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Dear Sirs,

Visual Effects Industry Tax Relief Consultation

I write to you with MMP Tax's formal response to the Visual Effects Industry Tax Relief Consultation.

About MMP Tax

MMP Tax provides specialist technology-based tax consultancy for corporate clients. Specific areas of our expertise include tax reliefs for research and development, patents, the creative sectors, specialised capital allowances, and corporate investments.

At MMP Tax we combine specialist knowledge of technology tax reliefs with practical experience in engineering and scientific disciplines. We apply these skills in a client-centric way to ensure our clients submit robust and verifiable claims.

The directors of MMP Tax have more than 30 years of direct experience in technology tax relief from a technical and consulting perspective, in addition to wide-ranging experience in industry. MMP Tax currently has representation on the HMT-HMRC Working Groups for R&D Tax Relief, the Patent Box, and the Above The Line-RDEC Working Group for R&DTR. MMP Tax also made a formal response to the Creative Sector Tax Relief Consultation last year.

MMP Tax strongly supports the introduction of the proposed Visual Effects Tax Relief.

MMP's Overall Position

The main issue is to ensure that the relief directly benefits firms in the visual effects industry. To date, the visual effects industry struggles to access Government support because it does not meet the qualifying definitions of schemes such as R&D Tax Relief or the new Creative Sector Tax Reliefs for animation, video games development, and high-end tv production. The new proposal fills this gap in targeted tax relief.

The visual effects industry has not only generated significant value-add for UK GDP in the form of investment, employment, and wealth creation, but it has also been a pioneer in new and advanced technologies and become a world-leader in its respective field.

However, the UK's leading position has been threatened in recent years because the industry is very mobile and very competitive. As a basic example of the global and fluid competitive nature of this industry, we could characterise it in terms of its three leading exponents:

- Double Negative – UK-based – founded in 1998
- Industrial Light and Magic – US-based – founded in 1975
- WETA – New Zealand-based – founded in 1993

Visual effects, along with the other creative sector technologies, is also increasingly linked into high-value and knowledge-based sectors such as electronics and software. These links are typical of knowledge-based sectors and represent the real value in modern production value chains.

This knowledge-based capital is in areas such as R&D, product design, core component production, and marketing. The knowledge drives higher-value jobs in higher-value industries. For instance, iPod production in 2006 accounted for 14,000 jobs inside the United States and 27,000 jobs outside the US. But American workers earned nearly double the amount earned by foreign workers (\$753 million to \$318 million) because they were providing the higher-value knowledge-based skills such as design, software and marketing¹.

The visual effects industry touches on all these areas and it makes sense that the government continues to focus targeted tax incentives on industries where the UK has a leading position and where the industry is likely to grow and contribute to the UK's stock of knowledge-based capital.

Our response to the Consultation is based on our own direct experience of the operation of R&D Tax Relief, Film Tax Relief, the Creative Sector Tax Reliefs, the Patent Box, our involvement in the various other innovation tax relief HMT-HMRC Working Groups, and on feedback from our own client network.

Overall, MMP Tax is concerned about:

- **The quantum of relief** – ie. the rate of relief must be sufficiently generous to rise above the **noise level** so that corporate investment decisions about new productions and their location are positively impacted by the relief.
- **Long-term certainty** – the scheme must involve long-term commitment by the Government to allow companies to take long-term investment decisions.
- **Visibility** – the scheme must be sufficiently simple, easy to administer, and well publicised so that companies are aware of it and are incentivised to use it.

¹ OECD Science, Technology and Industry Directorate – OECD Yearbook 2013

Our Response to the Consultation Questions

We have focused our response on areas where we have substantive opinions rather than deal with each specific question raised in the Consultation document.

We have also focused on the tax practicalities for the proposals. The industry respondents to the Consultation will doubtless provide far more detailed supporting evidence from an operational perspective, but we are able to offer insight into the actual tax, finance, and administrative implications for the current proposal.

Proposed Visual Effects tax relief option 1

We support this proposal, and we also support the suggestion that there should be a minimum threshold of visual effects expenditure. Otherwise, large films may simply incur a small amount of qualifying visual effects expenditure so that the overall cost of the production qualifies for the enhanced 25 per cent visual effects-FTR payable credit rate.

We are agnostic about the minimum level of visual effects expenditure as a proportion of the total production budget. Industry participants are probably best-placed to make recommendations about the minimum level.

Notwithstanding this, there may be logic in setting a threshold metric on the same basis as the high-end tv production tax relief (ie. per £XX of direct production cost/visual effects cost per hour of broadcast product) because it gives consistency to the whole creative sector tax reliefs framework.

Proposed Visual Effects tax relief option 2

We do not consider that the proposal to reduce the minimum threshold of UK expenditure requirement in Film Tax Relief from 25 per cent to 20 per cent would have a very positive effect. This reduction would not necessarily have any impact on the amount of qualifying visual effects work being undertaken in the UK.

The proposal is attempting to make it more attractive for foreign-based productions to spend their visual effects budget in the UK by setting a reduced threshold so the foreign-based production company can claim for film tax relief on its UK visual effects expenditure.

However, we consider that the proposal would have a reverse effect: it would simply mean companies spent less on production in the UK, and there would be no compensating targeted mechanism to ensure that more funding went on UK visual effects expenditure.

MMP Tax Alternative Proposal for Visual Effects tax relief

We would support an alternative proposal, where visual effects tax relief is targeted in the same way as other Creative Sector Tax Reliefs. This would target productions, whether for film or television, which were visual effects intensive.

