British Screen Advisory Council

'Bringing the audiovisual industries together'

Submission to:

HMRC consultation on 'Venture Capital Schemes: Risk-to-capital condition draft guidance'

31 January 2018

Contents

A. About BSAC 4

B. Overarching concerns 4

C. Specific issues with the guidance 5

D. Further issues 9

E. Conclusion 11

A. About BSAC

The British Screen Advisory Council (BSAC) is an independent, industry-funded umbrella group bringing together many of the most influential people working across the value chain in the audiovisual and interactive entertainment sector, including television, film, video games and digital media, and leading technology firms and ISPs[1]. The interests represented within BSAC form a key part of the Creative Industries at a time when the Government's Industrial Strategy has identified the sector as one of five world-leading sectors that should be cultivated in order to drive future economic prosperity for the UK. Independent film and TV production is a key part of the delicate ecosystem that supports a successful audiovisual sector and many early-stage companies within that sub-sector have benefitted from investment supported by EIS and SEIS, enabling the production of independent film and television content that would not otherwise have been possible given the lack of alternative sources of finance for such companies. We therefore welcome the opportunity to comment on the draft guidance relating to the new 'risk-to-capital' condition for Venture Capital schemes, including EIS and SEIS.

B. Overarching concerns

BSAC fully supports the policy objective of ensuring that the tax-advantaged venture capital schemes are focused on investment in early-stage companies that have the intention to grow and develop in the longer term. Such tax relief should not be available for investments that are not within the spirit of the schemes; that is, 'capital preservation schemes' where the investor's capital is not significantly at risk and/or the investee company does not have objectives to grow and develop. The new statutory 'risk-to-capital' condition for eligibility is therefore both welcome and appropriate. It was right for Government to reject calls for film and TV production to be added to the list of excluded activities: the policy objective is fully consistent with EIS and SEIS being used to support film and TV production companies.

Given the principles-based approach established by the risk-to-capital condition, the manner in which those principles are applied in practice will be critical and the guidance which will inform individual HMRC decisions is therefore extremely important. Our overarching concern is that the proposed guidance as currently drafted is capable of being interpreted in a manner which would, in practice, make it extremely difficult for early-stage film and TV production companies which have the intention to grow and develop in the longer term to benefit from investment through EIS or SEIS. Given the importance to the sector of securing such financing, the effect on UK independent film production in particular could be chilling, with negative knock-on effects for the broader audiovisual sector.

We recognise that the draft guidance is aimed at all non-excluded sectors and welcome the fact that it nevertheless acknowledges and takes into account some of the particular characteristics of the film and TV production sector. In particular, we welcome the recognition that the use of SPV's for particular production projects and

---

1 For a full copy of BSAC's Membership list, see our website, at http://bsac.uk.com/membership-list.html

the use of outsourcing for elements of the production process are usual industry practice rather than necessarily being indicators of capital preservation (as they might be in other sectors). Our concern is that, despite this, the draft guidance may nevertheless encourage an approach that fails to take account not only of the particular risk profile of the business of film and TV production, but also of the various ways in which individual film and TV production companies may attempt to mitigate that risk depending on the particular circumstances. The sector's business model is based on occasional 'hits' (which bring very high returns) compensating for more frequent 'misses' (in which costs are barely covered or real losses are made). Film and TV production is inherently risky; to grow and develop over the longer term, a company must ensure that it can stay in business in between the hits. Doing so requires a flexible approach which will vary between production companies (and for a single company over time) for sound commercial reasons. Taking as much risk as possible in a production business is a sure-fire way to quick commercial failure and no company does this; nor is it how entrepreneurs work. We therefore need to separate the principle of risk to capital for investors at the point of investment, from the principle of what is an appropriate level of financial risk for a production to take on at the point production starts work. For example, it is extremely common for a producer to reduce their financial risk to as low a percentage of the production budget as possible whilst still leaving themselves the opportunity to benefit from exceptional profits in unsold territories. We would like to see this commonplace approach to risk-taking more fully reflected in the guidance to ensure that film and TV production activity is not inadvertently squeezed out of eligibility for EIS / SEIS support altogether. We recognise that this is not the policy objective, but as the guidance currently stands it may nevertheless be the effect due to the level of potential subjectivity in applying the guidance.

C. Specific issues with the guidance

C1. Quantifying the potential loss of capital

The draft legislation requires there is a significant risk that there will be a loss of capital of an amount greater than the net investment return, i.e. a significant risk that the investor will realise a return of less than 70p per £1 invested. The draft guidance seems to contradict the legislation in certain sections, e.g. Example 3 states that '…only investment in film that is not covered or protected by pre-agreed income or support (referred to in the industry as the "gap") will be likely to qualify for tax relief…'. This comment could suggest to some that all of the investor's investment must be entirely at risk in contrast to the general thrust of the guidance which seems to suggest that risk to capital must be significant, not absolute.

