An industry game changer?

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Satvi Vepa considers video games tax relief and its intentions to encourage investment in the growing industry

Key Points

What is the issue?

According to the UK Games Industry Market Valuation 2020, the UK market for video games reached a record of £7 billion in 2020 – an increase of over 29.9% from 2019.

What does it mean for me?

The video games tax relief is intended to incentivise investment into development of games in the UK. Since its introduction in April 2014, 1,630 claims have been made, with UK qualifying expenditure totalling over £4.4 billion.

What can I take away?

The UK will presumably want to make sure that video games tax relief offers preferential incentives to the UK gaming industry when compared to EU and worldwide equivalents. It will be interesting to see whether its scope is widened as the gaming industry continues to grow.

The video game market has evolved into the UK's most lucrative entertainment sector. According to the UK Games Industry Market Valuation 2020, published on 19 March 2021, the UK market for video games reached a record of £7 billion in 2020 – an increase of over 29.9% from 2019. This is backed by steady increases in revenue over the last 10 years. The sector supports over 27,000 employees and there are over 44 million regular gamers in the UK.

In addition, it comes as no surprise that, whilst Covid restrictions have limited other forms of leisure and entertainment activities, the already highly successful video games industry has been booming.

It therefore seems an appropriate time to revisit one of the more successful of the government's targeted tax credit regimes in recent years, video games tax relief. Originally announced in 2012, the relief's stated aim was to incentivise investment into development of games in the UK. Since the introduction of video games tax relief in April 2014, 1,630 claims have been made in respect of video games, with UK qualifying expenditure totalling over £4.4 billion.

The relevant legislation can be found at Corporation Taxes Act 2009 Part 15B. Part 15B provides rules in respect of the calculation of profits and losses of video game trades and in respect of video games tax relief. This article provides a high-level overview of those rules.

Who is eligible?

Video games tax relief is available to be claimed by a video games development company in relation to a video game.
In order to qualify for the relief, a company must:

- be responsible for the designing, producing and testing of the video game;
- be actively engaged in the planning and decision making during the design, production and testing phase; and
- directly negotiate, contract and pay for rights, goods and services.

The development company must be paying UK corporation tax in order to benefit from the relief.

The relief cannot be claimed by an individual or a partnership and cannot be claimed by two companies that are involved in the development of a single video game. In such a situation, the company 'most directly engaged' in the qualifying activities is in principle entitled to claim relief. A company may also elect not to be treated as a video games development company.

How is a video games development company taxed?

A qualifying company is required to treat activities in relation to each video game that qualifies for video games tax relief as a separate trade. This is similar to the model used for the UK's film tax relief. Accordingly, a video games qualifying company may have multiple 'notional' trades, or separate companies may be incorporated for each video game. A video game trade commences when the design of the video game begins or, if earlier, when any income from the video game is received by the development company.

Video games development companies can account for their costs and income in a number of ways. Chapter 2 of Part 15B sets out a consistent approach to calculating taxable profits or losses, which applies regardless of whether the relief is actually claimed.

Defining income

In particular, income relating to a video game trade comprises any receipts by the company in connection with the production or exploitation of the video game. This can include receipts from the sale of the video game or rights in it, or royalties for use of the video game. Given that the majority of the income from the video game

will not be received until later stages of the trade, it is a proportion of the ‘estimated total income’ for the trade that is brought into account each year.

This estimate is to be made on a just and reasonable basis taking into account all relevant circumstances. Broadly, according to Financial Reporting Standard 5, the proportion of the estimated total income for the year is calculated by reference to the proportion of the development expenditure incurred each year compared to the estimated total development expenditure on the video game.

Defining costs

Costs of a video game trade are broadly defined as expenditure incurred by the company on development activities and on activities undertaken with a view to exploiting the video game. As there are no pre-trading expenditure rules contained in Part 15B, any pre-trading expenditure incurred by the development company is disregarded.

