

# **Production Tax Credits for the UK Video Games Industry: Lessons from the Canadian Experience**

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by



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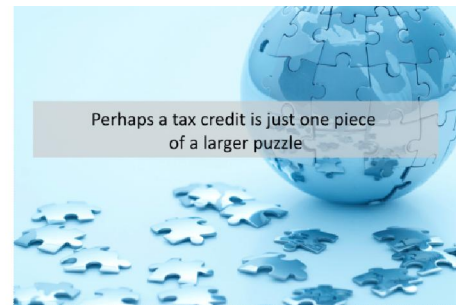


In Canada, there has been widespread use of refundable expenditure-based tax credits for film and television production. Moreover, in some Canadian jurisdictions – particularly Quebec – regional governments have used expenditure-based tax credits to support the video games industry. Indeed, Canada has seen strong employment growth in the video games industry in recent years. In 2008, employment in Canada’s video games industry grew by 28% to over 14,000.<sup>1</sup>

The discussion of tax credits in the United Kingdom (UK) often points to Canada as being a very aggressive user of tax incentives for the video games industry. More accurately, it has been certain regional governments – i.e., the provincial governments of Quebec and Ontario – which have chosen to introduce government intervention to attract developer companies and grow employment in the video games industry.

It is important to recognise that within Canada there are actually three models for video games industry support. At one end of the spectrum is the highly interventionist approach which Quebec has taken. Quebec lured Ubisoft to Montreal in 1997 with a one-off 10-year package of tax concessions, including a 37.5% tax credit on resident labour. Quebec quickly institutionalised these tax incentives and was able to lure other development studios and promote some spin-off growth. Today, Quebec’s tax credit is the centrepiece of its support regime.

- Expenditure tax incentives have supported the continued development of the UK’s film sector
- Some Canadian jurisdictions have tax credits that support the video games industry
- The Canadian video games industry is growing (28% year-over-year job growth)



It is also important to note that when Quebec was courting Ubisoft it had considerable slack in its labour force – even amongst skilled digital media workers – and enjoyed some of the lowest office rents in North America. Today, it continues to be a low-cost location, owing to low rents and low corporate taxes, and the tax credit.<sup>2</sup>

At the other end of the spectrum is British Columbia. A vibrant video games cluster has developed in British Columbia through serendipity more so than direct intervention. The arrival of Electronic Arts (EA) in the early 1990s was not government led; rather, it occurred as the result of EA’s acquisition of a local games developer (Distinctive Software). It is now home to studios for EA, Nintendo, THQ, Vivendi/Activision, Disney and Microsoft. It was only recently that the Government of British Columbia introduced a 30% investment tax credit for venture capital companies that invest in digital media companies in the province. As of late, digital media companies can also benefit from the province’s Renaissance Capital Fund – a co-investment vehicle managed by local VC companies. Today, British Columbia accounts for 40% of video games industry employment in Canada.

<sup>1</sup> Hicklings, Arthur and Low, *Canada’s Entertainment Software Industry: The Opportunities and Challenges of a Growing Industry*, prepared for the Entertainment Software Association of Canada, March 2009.

<sup>2</sup> Investissement Quebec, *Quebec: A Dynamic and Profitable Business Environment*, August 2009.

In between Quebec and British Columbia is Ontario. It is Ontario's approach to video games industry support that is perhaps most relevant to the UK; and moreover, might be considered the most innovative or forward-looking.

Ontario has, for several years, had an expenditure-based tax credit in place for interactive digital media production. This tax credit offers expenditure relief of 35% for *fee-for-service* production and 40% for standard production. In 2008-09, it provided some £6 million of relief to 330 projects with budgets of £40 million.<sup>3</sup>

		
Quebec (Montreal)	Ontario (Toronto)	British Columbia (Vancouver)
<ul style="list-style-type: none"> <li>▪ Long history of excellence in 3D design and animation</li> <li>▪ Up to 37.5% production tax credit (est. 1996)</li> <li>▪ Lured Ubisoft in 1997 (and others after)</li> <li>▪ 37% of Canada's games development industry jobs</li> </ul>	<ul style="list-style-type: none"> <li>▪ Up to 40% production tax credit that had been recently expanded</li> <li>▪ Numerous supporting programs</li> <li>▪ Recently lured a Ubisoft studio</li> <li>▪ 14% of Canada's games development industry jobs</li> </ul>	<ul style="list-style-type: none"> <li>▪ No production-based tax credit</li> <li>▪ But, a long-standing major publisher (Electronic Arts - 1991)</li> <li>▪ Close connection to California</li> <li>▪ 44% of Canada's games development industry jobs</li> </ul>

Recently Ontario has modified its industry-support programme and targeted it at the video games industry.