We would recommend that the guidance (at VCM8542 and VCM8560) is amended to remove this ambiguity and to align the guidance with the legislation. Specifically, we would recommend that the guidance is clear that there needs to be a significant risk that the investor could make a 'real' loss, i.e. receive a return of less than 70p per £1 invested (assuming 30% EIS income tax relief). Alternatively, HMRC should explain how they interpret the legislation such that they believe there must be a significant risk of losing a greater proportion of capital (and, importantly, quantify what that proportion is).

C2. What is 'significant' risk?

The guidance indicates that investment that is used to fund gap is considered to be at risk and investment supported by pre-sales is not. The guidance is not clear as to the point at which pre-sales can be agreed (if at all), in order for the risk of loss to be considered significant. The draft legislation, however, simply indicates that, at the time of allotting shares (as opposed to the moment a company contracts to produce a film, see below), there can be no agreements in place for pre-sales (or other pre-agreed income) that would result in a sufficient amount of investors' capital not being at risk. It is assumed that, in this context, 'pre-agreed income' would be income that the company is contractually entitled to receive. The guidance should be clearer in this regard and in line with the draft legislation, in particular it should:

- confirm whether, for example, pre-sales that were anticipated but not contracted at the time of share issue would be taken into consideration;

- confirm whether a company could produce a film that is brought to it or developed after share allotment, regardless of the level of pre-sales (i.e. in cases where, at the time of share issue, the availability or extent of pre-sales is unknown); and/or alternatively

- confirm whether any tax credits, subsidies, pre-sales or any other binding contracts that provide sales revenue or production reimbursement which are only agreed after the company legally commits to a production would not impact the earlier assessment as to whether capital is at significant risk.

C3. How big a shareholding does the entrepreneur need to maintain?

There are various references that suggest the venture capital schemes are intended to support companies where the 'entrepreneur' maintains a certain majority (unspecified) shareholding in the investee company. We recommend that there is no minimum shareholding as:

- the actual shareholding retained will be a function of arms' length negotiation;

- there are a very wide range of shareholdings retained in the wider venture capital sector, from small minority shareholdings through to large majority shareholdings: every commercial situation is different;

- having a key role in management decisions is a more reliable indicator; and

- the founder may have other ways of being rewarded (e.g. producer fees, which can be large) so the shareholding retained is not representative of overall reward and thus not an adequate indicator.

C4. Application of the guidelines with regards to fund managers

Requiring a complete lack of any relationship between the company's founder and the investors (or fund manager) is unrealistic. For example, the founder may not have set up their company at the point she/he approaches the fund manager, as they may want to get an indication that the fund manager would be able to arrange investment first. Also, the fund manager may (and typically does) undertake certain administrative tasks, such as incorporating the company or assisting with the submission of an application for advance assurance, because they have more experience in these areas or because the entrepreneur, at that point, does not have the cash, the know-how or the inclination to do so.

Fund managers can play an active and important role in making bridges between otherwise unconnected parties, bringing together talent/entrepreneurs with access to funding, developing business plans and using their industry expertise to help companies grow. In our view, they should continue to be allowed to aggregate capital and provide ongoing support to support talent/entrepreneurs in seeking to build long-term, successful businesses, without impacting negatively on EIS qualification. This bridging role is more generally valuable in the creative industries where skills in business mentoring and a detailed understanding of business models and risk capital are at an absolute premium.

C5. Fragmentation

Fragmentation is identified as a factor to consider in determining the level of risk associated with the investment. The specific characteristics of the film and television industries need to be taken into account when considering this factor. For example, different companies set up by the same individual or entity (or with shareholders in common) may be required to deal with different elements of IP or to deal with different creative partners or financial arrangements. Whilst we share the common goal of building scalable, successful businesses with all creative activities being housed under one roof, the reality in the creative industries is one of fragmentation for a whole host of reasons, none of which have anything to do with accessing tax reliefs: this fragmented structure has always been a defining characteristic of the sector because of the essentially project-driven nature of the entertainment business.

C6. Indicators of growth ambition

The intention to increase the number of employees, as an indicator of growth ambition, should be considered in the specific context of the film television industries, where headcount is usually low. This is a function of the way the industry operates; a small increase in headcount may be all that is needed to scale up because freelance people and outsourcing can be utilised on a particular production (and charged into the production budget), which keeps overheads low. The growth and development ambition is to increase the scale and/or frequency of the production projects undertaken by the company.

