject of an unconditional obligation to pay and have been paid within four months of the end of the period of account in respect of which the tax relief is claimed.

"UK expenditure" means expenditure on services performed in the United Kingdom or goods "used or consumed" in the United Kingdom. The used and consumed test does not focus on the supplier of goods and services but instead concentrates on the recipient or customer of those goods and services as the means of determining UK expenditure. Application of the test is straightforward in the case of those services supplied in relation to principal photography because it is clear where they are used or consumed. For example, all costs paid to actors, directors and crew form part of UK expenditure where they relate to principal photography in the United Kingdom but do not form part of UK expenditure where they relate to principal photography overseas. The nationality or residence of the actors, directors or crew is irrelevant for the

purposes of determining UK expenditure. In other words fees paid to George Clooney for acting services in the UK will attract the relief.

In the case of services which do not involve or are not linked to principal photography (for example the services of composers and screenwriters) the application of the used or consumed test is more complicated because it is common for some of these services to be used or consumed in more than one way. For example, in the case of a scriptwriter, the script will be used during development for the preparation of the budget and production schedule, during pre-production and principal photography to give actors words to speak during rehearsals and shooting and during post-production if it is used for recording voiceovers. Expenditure on the script can be apportioned, on a fair and reasonable basis, between these different activities and, to the extent such activities take place in the UK, such expenditure will be UK expenditure. To the extent such expenditure is incurred during pre-production, principal photography and/or post-production it also qualifies as core expenditure and therefore for the new tax relief.

2.7 Two elements of the relief

There are two elements to the relief. First, the FPC is eligible for an enhanced deduction. The value of the enhancement (the "**Enhanced Losses**") is 100% of the Qualifying Expenditure for films with core expenditure of £20 million or less ("**Limited Budget Films**") and 80% of the Qualifying Expenditure for films with core expenditure in excess of £20 million ("**Bigger Budget Films**"). The costs of production of the Film incurred by the FPC (including on development) ("**Ordinary Losses**") will still be deductible under normal rules for film expenditure. The aggregate of the Enhanced Losses and the Ordinary Losses are referred to in this note as "**Total Losses**".

Second, the Total Losses can be used in two ways. The entire amount of the Total Losses can be set against income of the FPC or, alternatively, a portion of the Total Losses up to a maximum amount equal to the Qualifying Expenditure can be surrendered for a payable tax credit - the non-surrendered Total Losses can still be set against income of the FPC. For Limited Budget Films the payable tax credit is 25% of the Total Losses surrendered. For Bigger Budget Films the payable tax credit is 20% of the Total Losses surrendered. For reasons set out in paragraph 3 below, the FPC will usually surrender the Enhanced Losses before surrendering Ordinary Losses.

Assuming the maximum Total Losses are surrendered for the tax credit (ie an amount equal to the Qualifying Expenditure is surrendered), the benefit to a film of the new relief can be roughly summarised for Limited Budget Films as 25% of the Qualifying Expenditure up to a maximum of 20% of the core expenditure and for Bigger Budget Films as 20% of the Qualifying Expenditure up to a maximum of 16% of the core expenditure. See Appendices 1 and 2 for a calculation of how the benefit is calculated for Limited Budget and Bigger Budget Films and, in the case of Limited Budget Films where the UK expenditure is either 80% or 50% of the core expenditure.

2.8 Claiming of the tax credit during production

An FPC can, if it wishes, claim the tax relief in instalments at the end of each of its accounting periods during production of a film rather than only upon completion. This will be useful for animated films and films with substantial visual and special effects which may have long production and/or post production schedules. It may also be useful for cash flow purposes. Any

such claim must be accompanied by an interim British film certificate issued by UKFC (or the DCMS if the interim certificate relates to a film that started principal photography prior to 1 January 2007).

3. Taxation of Film Production Companies

3.1 New taxing regime

A new taxing regime has been introduced for FPCs by the Finance Act which gives rise to a number of interesting issues.

First, an FPC will be subject to tax on any income arising from a film which includes any "receipts" by the FPC in connection with the making or exploitation of the film. HMRC has made it clear that "receipts" does not include loans which would not normally be income in the hands of the company. In particular, a loan against the tax credit should not constitute a "receipt" for these purposes.

