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ANALYSIS: *INGENIOUS FILM PARTNERS 2* - TRIBUNAL RECHARACTERISES COMMERCIAL INVESTMENTS

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Analysis

Ingenious Film Partners 2: tribunal recharacterises commercial investments

Speed read

The tribunal has issued its decision in *Ingenious Film Partners 2 LLP.* Whilst there are some positives for taxpayers as regards the trading and profit motives of the relevant LLPs, the tribunal recharacterised – and considerably reduced – the 'true' commercial investments that the LLPs claimed to have made. Whilst those transactions were capable of producing benefits to investors, their benefits are likely to be substantially reduced. The alternative, however, could be worse. If the LLPs are right as to their investments, then the tribunal saw no basis for such investments being genuine and, in that case, benefits might be lost altogether.

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'*… that which we call a rose, by any other name would smell as sweet*'
(*Romeo and Juliet*, cited in the *Ingenious Film Partners 2* case report at Chapter VI, Section 4)

'*Not if you called 'em Stenchblossoms*'
(Bart Simpson)

On 2 August 2016, the First-tier Tribunal issued its decision in *Ingenious Games LLP, Inside Track Productions LLP, Ingenious Film Partners 2 LLP v HMRC* (TC 2012/6581; 2013/118; 2013/122).

This case has had a contentious history, including judicial reviews by Ingenious (*R (Ingenious Media Holdings plc and another) v HMRC* [2015] EWCA Civ 173) and possible accusations of dishonesty by HMRC (*Ingenious Games v HMRC* [2015] UKUT 0105). Running to almost 350 pages and incorporating views on everything from film valuation to HMRC's opinion of the film *Blackball* ('risible'), it promises to have an equally contentious future.

Background

The appellants were partnerships that invested in films, through Inside Track Productions LLP and Ingenious Film Partners 2 LLP, and video games, through Ingenious Games LLP (for convenience, references are just to films below). Overall, the LLPs took interests in a succession of high profile projects – most prominently, investing in *Avatar* – and claimed considerable losses, amounting to £1,620m.

The structure

In broad terms, the appellants claimed that:

i. Each LLP agreed with a production company to fund 100% of the costs of films that would be distributed by a commissioning distributor (the 'distributor'). The production company and the distributor were Hollywood studios (or their affiliates).
ii. The LLPs' funding came from capital contributions from its members. Individual members provided 30% of the costs (in one case 35% but, for simplicity, 30% is used throughout below). The remainder came from a corporate member (the 'corporate member').
iii. The corporate member's contribution was funded by a loan from the distributor but the cash was paid directly to the production company.
iv. Once that cash had been transferred, the LLP paid across the funds from the individual members.
v. Income was realised from the exploitation of the film and was payable to the LLP. However, part of that income was retained by the distributor (including in repayment of the loan to the corporate member).
vi. Losses arose to an LLP because it funded 100% of the production costs, but wrote down the value of the film to its net realisable value, which was approximately 20% of cost.

In considering the appellants' claims, the tribunal asked first, what were the actual rights and obligations created by the agreements; and, second, what tax consequences arose as a result.

The transaction

The tribunal considered that, contrary to the appellants' arguments, the arrangements did not entail a genuine investment in 100% of the costs of the films:

- The corporate member had not, in reality, contributed any amounts to the LLPs. There was little acknowledgement of the corporate member's contributions in the membership agreements of the LLPs, and the supposed capital contributions made little difference to the rights of the corporate member in the LLPs. As such, the LLPs only held the 30% from individual members.
- The LLPs were never required to pay 100% to the production company because such payment was contingent on funds having been transferred from the distributor first.
- Although receipts from the film were nominally directed by the LLP to the distributor, it could not be said that the LLPs had received amounts that they then gave away, particularly given that the arrangements happened at the same time.
- At all times, the distributor held all beneficial rights in the films, with the LLPs acting as little more than trustee for the distributor.

The appellants argued that the physical movements of cash were a matter of convenience that did not alter the legal effect of the contracts. However, the tribunal considered that they reflected the real transaction, which was not a 100% investment, but a 30% investment in the films (the '30% investment').

Crucially, the tribunal held that an analysis of the income flows showed that receipts from the films were effectively split 30:70 between the LLPs and the distributor.

If the LLPs were regarded as having paid 100% (and not 30%) of the production costs, then the LLPs were receiving no more than 54.55% of the receipts. A 100%

investment on those terms could not be commercially justified.

On the face of it, this is similar to the position in *Ensign Tankers v Stokes* [1992] STC 226, in which the court considered that the film partnership's investment was only 25% of its stated expenditure.