Similarly, the fact that investors in early stage businesses may have a desire to reap the benefits from the high risk early stage investment and re-invest in another early stage opportunity should not indicate, or be confused with, the companies' intentions to grow and develop.

C7. Playing a 'considerable' role in management decisions

The guidance requires that the company's founder 'plays a considerable role in management decisions' if the company is not to be considered to involve capital preservation. We recommend that the guidance confirms what 'considerable' would be taken to mean in this context.

C8. Confirmation of identity of investors

HMRC's Advance Assurance Consultation response states (at paragraph 2.8) that from 2 January 2018 they will only opine on Advance Assurances where the application names the individuals, fund managers or other promoters who are expected to make the investment. Due to the way a fund operates, the investor's identity will not be known until after fund close (which is after advance assurance would be required). We assume HMRC will only require confirmation of the fund manager/promoter and recommend that this is made clear in the guidance.

C9. Track record of company or entrepreneur

The track record of the company should not be confused with the track record of the entrepreneur or producer: in the media sector in particular, entrepreneurs that have a strong commercial track record can still struggle to access funding. We recommend that this is made clear in the guidance.

C10. Investors are 'broadly independent third parties'

We recommend that 'broadly independent' should be better defined in the guidance.

C11. Post investment checks

The guidance should make clear that HMRC will not use post-investment checks to determine, on a purely subjective basis, that the company should have done better and therefore decide that relief is withdrawn. Hindsight is a wonderful thing: the retrospective withdrawal of relief in film and TV business would kill the associated investment market stone dead.

C12. Trading stock

The guidance refers to creating assets that are expected to be sold on, either at a profit or a small loss, as an indicator of a capital preservation scheme. It does not appear to allow for the exclusion of items that, whilst an 'asset' in nature are actually trading stock in that particular business. For example, if a film and TV production company created some scripts for resale, they would be trading stock and not fixed assets. We recommend that this is clarified in the guidance.

C13. Advance assurance consultation response – role of advisors

We do not agree with the implication made at 2.12 of the consultation response regarding the use of professional advisors to provide comfort on EIS eligibility in lieu of an advance assurance from HMRC, particularly given the subjective nature of the new risk-to-capital guidance.

C14. Advance assurance consultation response – turnaround times

We note that HMRC expect the new 'risk-to-capital' test to result in significantly faster turnaround times in relation to advance assurance applications on the grounds that many previously borderline cases will be clearly excluded under the new rule, allowing HMRC to reach by April 2018 its target of ruling on advance assurance applications within 15 working days. While more timely decisions would be welcome, we note that the new test requires the application of **principles** in relation to complex individual cases and urge HMRC to fully take into account in relation to each application the particular characteristics of the film and TV production sector and, within that context, the particular circumstances of the individual application. A number of decisions made over recent weeks have raised concerns of a 'cookie cutter' approach aimed at clearing the backlog, in which the new test has been applied with an apparent lack of understanding of the nature of the film and TV production sector.

D. Further issues

We would also like to take this opportunity to raise three further points relating to EIS and SEIS. Although these issues are not affected by the new statutory 'risk-to-capital' condition, the review of the guidance provides an opportunity for them to be addressed.

D1. Commencement of trade when multiple SPVs involved

Current interpretation results in potential delays in claims for EIS relief where a film production company uses multiple SPVs for individual films (an approach which enables the IP in any one project to be 'ring fenced'). The issue arises because:

a) a company cannot make a claim for an EIS 3 certificate on behalf of an investor until it has traded for at least 4 months (Section 205(4) and Section 176(2) ITA2007); and

b) HMRC treat the trade of Film Production as commencing at the start of Principal Photography rather than at the start of Pre-Production ('Pre-Production' is broadly deemed to commence when a film is 'Greenlit', i.e. fully financed and ready to commence spending).

In contrast, Section 1188(4) CTA2009 (Film Tax Relief) deems a trade of Film Production to commence when Pre-Production begins or, if earlier, when any income from the film is received. It would be helpful if HMRC interpretation of commencement of a trade of Film Production for EIS purposes was aligned with Section 1188(4) CTA2009.

In addition, HMRC have confirmed that if an EIS company is making several films, each in a separate SPV, then each trade will be treated as separate for EIS purposes. Consequently, only part of the overall trading activity is deemed as started when each film is commenced and so EIS relief can only be claimed once the final film is commenced. To be clear, the date of the relief will always go back to the date of issue of the shares, so if three films were made in two years through separate SPVs there is a possibility that investors could have to submit a 'non-claiming' Tax Return initially, and then amend that Tax Return and re-submit it as the further sums were spent, and then claim a tax refund from HMRC.