Second, for the purpose of determining profit or loss in any period, an FPC is required to bring into account a proportion of the total estimated income from a film treated as earned at the end of that period. That proportion is calculated by multiplying the estimated total income from the film by the amount of costs incurred (and reflected in work done) at the end of that period and dividing the resulting product by the estimated total cost of the film. In situations where the estimated cost of the film equals or is more than the estimated income from the film the company should not have a net tax liability. However, there is a concern that in situations where the estimated income from the film exceeds the estimated total costs this could potentially lead to a tax liability for (or less tax credit being received by) the FPC in a period prior to that in which the film is completed and prior to any income actually having been received. This potential liability could be avoided if an FPC is contracted to produce and deliver a film to a commissioning company in return for such company providing the finance of the film less the tax credit. In such cases, the income should be the cost of the film (including a production fee to the FPC) less the amount of the tax credit. However, producers may not all wish to adopt such an SPV structure, not least because it would prevent the FPC subsequently disclaiming part of the tax credit if that ultimately proved to be the better way to use the tax relief.

Total estimated income will be calculated in accordance with generally accepted accountancy principles and as such that income will not be taxed until it is actually earned. HMRC has also confirmed that the estimated income which needs to be brought into account for determining whether it has made a profit or loss in any given period should not include hypothetical, potential or predicted income. In other words a sale agent's estimates do not have to be brought into account.

3.2 Application of losses

The general principles on utilisation of both the Enhanced Losses and Ordinary Losses have been clarified in the Finance Act.

Whilst a film is in production, the Enhanced Losses and Ordinary Losses may only be carried forward and set off against the profits from the same trade, i.e. the same film (because under the new rules each film is treated as a separate trade for tax purposes).

Once a film is completed or abandoned then for all accounting periods during the continuation of the trade, Ordinary Losses are available in the usual way for set off against profits of the FPC in an earlier accounting period, in the same accounting period or by surrender against profits of other companies in the same group as the FPC in the same accounting period. However, the Enhanced Losses can only be carried forward to set off against further future profits of the trade.

Once the film trade ceases, any losses that remain in the FPC (generally the Enhanced Losses) may only be set off against profits from other films made by the same FPC or surrendered intra-group to set off against profits from another qualifying film provided that such company is an FPC (i.e. it has already commenced a new trade of making a British qualifying film) and provided in either case any such film is already in pre-production at least at the time the first film trade ceases. If this is not the case, such terminal losses will not be available for further use. This is unlikely to occur in most scenarios as the maximum Enhanced Losses will have generally been surrendered for the tax credit leaving no such terminal losses available to carry forward.

3.3 Transfer pricing

Unfortunately, HMRC have not yet provided specific guidance on transfer pricing (other than confirming that the usual transfer pricing policies apply). The level of benefit referred to above assumes (at least in the case of large budget films) that the film is sold for, or generates income equal to the production cost less the payable tax credit and without leaving any taxable profit in the FPC. In the case of a studio or other production where a wholly owned subsidiary is set up to make a film, if the transfer pricing rules impute or necessitate a higher sale or income figure or any element of profit for the production services the net benefit may be eroded. It appears that HMRC intend to leave it to tax advisers to advise on the arm's length price that should be applied for the SPV's production services.

However, we consider that the appropriate way to deal with transfer pricing is to sell the film for the production cost less the payable tax credit but leaving a small taxable profit as a production fee in the production entity (which reflects the fact that the FPC is merely commissioned to make the film and does not take any risk in connection with the film's financing).

4. Discounting or cash flowing the tax credit

Independent producers will be relying on a third party to cash flow the tax credit (which makes up an important part of their film budget).

Clearly, lenders are likely to discount the tax credit based upon the risk of the tax credit not being received. The fact that HMRC is entitled to withhold payment of the tax credit in the following circumstances will undoubtedly add to the uncertainty and risk and may influence the quantum of the discount:

- (i) the FPC's corporation tax return is under enquiry;
- (ii) where the FPC has an outstanding corporation tax, PAYE and NIC, or foreign entertainers tax liability.

Most lenders will want a film producer to establish an SPV to make its film for commercial and bankruptcy remote reasons. However, it will also be advantageous for a lender to insist upon an

SPV to try to minimise the risk of the tax credit not becoming payable (on the basis that an SPV is less likely to have tax liabilities).