- Ontario has modified its tax credit, so that video games publishers can make better use of it. It relaxed the requirement that 90% of expenditures be made in Ontario.
- Ontario has introduced a fund for interactive digital media industry (Interactive Digital Media Fund) and is designing a co-investment fund that will be open to video games companies.
- In April 2009, Ontario unveiled its Intellectual Property Development Fund ("IP Fund") open to the screen-based sector, including the video games development segment.

At the same time, Ontario has expanded its video games industry support by introducing a business skills training programme, a marketing and promotion programme, and an investor network.

<sup>3</sup> Ontario Media Development Corporation, "Tax Credit Applications Received and Certificates Issued in 2008-09," *Ontario Media Development Corporation*, downloaded at: <http://www.omdc.on.ca/Page5570.aspx>, January 26, 2009.

While it might be too early to tell whether Ontario's model of industry support will be successful, the fact that Ubisoft accepted an offer in 2009 to locate a new publishing studio in Toronto is certainly a vote of confidence.

Why do we think the UK should pay particular attention to the Ontario model? First, like the UK, Ontario is largely trying to catch-up with other jurisdictions where the video games industries have grown quickly, with or without intervention. Within Canada, Ontario has to compete with a province with a natural advantage (British Columbia), and a province with an early lead in using tax relief in an effective manner (Quebec). This is not unlike the UK's situation: competing with the US (natural advantages), and Quebec and France (with intervention). Finally, the UK finds itself in a position where it has to attract outside investment, to some degree, to fuel industry growth.

The Ontario model includes a very competitive tax credit; but it does not rely exclusively on the tax credit. It complements the tax credit with co-investment funds, and incentives for cross-platform content development. It also offers a fair bit of value-chain support: from research and development (R&D) support to export promotion to incentives for private equity investment. Recently, it has started to adhere to the view that an anchor publisher is also vital to the development of its video games cluster.

#### Ontario's multi-pillar approach:

- Production Tax Credit
- Interactive Digital Media Fund – small investments in smaller games
- IP Fund – early-stage investment in prototyping
- Directed investment to attract a top-level publisher
- Various training and professional development programs

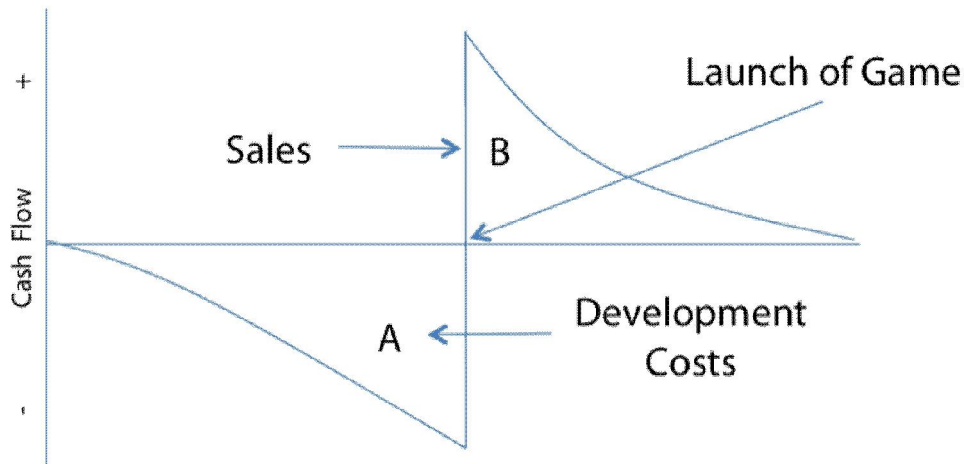
Production tax credits are only part of the equation; and the Ontario government recognises this. Assisting video games developers to be more globally competitive requires a competitive expenditure-based tax credit, but it also requires complementary support mechanisms.