In contrast, when a Film Production Company is making several films in one company or through the same subsidiary SPV, HMRC accept that the whole trade started with the commencement of Principal Photography of the first film and all EIS relief can be claimed from the outset.

Overall, the two approaches make no difference to the amount of the claim or the tax year it relates to, but the necessity for 'piecemeal' tax return claims where multiple SPVs are used adds extra administration costs for the investor, the EIS company and HMRC.

We therefore recommend that the guidance be amended to the effect that corresponding film and TV production trades in separate SPVs will be treated as one trade for the purpose of s205(4)(a)ITA2007.

D2. Restrictions on providing loans to EIS companies

HMRC's current application of independent loan repayments to EIS shareholders raises issues where investors make loans alongside EIS shares.

If EIS shareholders receive any 'value' from the investee company during the period from 12 months before investment up to 3 years after investment, EIS Tax Relief may be removed up to the amount of value received. This is designed to stop tax relief on money that is either circular and returns to the investor, or effectively buys goods and services whilst getting tax relief. Value received can include the repayment of share capital and securities as well as loans, even if these are matters independent to the subscription for EIS shares. This is, in part, designed to stop people converting loans in to EIS shares and claiming tax relief without making any effective new investment.

We support this overall approach. However, HMRC have also made clear that so called 'Film Equity Investments' are caught by this legislation and we query whether this particular interpretation accords with the intent of the relevant legislation. It is not clear that the legislation at s216(a) ITA2007 was designed to penalise someone who separately made a loan to the company or invested with a split of EIS Shares and Loans, as evidenced by the existence s216(b) ITA2007 where debts are specifically

catered for. It is of concern if film production companies are restricted in financing because EIS shareholders cannot independently provide non-share finance in line with the provisions of s216(b)ITA2007.

It would be helpful if HMRC would confirm in guidance that Film Equity is not caught by s216(a) ITA2007 and that film production companies can be invested in through a mix of EIS shares and Loans or Film Equity.

D3. Excluded trade – Receiving royalties or licence fees

ITA 2007, s192(e) lists as an excluded trade 'Receiving royalties or licence fees'. The purpose of this exclusion (drafted before the emergence of the digital economy) was to stop EIS companies passively buying, for example, a patent and just sitting back and receiving royalties. However, the emergence of the digital economy suggests that the breadth of the exclusion should be re-examined. As currently drafted, the exclusion means that the online selling of 3rd parties' downloadable products is an excluded trade for EIS purposes whereas selling physical versions of the same product is allowable. The digital distribution is caught because, each time a wholesaler or retailer sells a download they are receiving a licence fee. We acknowledge that there is an exclusion in ITA 2007, s195 for people selling IP that they have created themselves, but it appears anomalous that a CD Shop qualifies but a Music Download Website platform does not because it did not create the music itself.

We would encourage HMRC to consider revisiting this matter with a view to ending the exclusion for an ordinary trade of wholesale or retail digital distribution.

E. Conclusion

As noted above, we recognise that the draft guidance is aimed at all non-excluded sectors and welcome the fact that it nevertheless acknowledges and takes into account some of the particular characteristics of the film and TV production sector. In particular, we welcome the recognition that the use of SPV's for particular production projects and the use of outsourcing for elements of the production process are usual industry practice rather than necessarily being indicators of capital preservation (as they might be in other sectors). Our concern is that, despite this, the draft guidance may nevertheless encourage an approach which fails to take account not only of the particular risk profile of the business of film and TV production, but also of the various ways in which individual film and TV production companies may attempt to mitigate that risk depending on the particular circumstances. The sector's business model is based on occasional 'hits' (which bring very high returns) compensating for more frequent 'misses' (in which costs are barely covered or real losses are made). Film and TV production is inherently risky; to grow and develop over the longer term, a company must ensure that it can stay in business in between the hits. Doing so requires a flexible approach, which will vary between production companies (and for a single company over time) for sound commercial reasons. We would like to see this more fully reflected in the guidance to ensure that film and TV production activity is not inadvertently squeezed out of eligibility for EIS / SEIS support altogether. We know that this is not the policy objective, but as the guidance currently stands it may nevertheless be the effect.

BSAC is well placed to advise on how best to achieve the desired policy outcome in relation to the use of EIS and SEIS in the film and TV production sector and would be happy to work with HMRC to ensure that the guidance operates effectively and without unintended negative consequences for the sector. We would also suggest that the guidance is reviewed after six months – with industry input – so that any teething problems can be identified and ironed out.

For more information about BSAC
Please see our website
www.bsac.uk.com

British Screen Advisory Council
58 Broadwick Street, London, W1F 7AL

Telephone: +44 (0)20 7287 1111
Email: bsac@bsacouncil.co.uk