The above issues will also be of concern to studios which will also want certainty that the tax credit (which they are cashflowing) will be paid.

5. Transitional provisions

For films that were completed on or before 31 December 2006 sale and leaseback transactions utilising sections 42 and 48 are still available provided that the sale and leaseback transaction is completed by 1 October 2007. As the new tax relief only applies to films commencing principal photography on or after 1 January 2007, there are transitional provisions to deal with films which started shooting before 1 January 2007 and are not completed by that date (**Overlapping Films**).

Overlapping Films will qualify either for the new tax relief or for a sale and leaseback transaction utilising section 42 (even if the budget is less than £15,000,000).

5.1 Overlapping Films qualifying for the new tax relief

An Overlapping Film will qualify for the new tax relief if:

- (i) it is certified as British either by passing the Final Cultural Test, being the test which came into effect on 1 January 2007, or it is a Qualifying Co-Production;
- (ii) it is intended for theatrical release on the first day of principal photography; and
- (iii) all the other relevant conditions set out in paragraph 2 above are met.

5.2 Overlapping Films qualifying for a sale and leaseback

A sale and leaseback transaction utilising section 42 only will be available to an Overlapping Film if:

- (i) an application for interim or final certification of the film as British has been made and such application has been refused (either because the film does not pass the Final Cultural Test or it is not a Qualifying Co-Production);
- (ii) the Overlapping Film passes the test set out in Schedule 1A of the Films Act 1985 (this is essentially the First Cultural Test which was later replaced by the Final Cultural Test);
- (iii) there is an intention to release the film theatrically (although this intention does not need to be held on the first day of principal photography);
- (iv) all the other relevant conditions required to claim section 42 relief are satisfied; and
- (v) the sale and leaseback transaction is completed by 31 March 2008.

If you have submitted an application form to the DCMS and certification has been refused because the Overlapping Film does not pass the Final Cultural Test then we understand that

there is no need to submit another application for the film to qualify under Schedule 1A as the DCMS will simply re-assess the same application.

B NEW CULTURAL TEST

1. Introduction

A film will only qualify for the new tax relief if it is a Qualifying Co-Production or if it satisfies a new cultural test. The new test has been introduced by way of a revision to Schedule 1 of the Films Act 1985 and replaces the old production expenditure, labour cost and maker tests. The archive footage test remains and is unaltered. In other words no more than 10% of the playing time of a film may include parts derived from any other film unless those parts (i) were made by the same FPC or producer; and (ii) have not been previously certified as a British film. The 10% limit only applies to visual images and not to sound and, as before, there is a discretion to waive this limit in the case of documentaries.

2. Points test

Subject to the "golden points" rule, a film will pass the cultural test if it is awarded 16 out of a possible 31 points. There are four categories of points covering cultural content, cultural contribution, cultural hubs and cultural practitioners attracting up to 16, 4, 3 and 8 points respectively all as set out in more detail in Appendix 3. Cultural content measures the British subject matter of the film, cultural contribution measures the contribution of the Film to British cultural diversity, cultural heritage and creativity, cultural hubs measures the use of UK's film making facilities and cultural practitioners measures the use of personnel with creative input. Points are awarded in the cultural practitioners category for both citizens and residents of both Britain and Member States of the European Economic Area. The "golden points rule" means that a film scoring all of the cultural hub and cultural practitioners points and all of the English language points in the cultural content category also have to score at least an additional two points (ie 17 points in total) in the cultural content category either because the lead characters are British citizens or resident or because the film is based on British subject matter or underlying material.

The legislation makes clear what has to be done and/or how much work has to be carried out in the UK any category to obtain the points available and how the points are allocated when more than one is available. The amount of work carried out in the UK or elsewhere is determined for the purpose of principal photography by the number of days spent on the work and for all other purposes by the reference to the amount of expenditure on the work.

In respect of the cultural contribution category the DCMS has issued guidance on what is meant by this and how points are awarded. In addition, UKFC has indicated that it will be flexible in awarding these points and invites film makers to make a case for how their films may contribute to cultural creativity, cultural heritage or cultural diversity.

