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Await DTI

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PRIME MINISTER

FILM INDUSTRY TAXATION

You asked for a joint DTI/Treasury note on the taxation of the film industry (David Barclay's letter of 29 May) which I now attach.

2. Last Thursday night, after the note had been completed, John Moore had to reply to a debate on the tax treatment of films in the Finance Bill Standing Committee. While he was careful not to prejudge your decision, he spoke broadly on the lines set out in the paragraphs reporting the views of Treasury Ministers. He reports that the debate generally went well and that Conservative backbenchers seemed satisfied with the explanations he had given and with his assurances about the action to be taken in the immediate future. He does not therefore expect any parliamentary difficulty on this issue at later stages of the Bill.

3. There is one point in the note which I think especially deserves to be drawn to your attention. You will see from paragraph 13 that the Treasury believe a concession to the film industry would be very difficult to contain. The publicity which last Thursday's debate received in the press has already stimulated comments. The Equipment Leasing Association in particular have stressed to Revenue officials that far more important industries (such as those in high technology) have accepted the change in the capital allowance regime, although adversely affected by it. They have therefore threatened that if any special treatment is provided for films, they will withdraw the support they have previously given to the Budget strategy and have suggested that a wide cross section of industry would react in the same way.

4. This view fits in closely with my own assessment. The Equipment Leasing Association represents a large proportion of the financial institutions. In view of the extent to which leasing is being curbed by our proposals, their support for the Budget strategy has not only been valuable in itself but may be taken as a good

indication of City opinion generally. I should be most concerned if that support were jeopardised.

5. I am copying this minute to Norman Tebbit.

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(N.L.)

12 June 1984

FILM INDUSTRY TAXATION

The central issue is whether there is a case for introducing tax rules for the film industry which are more favourable than those currently on offer.

2. Before the Budget the Department of Trade and Industry was in the course of preparing a White Paper on the film industry which would have announced the abolition of the statutory framework in which the industry operates. The proposals included the abolition of the Eady Levy. Ministers had already agreed to the inclusion of a Films Bill in the next session for this purpose.

3. The policy was based on two main assumptions:

(i) Films would continue to qualify for 100 per cent first year capital allowances (FYA's); and

(ii) The substitution for Eady Levy funding of voluntary private sector funding from within the film industry for limited defined purposes. This agreement was negotiated by Mr Baker who believes that it depends on the industry operating within a sympathetic tax regime.

4. Tax regime: Before 1979 expenditure on films was treated as a revenue expense. The normal procedure was for the tax inspector to agree a probable pattern of income for the film and apportion write-off accordingly. In 1979, a legal interpretation required expenditure on film making to be treated as capital investment, so qualifying for machinery and plant capital allowances. That meant that films attracted the 100 per cent first year investment incentive. This change was exploited, partly by people looking for a tax shelter and partly by American film companies using leasing through London in order to pick up our tax subsidy. The 1982 Finance Act (Section 72) brought in rules which applied the pre-1979 principles.

(These principles are on similar lines to accounting practice in the United States, where there is a formal accounting standard for the treatment of films). But British-made films were given a transitional period; eventually, capital allowances for these films were to be withdrawn in 1987.

5. However, the reform of corporate taxation in the 1984 Budget included the phased withdrawal of 100 per cent FYAs from the whole of industry, including film making.

FILM INDUSTRY'S CASE

6. The industry claims that loss of FYAs will have serious effects. They had hoped that by 1987 the Government would agree to extend the capital allowances indefinitely, or at least their continuation until 1987 to which they believe the Government were committed by a PQ in January 1983. The industry's immediate reaction to the Budget was to press for continuation of the 100 per cent allowances but it now recognises that this would not be compatible with the objectives of corporate tax reform. The industry proposes instead that expenditure be treated as a revenue expense, but with the Section 72 rules modified to allow earlier write-off of this expenditure. The proposals are to write-off 50 per cent of expenditure on delivery of the completed film, a further 25 per cent on first release, and the final 25 per cent twelve months later.

7. The film industry's case for this treatment is:

(i) Writing-off expenditure against related income is inappropriate for the UK film industry. In contrast to the US film industry which is able to maintain production companies that make and distribute films on a continuing basis, in the UK films are most commonly made by companies set up specifically for each individual film.

(ii) Most industrial companies receive income on a continuing basis with a large proportion of output sold in the year of manufacture. Thus expenditure can be written-off when incurred. The film industry, however, produces a long term product through one-shot companies and is therefore disadvantaged by the tax regime. Other industries providing "long term" products (eg building construction) match income with expenditure through staged payments, but this is not generally possible with films where the product cannot be judged until it is completed.

(iii) The film industry is particularly affected by the Budget because since 1979 virtually all its costs were treated as capital and therefore qualified for FYAs. The industry claims that this places them in a unique position among production industries: for most companies only a very small proportion of their costs are on capital expenditure.

(iv) Expenditure on items such as script-writing, development of film scores and general preparations for a film are in the nature of current expenditure which does not create "work in progress" of any capital value.

(v) The US dominates the industry with 50 per cent of the market compared to the UK's 4 per cent. International competition is tough, partly because other countries - USA, Canada, France, Germany, Italy, Australia and New Zealand - provide supportive tax regimes or subsidies, or both, for their domestic film industries. This makes film-making in the UK a relatively high-risk business, and is a further reason why films continue to be made on a one-off basis.