The UK already has some direct and indirect government support accessible by the video games industry. There is an R&D tax credit and Technology Strategy Board grants. There are also games-industry training programmes accredited by Skillset. In some cases, UK companies can utilise the Enterprise Investment Scheme and the Venture Capital Trusts to raise private equity financing. The National Endowment for Science and Technology and the Arts (NESTA) also has a series of initiatives to promote innovation through mentorship, knowledge transfer and skills development. Wales' Creative IP Fund is open to the video games industry and Scotland has introduced a Digital Media IP Fund. What the UK is still lacking, however, is a tax credit, and perhaps a more coordinated approach to industry support.

So why is the multi-pillar approach – adopted by Ontario and sought by the UK – so important? In Nordicity's view, the UK film tax credit cannot be simply copied into the video games development industry. Film is characterised by large investments and long time horizons. In contrast, the video games industry is characterised by wide array of new business models. Many of these new business models, particularly in the online, mobile and social gaming spheres, have widely different cash flow patterns.

Nordicity's research of Ontario's video games sector indicates that standard tax credits are much more useful to certain types of video games companies, particularly those engaged in the development of a small number of large projects – i.e., those companies with business models closer to that of film production. Standard expenditure-based tax credits – resembling those in the film industry – can often be less useful for those video games developers engaged in development of games for emerging platforms.

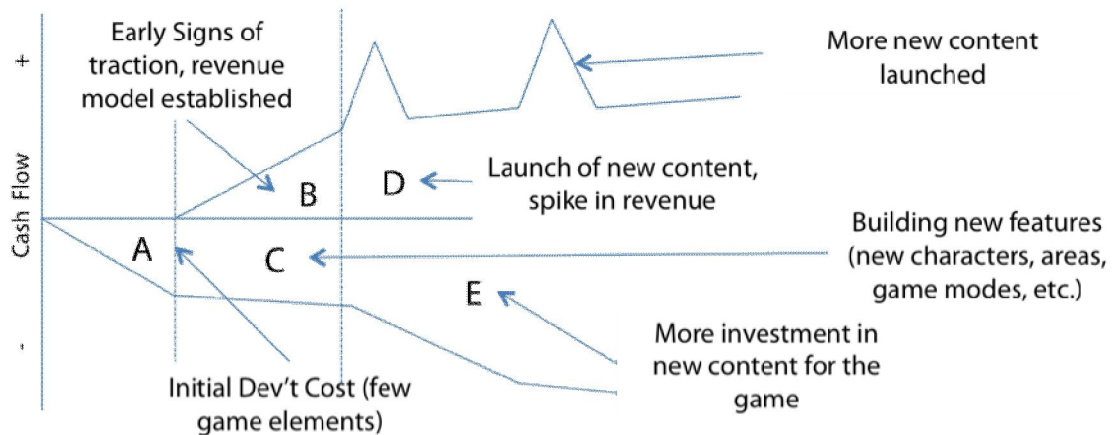
## High-cost Games Development Process



Source: Jason Della Rocca, Presentation to GameON:Finance, Toronto, Ontario, October 2009

There are several reasons why a standard production tax credit may not always be well-suited to smaller companies with shorter development cycles. Tax credits often come with a significant administrative burden on behalf of the applicants. In so far as tax credits are tied to the tax assessment cycle, they can also entail delays in receipt. Quite simply, the monetary benefit of a standard tax credit subsidy can fall short of the legal fees and opportunity cost. For growing companies, where cash flow is vital, any unnecessary wait for cash can negatively affect competitiveness. What is more, for smaller companies, labour expense is often in the form of deferred wages rather than cash expenditures; this type of labour compensation can make it difficult to claim a tax credit.