These rules are subject to any other provision in the Corporation Tax Acts prohibiting or restricting a deduction for costs. There is express provision confirming that any expenditure incurred on the creation of an asset is to be treated as revenue in nature (rather than capital). However, costs incurred on the purchase of other capital items remain capital expenditure so capital allowances remain available.

Claiming video games tax relief

Video games tax relief is a corporation tax relief that allows a development company to make additional deductions from their taxable profits; and/or to surrender qualifying losses for a payable tax credit.

For video games tax relief to be available, at least 25% of the ‘core expenditure’ must be ‘European expenditure’; i.e. expenditure incurred on goods or services that are provided from the UK or the European Economic Area. Core expenditure is expenditure incurred on designing, producing and testing the video game.

The additional deduction for the first accounting period amounts to the lesser of:

i. the amount of core expenditure that is European expenditure; and
ii. 80% of the total amount of core expenditure.

For future periods, the additional deduction amounts to the lesser of the total amount of core expenditure that is European expenditure incurred to date; and 80% of the total amount of core expenditure incurred to date – in each case, less the total amount of additional deductions given in previous periods.

Qualifying companies in a loss making position will be able to claim a payable tax credit. Losses available for the accounting period of the trade or, if less, the available core expenditure for the accounting period, may be surrendered for a payable credit equal to 25% of the amount surrendered.

Interaction with R&D

The scope of the video games tax relief may overlap with that of UK research and development relief available to companies that work on innovative projects in science and technology. For example, software developed in the gaming industry has found application in a range of science based sectors, such as medicine and aeronautics.

Part 15B s 1217C(4) deals with this overlap by stating that video games tax relief is not available in respect of any expenditure if R&D relief (whether by additional deduction or by a payable credit) is available in respect of the same expenditure.

It is worth noting that due to EU State Aid restrictions in force prior to 1 January 2021, HMRC guidance at VGDC20230 sets out a more onerous restriction: where R&D SME relief is claimed on a project, that project cannot claim any other state aid reliefs (including video games tax relief). The same restriction did not apply for large companies, as R&D relief under the large scheme is not state aid.

M&A transactions

In addition to the specific rules for video games tax relief and the calculation of profits and losses of video game trades, it is worth briefly considering the impact on M&A transactions; for example, on the sale of a development company during the development stages of a video game.

The attribution of value for tax assets in M&A transactions remains a case-by-case question; however, given that considerable importance is given to the video games tax relief payable credit in the gaming industry, the sellers of a qualifying company may be expected to seek value for any video games tax relief payable credits due to

the target.

To the extent that the payable credit has not yet been received by the company, this may be structured as additional consideration paid by the buyer (potentially payable as and when received after the sale); or incorporated within closing pricing (for example, as a tax asset in closing accounts). In either case, a buyer can be expected to require protection against the risk of video games tax relief not being available to any extent and the risk of the relief being clawed back; for example, if there is a risk that the final certificate stating that the video game is a 'British video game' may not be issued (see below).

Advice should be sought depending on the specific facts of the transaction.

Impact of Brexit

Video games tax relief is only available in an accounting period where the company's tax return is accompanied by either an interim or a final certificate from the Secretary of State certifying that on completion of the video game, the 'culture test' will be satisfied and the video game will be a 'British video game'.

The requirement for the video game to satisfy a culture test derives from the state aid rules and the general block exemption available for certain activities supporting culture. The UK's new Subsidy Control Regime, which replaced the EU State Aid rules from 1 January 2021, is less prescriptive; and the existing block exemptions under the EU State Aid rules have not been implemented or replicated in the UK's Subsidy Control Regime. The result is that the government has broader discretion now than it did prior to Brexit to amend certain tax reliefs which previously qualified as state aid, including video games tax relief.

Although no changes have been announced, the UK will presumably want to make sure the relief offers effective incentives to the UK gaming industry when compared to worldwide equivalents. It will be interesting to see whether the scope of video games tax relief is widened in the future as the gaming industry continues to grow.

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