(vi) The UK film industry has been something of a success story over the last few years. There have been a number of highly successful British films, and we have also achieved a world-wide reputation for special effect films, which are generally financed from US sources. Expenditure by US film companies on goods and services in the UK last year was about £140m. A film can cost about £30m; but film making is highly mobile.

THE VIEWS OF INDUSTRY MINISTERS

8. Industry Ministers accept the film industry's arguments that without modification of the regime on offer the industry will contract: the DTI estimate that UK film production might fall by between one-third and one-half. Industry Ministers argue that Section 72 is already a special provision for the film industry, but it requires

modification to introduce a write-off procedure more consistent with UK film industry practices, although not necessarily the one proposed by the industry. The reasons are as follows:

(i) They agree that the tax system should aim to be neutral in its effect on economic decisions, but argue that the strict application of Section 72 would be a departure from neutrality because of the nature of film making in the UK.

(ii) As they see it there would be no conflict with the Budget strategy, particularly as it is likely that the industry would accept modifications of Section 72 which would exclude the use of leasing, which was the means by which tax losses were absorbed by businesses unconnected with the film industry.

(iii) Some arrangement along these lines would enable the Government to publish a White Paper on the lines originally intended.

(iv) If the case is not accepted there would be a need to reconsider proposals to abolish the Eady Levy and associated quangos so as to provide alternative forms of financial help to the industry, such as levies on television and video.

9. Industry Ministers are also concerned about the inter-dependence of films, cable and DBS. It is important that the UK film industry should continue to thrive so that it can meet the increasing demand for its products to feed cable and DBS. The alternative would be to lose these media to US film products.

TREASURY MINISTERS' VIEW

10. The effect of the proposals would be to give film making much of the advantage of 100 per cent FYAs. It would imply a significant breach of the general tax principle that expenditure should not be written off until it can be matched against the income arising from that expenditure. The revenue costs would be as follows:

£ million

1986*-87	1987-88	1988-89	1989-90
35	65	50	50

*FYAs finally withdrawn 31.3.86

11. Treasury Ministers do not accept that a faster write-off of expenditure would be neutral. It would allow companies to create tax losses which could be cashed in. And only if investors or production companies could do this would the changes be of any use to the industry.

12. A modified Section 72 would thus conflict with the Budget, which was to move to an even-handed corporate tax system that would not discriminate in favour of or against any particular type of asset or sector of industry. Investment in films, or in any other activity, should be primarily attracted by genuine pre-tax returns, rather than by the distorting effect of tax subsidies. Deliberately to introduce a new regime for films would be seen as perverse and a weakening of Ministerial resolve to carry through the overall strategy.

13. Many other industries (shipping, cable, agriculture, computers) are pressing strongly to be exempted partly or wholly from the Budget changes. A concession to the film industry would be very difficult to contain.

14. The concession would be expensive (paragraph 10), and worse if it spread. There are no obvious reasons why the film industry should be regarded as special. If this money "buys jobs" in the British film industry, it will also result indirectly in lost jobs and production in other industries. And in the majority of cases, the benefit of the subsidy goes to foreign investors, particularly Americans, who also retain the profits. This is too high a price to pay.

15. Treasury Ministers do not accept the film industry's argument that normal accountancy and tax principles discriminate against the industry. Many other industries produce long term products. Matching of expenditure with the related receipts is the required practice throughout industry, and the rules ensure that in these cases neither losses nor profits are anticipated for tax purposes. The fact that British films are often produced by a one-off company, rather than by companies with rolling programmes, is irrelevant.

16. It is a fallacy to think the clause could be successfully amended to leave out leasing. Either the early write-off needs to be available for non-film companies, such as the banks, or there would be little purpose in making the change because American or institutional finance would have no ready channel for entry.

17. However, Treasury Ministers are prepared to do what they can to help the industry in ways consistent with the Budget strategy. Essentially these are:

(i) British films will continue to be entitled to capital allowances until 1987 as promised in PQ of January 1983, though the allowances will now be at the new depreciation rate for machinery and plant generally, which is all the industry could have reasonably assumed. This will now be made permanent. In practice most film makers will prefer to be taxed under Section 72 and they will be allowed to choose this treatment instead of allowances if they so wish. The Finance Bill will be amended to provide for this option.

(ii) The possibility of bringing films within the Business Expansion Scheme (BES) is being explored, and this will also be provided for in the Finance Bill. This is a measure which will be particularly helpful to the smaller high risk independent UK production company. (It will not however apply to the larger companies for whom the write-off provisions are the prime consideration).

IN SUM

18. The central question is whether Section 72 of the 1982 Finance Act should be modified in the interests of the film industry.

- If Ministers judge there is no case for modification it will be necessary to review the proposed White Paper, and possibly to consider alternative methods of raising funds for the film industry.

- If Ministers decide that there is a case for modification the major question is how the concession could be ring-fenced to contain the revenue consequences and damage to the aims and strategy of the Budget, and what level of support should be provided.

19. This paper has been prepared by the Treasury and agreed with the Inland Revenue and the Department of Trade and Industry.

H.M. TREASURY
JUNE 1984

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June 79. Film Finance