3. Animation and documentaries

The Government recognises that animation and documentary films are made in a different way to live action fiction films and therefore points are awarded slightly differently for these genres. The legislation sets out the alternative cultural tests which apply to animations and documentaries.

These are not that different to the cultural test that applies to live action fiction films. In fact the only changes are to certain aspects of the cultural hubs and cultural practitioners categories and,

in the case of documentaries, the lead characters section of the cultural content category. For example, the heads of department which attract points for a live action feature film include the lead cinematographer, the lead production designer and the lead costume designer but for an animation will include lead layout supervisor and lead modelling supervisor and for a documentary will include lead cameraman and lead researcher. A documentary will be awarded points for participants rather than actors and cast and for research and development rather than visual effects. An animation receives points under the cultural hubs category for the shooting, layout and story boarding rather than the principal photography carried out in such studio.

4. Interim Certification

The revised Schedule 1 entitles FPCs to apply for an interim British film certificate before the film is completed so that it can obtain the new tax relief during production. This will be issued if UKFC is satisfied that the film, if completed in accordance with the proposals set out in the application, will be a British film. It may be given subject to conditions and may be expressed to expire after a specific period.

5. First formulation of the cultural test

The cultural test described above is the Final Cultural Test, being the second formulation of the cultural test and it applies to all films commencing principal photography on or after 1 January 2007. The First Cultural Test, which took effect from 1 April 2006, did not include the cultural contribution category or the "golden points" rule. Points were more heavily weighted towards the cultural hubs and cultural practitioners categories which had a larger number of sections and attracted 15 and 13 points respectively with only 4 available points in the cultural content category. The changes to the test were required by the European Commission as a condition of giving the State Aid approval of the new tax relief.

The First Cultural Test has now been largely reproduced in schedule 1A to the Films Act 1985 but schedule 1A is only relevant to certain Overlapping Films.

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Appendix 1

Large budget films: core expenditure of more than £20 million

| | |
|-----------------------|----------------------|
| Core expenditure | 100 |
| UK spend | 80 (max 80%) |
| Enhancement | 64 (80% x 80) |
| Total tax deductions | 164 |
| Surrender to treasury | (80) |
| Tax loss c/f | 84 |
| Tax credit @ 20% | 16 |
| Income, say | 84 |
| Tax loss b/f | 84 |
| Taxable profit | 0 |
| Net cash benefit | 16 |

Appendix 2

Low budget films: core expenditure of £20 million or less

| | | |
|-----------------------|----------------|----------------|
| Core expenditure | 100 | 100 |
| UK spend | 80 (max 80%) | 50 |
| Enhancement | 80 (100% x 80) | 50 (100% x 50) |
| Total tax deductions | 180 | 150 |
| Surrender to treasury | (80) | (50) |
| Tax loss c/f | 100 | 100 |
| Tax credit @ 25% | 20 | 12.5 |
| Income, say | 80 | 87.5 |
| Tax loss b/f | 100 | 100 |
| Taxable profit | 0 (-20) | 0 (-12.5) |
| Net cash benefit | 20 | 12.5 |

Appendix 3

Cultural test

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| <p>Cultural Content: 16 points</p> <p>Film is set in UK: up to 4 points</p> <p>Up to three characters are British: up to 4 points</p> <p>Based on British subject matter/ underlying material: up to 4 points</p> <p>Original dialogue in English language or regional/minority language: up to 4 points</p> | <p>Cultural contribution: 4 points</p> <p>Creative and innovative approach to film making: up to 2 points</p> <p>Contribution or reflection of British cultural heritage: up to 2 points</p> <p>Representation or reflection of British cultural diversity: up to 2 points</p> | <p>Cultural hubs: 3 points</p> <p>At least 50% of work on any of principal photography, visual effects or special effects: 2 points</p> <p>At least 50% of work on any of music recording, audio post-production or picture post-production: 1 point</p> | <p>Cultural practitioners: 8 points</p> <p>Director: 1 point</p> <p>Scriptwriter: 1 point</p> <p>Producer: 1 point</p> <p>Composer: 1 point</p> <p>At least one lead actor: 1 point</p> <p>At least 50% of cast: 1 point</p> <p>At least one Head of department: 1 point</p> <p>At least 50% of crew: 1 point</p> |
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