Accordingly, visual effects tax relief could be structured in the same way as for film, animation, video games development, and high-end tv production. A restriction could be

imposed so that no production could claim for more than one type of creative sector tax relief to stop double-dipping.

This type of proposal would have the following advantages:

- it would be consistent with the overall Creative Sector Tax Relief framework
- it would specifically target UK-based visual effect expenditure, covering both film and tv production
- it would be easy to understand and implement

Definition of Visual Effects

There should be a definition of Visual Effects. There is a potential for substantial crossover between the other Creative Sector Tax Reliefs (eg. animation, or video games) or even with the qualifying definitions of R&D Tax Relief.

The definition will also need to consider the type, purpose and content of Visual Effects (eg. is there a distinction between visual effects for title sequences; or visual effects that are not done for broadcasting purposes – eg. education purposes; or visual effects that are done for television rather than for film).

Further, we would also argue for a definition that includes visual effects work done for advertising purposes. This is because the visual effects for advertising are also invariably significant and innovative – they need to stand out so they capture attention in the advertising world. This work undertaken by studios is not advertising work per se: it remains a production commission and is only a delivery mechanism for the advertising, rather than the advertising itself.

Film Tax Relief Model

MMP agrees that the Film Tax Relief model is appropriate to use as the core foundation for visual effects relief. The FTR model is well-established; the principles are clear; and it fits better with the creative nature of the visual effects industry, when contrasted with other innovation tax schemes such as R&DTR and the Patent Box.

Cultural test

We would argue that a cultural test should not be applied: by their very nature, visual effects are likely to involve effects that do not necessarily have a cultural origin.

If it is deemed necessary to have a cultural test, then it should be drawn as widely as possible. Animation, tv and film production lend themselves to tighter definitions of cultural impact because there is a more tangible and physical nature to their activity: the productions will involve British actors, British scenery, British suppliers etc, and the output is more likely to have visible British connotations.

In contrast, it is far easier to do non-culturally British work when creating visual effects: there is an intangible abstract nature to this work which, although no less culturally British, has more freedom to be non-culturally British.

However, we recognise that such a cultural test may be required from a European State aid context.

If a cultural test is required, we would support the role of the British Film Institute to act as overseer, in the same way that it already does for animation, high-end tv production, and film tax relief.

Non-commissioned work/speculative expenditure

There should be scope to allow this type of expenditure to be included – as in the R&DTR model – even if the project fails or is simply treated as speculative research for new projects.

SME vs Large Company

There is a danger that the relief will focus almost exclusively on large companies because they are more likely to undertake the large scale productions that are visual effects intensive. This means SMEs will miss out on this relief.

If a key objective of the relief is to support job creation and wealth generation through incentivising productions to be commissioned, then this objective will be missed if the relief does not take into account that small independent production companies are often the pioneers of new visual effects by commissioning specific effects for their low-budget productions.

So, the relief should not ignore how smaller businesses will often commission visual effects work on a small budget, and that these commissions may not take place or may go abroad if the SME does not have an incentive to do it in the UK. As such, the visual effects relief should be available for all sizes of production budgets.

Debugging

Debugging costs should be allowed as eligible expenditure. There is a material distinction between debugging that takes place in visual effects work, and debugging that takes place in software application R&D.

Debugging is classified as ineligible in the R&DTR scheme, where R&D is correctly defined as completed when the technological uncertainty of new development is finished. Debugging in this context represents post-R&D/pre-production work and is consequently deemed ineligible for R&DTR. It is relatively straightforward to identify with debugging in software applications where the R&D has finished and pre-production work has commenced.

In contrast, debugging in visual effects work is an integral part of the special effects process and incorporates new functionality as much as simple code fixing.

Project-based

Productions are generally accounted for separately in the creative sectors. Most development companies measure their financial information on a project-by-project basis so this will conform to the FTR structure.

Therefore, it should be practical to administer the proposed relief on a project-by-project basis.

Co-productions

The creative industries involve frequent collaboration and formal cost-sharing/joint-venture partnerships between different firms. It is part of the nature of the industries where creative skills are very specialised and highly dispersed across the industries, and where the projects are discrete so entities can clearly distinguish between separate projects for separate timelines, without creating excessive risk or dilution of an individual firm's DNA.

The visual effects tax relief proposal should make allowances for both formal special purpose vehicles and project-based cost-sharing agreements where co-productions are established.

Administration

The administration of the visual effects tax relief should be overseen by the specialist HMRC Film Tax Credit unit in Manchester that oversees the FTR (and in conjunction with the Creative Sector Tax Reliefs).

This approach will deliver consistency, timeliness and expertise in the claim-handling process. The FTR team represents a natural home for all the Creative Sector Reliefs, including Visual Effects, and which will require similar levels of consistency, timeliness and expertise in their implementation and application.

Conclusion

The UK is a world-leader in creative sector technologies, including the visual effects industry. These technologies are driven by knowledge-based capital which will create higher skilled and higher value jobs. They also tend to be export-orientated and innovative, bringing innovation and overseas investment into the UK economy.

The creative sectors are also highly mobile and internationally competitive. Direct government tax relief intervention will encourage visual effects commissions to take place and to grow in the UK. The UK has a comparative advantage in these sectors and this type of government intervention will help to preserve the UK's position as one of the most compelling production locations in the global marketplace.

The proposed visual effects tax relief will help to maintain the UK's position as a world-leader in visual effects and we wholeheartedly support its introduction.

Yours sincerely,

Peter Denison-Pender, Director