



QUEEN ANNE'S GATE LONDON SW1H 9AT

16 October 1989

WBL at his stage.

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Dear Nigel,

BROADCASTING BILL: TAX IMPLICATIONS
OF CHANNEL 4 TRUST

Our proposals for Channel 4 envisage ownership of the Channel being transferred to a new statutory Channel 4 Trust. I understand that, unless we make provision to the contrary, this transfer could result in Channel 4 becoming liable to pay Capital Gains Tax and Corporation Tax. I do not believe that we intended to create such a liability, which would represent a serious financial burden for Channel 4, and I hope you will agree that we should take steps to remove it.

As you know, the Channel 4 Television Company is now a wholly owned subsidiary of the IBA, set up under section 12(2) of the Broadcasting Act 1981 to provide the Channel 4 service on behalf of the Authority. The company is incorporated under the Companies Act with share capital (ordinary shares of £1 each, authorised, issued and fully paid) of £100. Under our proposals, the IBA will be replaced, probably on 1 January 1991, by the new Independent Television Commission (ITC) which will hold the Channel 4 shares until 1 January 1993, when the Channel 4 company will be transferred to and absorbed within the Trust. The company will at that point cease to exist as a separate entity.

I am concerned about two areas of potential tax liability. First, it is likely that, at the time of transfer to the Trust, the Channel 4 assets (including programmes which have been made but not yet transmitted) could amount to approximately £100 million. Channel 4 could therefore become liable for a Capital Gains Tax payment of 35%, i.e. £35 million. I am advised that there are two possible ways of avoiding this liability. If the conditions of section 267 of the Taxes Act are met, no chargeable gain would be deemed to arise. There seems, however, to be some doubt whether that section would apply to the present case. An alternative course might be for the Channel 4 holding to be transferred via the Secretary of State, who would then best the holding in the Trust. I should be grateful for your advice as to which route we should follow.

Second, I do not believe that there should be any tax implications arising from Channel 4's trading activities after its establishment as a

The Rt Hon Nigel Lawson MP

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Trust. At present Channel 4 is not subject to Corporation Tax on the funds its received from the IBA to finance its operations. The company is regarded by the Inland Revenue as carrying on a "mutual trade" with the IBA and transactions in the course of that mutual trade are ignored for tax purposes. However, Channel 4 is subject to Corporation Tax on all other income.

In future, Channel 4 will be expected to sell its own advertising time in order to finance its programme making activities. It will be given a budget baseline equivalent to 14% of total terrestrial broadcasting revenue (that is the total advertising, sponsorship and subscription revenue from Channel 3, Channel 4, S4C and Channel 5). If it earns less than the budget baseline, the ITC will have powers to impose a special levy on Channel 3 companies to fund the difference up to a maximum of 2% of total terrestrial broadcasting revenue. In the event of Channel 4 raising more than the budget baseline it is proposed that 50% of the surplus would be paid to Channel 3 companies (as a quid pro quo for their having to fund any shortfall). 25% would be held by the Trust in reserve against the possibility of future deficits, and the remaining 25% could be used, at the Trustees' discretion, for additional programme making by Channel 4. Under these arrangements, any monies paid by Channel 4 to Channel 3 would, of course, be liable to Corporation Tax payable by the Channel 3 companies. The sums retained by Channel 4 should not in my view be regarded as profits and should not, therefore, attract Corporation Tax.

A comparison with ITV companies might be helpful. ITV companies sell their own advertising time in order to finance their programme making activities. They pay no tax on their advertising income. But the difference (i.e. the profit) between legitimate programme costs and advertising revenue is subject to Corporation Tax. On that basis it might be argued that any difference between advertising revenue and programme expenditure for Channel 4 should also be subject to Corporation Tax. But there are major differences. In the first place, ITV companies do not have budget baselines. The profit level is genuinely the difference between advertising revenue and the amount they choose to spend on programming. In the case of Channel 4 the 14% budget baseline is pre-determined. Second, profit for ITV companies can be distributed to shareholders, or ploughed back into the business. In the case of Channel 4 the surplus, insofar as it is retained by Channel 4, is either to be used for additional programming (in which case it is no longer profit) or held in reserve against future deficits.

It is difficult to predict what amounts might be raised in this reserve fund. Arguably there will be none. However, at best, one suspects that Channel 4 would be unlikely to earn by the sale of advertising more than 16% of terrestrial broadcasting revenue, and at present prices that would mean

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a surplus over the budget baseline of approximately £25 million a year. Since only one quarter of that would be held in reserves, this could amount to £6 million a year. However, most financial forecasts suggest that over a ten year period Channel 4 will find it progressively more difficult to compete in the sale of advertising while at the same time maintaining its remit. If this proves to be the case, Channel 4 will, in due course, have to call on the reserve fund. We have not yet decided what should happen to any surplus that might remain at the end of the ten year licence period. It could be paid into the Consolidated Fund; or alternatively could be rolled forward as a reserve for the next licence period.

I hope that you would agree that Channel 4 should not be liable to Corporation Tax on any surplus finance which it might retain to be used in the event of future deficits. But if you felt unable to agree to this general principle I should draw your attention to one specific area where a tax concession would in my view be necessary. When Channel 4 starts to generate its own advertising revenues the company is likely to have programme stocks of some £100 million. I believe that the cost of programme stocks should be deductible for Corporation Tax purposes when written off against income from the new trade. Channel 4 will have given value for this stock of programmes and the fact that the purchase will have been financed using funds received from the IBA should not prevent Channel 4 receiving a tax deduction for the cost of the stock when it has commenced to trade on its own account. Otherwise, Channel 4 would be liable to a Corporation Tax payment of £35 million.

I am copying this letter to MISC 128 colleagues and to Sir Robin Butler.

Yours,
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