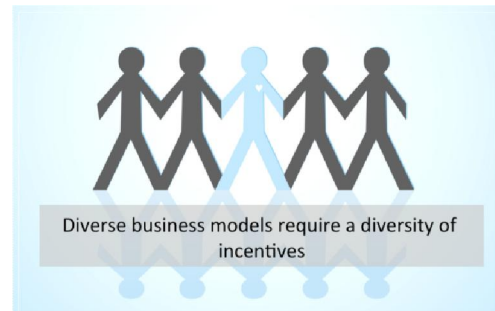
## Emerging (Social/Casual) Games Development Process



Source: Jason Della Rocca, Presentation to GameON:Finance, Toronto, Ontario, October 2009

This diversity of business models further underlines the need for a diversity of incentives. Ontario has responded to the risk of video games developers “falling through the tax credit cracks” by introducing complementary co-investment programmes: the Interactive Digital Media Fund makes small non-refundable contributions to move video games concepts into a market-ready product. Ontario also provides incentives for cross-platform IP development, so as to increase the chances of the IP’s market success.

An expenditure-based tax credit should form part of the UK’s support regime; but there should also be complementary mechanisms in place, so that developers do not fall through the tax credit cracks. Ideally, the tax credit should be designed to minimise administrative burden and lead to fast payment. When it comes to tax credits, design matters.



## Tax credits: Why should they be part of the support regime?

Perhaps, more than any other type of support measure, tax credits are market driven. They support decisions made by entrepreneurs and creative people, rather than government, insiders, or even financiers. In this regard, tax credits are most likely to lead to outcomes as close as possible to market outcomes, including the creation of marketable IP.

In addition, tax credits are reasonably predictable. Typically, they are not capped or rationed in any manner. So, video games entrepreneurs can be certain of receipt. This certainty will encourage investment of time and financial resources, and promote the creation of marketable IP.

A market-driven tax credit within a coordinated system of industry support should lead to the creation of marketable IP. However, the tax credit should also be designed to encourage optimal rights retention, for example: retention of format rights, technical rights, character rights, or sequel rights. A tax credit incorporating some type of sliding-scale rate that adjusts with different degrees of IP ownership could encourage greater IP ownership, in so far as this is seen as a key driver of long-term industry development.

### Tax credits offer a market-driven tool for support

- Allocation driven by entrepreneurs rather than financiers
- More likely to lead to market outcomes: the creation of marketable IP
- Predictable; not subject to rationing
- Are flexible enough to underpin rights-optimization strategies

Ultimately, only well-capitalised and financially strong games-developer companies can be in a position to invest in games development with a minimal amount of advances from downstream distributors, i.e., publishers. A market-driven ownership-tilted tax credit can also play a role in this

regard if it can be effective in either lowering video game developers' cost structures or enhancing the value of their content.

As UK policy makers ponder whether to introduce a production tax credit for video games, there are a number of issues to consider.

## Where to go from here?

The growth of the video games industry is driven by a number of factors. For some jurisdictions, these factors are indigenous; where the factors are not indigenous, government intervention can attempt to level the playing field.

Ontario has some indigenous advantages; but it also recognises that it will require some intervention to be competitive. Ontario's model of industry support offers an example of how government can create an environment where tax credits provide core support, but where complementary support programmes encourage emerging business models, IP development and cross-platform cooperation.

## Summary of Key Conclusion

- **The Canadian experience demonstrates that growth of the video games industry is driven by a number of factors, including intervention**
- **Consider Ontario's multi-pillar approach: a diversity of incentives for a diversity of business models**
- **Consider the market-driven approach offered by a tax credit, to promote the creation of marketable IP**
- **Underline financial performance and encourage optimal management of rights**

The UK might consider looking to Ontario's multi-pillar approach, particularly because it is designed to capture video games developers that might fall through the tax credit cracks. However, the UK should also seek to innovate upon the Ontario model by designing tax credits that are flexible enough to be economic to games developers with emerging business models, and at the same time, offer strong incentives for the creation of marketable IP.

Tax credits remain the centrepiece of Ontario's support regime, and should form part of the UK's support toolkit. Tax credits offer one of the most market-driven forms of support available to



governments. They are highly predictable, and thus, encourage human and financial investment. These types of investments will promote the creation of marketable IP and corporate growth in the video games industry.

Recognising that the long-term development of the video games industry in the UK will only come when the industry is able to achieve optimal management and monetisation of its IP rights, any tax credit should work in concert with other support mechanisms to promote the creation of marketable IP, reduce developers costs, raise their profitability, and improve their capitalisation: thereby positioning the industry to maximise the value it derives from the content it creates.

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