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BRITISH TAX AUTHORITY PUTS A MAJOR DAMPER ON UK FILM INVESTMENT STRUCTURES

On February 10, 2004 the UK film industry suffered a major setback when the Inland Revenue (the UK Tax Authority) put an end to and effectively closed down the burgeoning equity funds sub-sector. Some seventeen production partnerships managed by financiers that used "Generally Agreed Accounting Principles" ("GAAP") are understood to have been affected.

Inland Revenue closed a tax loophole utilized by many film production partnerships that permitted trading losses incurred within partnerships to allocate tax losses to partners. These production partnerships utilized a formula to combine equity investment in films with certain UK tax deferrals or sheltering, which allowed the partners in film partnerships to offset their income or include losses in their income. The loophole was closed with immediate effect. Sale and leaseback transactions remain unaffected by the ruling, however, although the government is currently examining separate proposals for the revision of sale and leaseback set-ups under Section 48 of the *United Kingdom Income Tax Act* ("UK ACT"). It is estimated that up to 200 million pounds (US 375 million dollars) in production volume is likely to be lost. Film industry officials believe that they have been unfairly hit by the changes intended to address problems in other business sectors.

The UK Film Council – which appears to not have been consulted about the Inland Revenue action – together with representatives from BSAC and PACT, met with Inland Revenue on February 12, 2004 and made the case for transitional arrangements following the changes to the rules covering losses through partnerships.

We understand that the UK Film Council proposed to Inland Revenue that transitional relief should be available to a film that is intended to be British qualifying, where all the financing partners are in place and where cash expenditure had already been committed by February 10, 2004. The UK Film Council is now working with BSAC and PACT to supply the Inland Revenue with a schedule of films set to go into production this year which will be affected by the announcement. The UK Film Council also stressed the need for an urgent resolution to the current uncertainty they see in the British film industry.

It is to be emphasized however that, as stated earlier, the ruling announced on February 10, 2004 will not affect the Section 48 UK ACT tax break. Those equity investment partnerships do not rely on the GAAP formula but on a Section 48 formula that is unaffected by the Inland Revenue announcement (although it is currently under review).

In response to the aforementioned changes, a certain sale and leaseback promoter announced last week that its rate offer to producers for 2004/2005 commencing after the UK tax year-end on April 5, 2004, would be lowered to 13% until the uncertainty clears and investor intentions may be properly gauged. The percentage difference between the actual amount received and the percentage paid by the UK tax authorities will be attributed to the investors in the partnerships in order to provide an added return on their investment.

In anticipation of the clamp-down on tax savings, certain UK entities have developed a new form of film investment product. Under this product, UK investors purchase shares in two separate partnerships,

which give them a right to recoup part of their investment, obtain a significant share in net profits and benefit from tax relief (under legislation brought in by the UK government to encourage investment in films). They believe their approach is low risk in terms of Inland Revenue challenges and its complexity is justified by the additional benefits they offer to investors.

Fraser Milner Casgrain LLP will inform its clients of developments concerning the Inland Revenue decision, of any interim measures where transitional relief will be provided to existing and accepted productions, and any new equity or film investment structures which are deemed acceptable.

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