The legal effect

The tribunal claimed to be examining the legal effect of the arrangements and referred to the comment of Bingham J in *Antoniades v Villiers* [1988] 3 WLR 139:

'the true legal nature of the transaction is not to be altered by the description the parties choose to give to it'.

It is debatable whether the tribunal was really analysing the legal effects of the contracts. For example, *Ensign Tankers*, although referring to the effects of the agreements, primarily focuses on the construction of statutory provisions in light of the arrangements, in a more conventional *Ramsay* approach.

Mr Milne (for the appellants) made this point, but the tribunal noted that *Ramsay* applied more generally. Whilst *Ramsay* can apply outside the tax world, if the implication is that it applies to the construction of contracts, rather than just statute, that is questionable.

Leaving aside the legal effect of the documents, however, is the characterisation of the arrangements fair? The arrangements appeared significantly more substantial than those in *Ensign Tankers*, but the tribunal found ample evidence to support their characterisation of the transaction as a 30% investment. Certainly, the tribunal had no qualms in referring to the 'true' transaction as having been 'dressed up' and 'disguised'.

Ultimately, therefore, if a more conventional application of *Ramsay* would lead to the same conclusion, this may be just a rose by another name.

Tax consequences

Having considered the effect of the arrangements, the tribunal turned to the issues in the appeal:

- Were the LLPs carrying on a trade?
- Were they doing so 'with a view to profit'?
- What expenditure did the LLPs incur for the purposes of their trade?
- Were the losses computed correctly as a matter of GAAP?

Trading

The LLPs claimed to be film producers. The tribunal has seen various cases in which LLPs suggested they were making films, but undertook almost no activity in relation to films and received a simple, fixed return. (For example, the Upper Tribunal's decision in *Acornwood* [2016] UKUT 361 was issued just two days after the *Ingenious* decision.)

In a conclusion that will no doubt displease Ingenious, the tribunal regarded Ingenious staff as acting as if they were carrying out production activities that did not exist in a meaningful way, noting that the LLPs had little creative or practical control over the films and did not acquire any beneficial interest in the films.

In contrast to other film cases, however, the tribunal concluded that whilst the LLPs may have done little more than acquire a revenue stream, these were investments which entailed speculation. In addition, the LLPs retained some rights to consider and approve films. Whilst they may have done this to look like producers, 'the question is not why they did it, but what they did'.

Having put fiscal motive to one side, the tribunal picked it up again because in equivocal cases (such as this) motive was relevant. It was not determinative but, as in *Ensign Tankers*, it required the tribunal to consider what remained after discarding the clothes in which the real transaction had been 'dressed up'.

What remained was the 30% investment; and, on that basis (but only that basis), the LLPs were trading.

For completeness, Ingenious Games was not regarded as undertaking the same level of activity as the other LLPs and so was not treated as conducting a trade on any view.

'View to profit'

For the LLPs to be tax transparent (and allow investors access to their losses), they needed to conduct their business 'with a view to profit'.

Despite dating back to the Partnership Act 1890, this phrase has not often been considered by the courts. The tribunal here regarded the phrase as having a loose meaning, requiring only that the taxpayer had some intention to achieve a profit (simply, income over expenditure) and had conducted its business accordingly. Whether arrangements were undertaken for tax purposes was not relevant, if there was also a view to profit.

There is also a further objective element. If a business was carried on with no realistic possibility of profit, then it could not be said to have been carried on with a view to profit.

What was telling for the tribunal was that if this were a 100% investment, the LLPs could expect receipts of no more than 54.55% and that could not support a realistic prospect of profits

In this case, the tribunal held that the evidence did not readily demonstrate a business conducted for profit. The green-lighting of films was limited, with no emphasis on how films might translate into profit. Instead, revenue appeared more important. That may be significant for tax arrangements, where almost any income resulted in a positive after-tax return, but revenue is not profit.

What was telling for the tribunal was that if this were a 100% investment, the LLPs could expect receipts of no more than 54.55% and that could not support a realistic prospect of profits.

However, on the basis that the arrangements were (despite appearances) operated as a 30% investment, the LLPs were conducted with a view to profit but, again, only on that basis.

Such a granular examination of profit might concern many others who, in practice, have used partnerships with only a cursory acknowledgement of profitability to distinguish them from clubs and charities.

The answer may be that it is a crude test – any profit will do and, in most cases, partnerships will be conducted, at least tangentially, with some view to profit. In the case of tax arrangements, it is not that the tax motivation is problematic in itself; however, where a pre-tax loss can become a post-tax profit, less thought may be

given to conducting a pre-tax profitable business.

Expenditure

Although often the crux of such cases, the tribunal's findings meant that the question of expenditure was dealt with in (relatively) simple terms.

The tribunal noted that expense was incurred where taxpayers bore the economic consequences of their expenditure; and, unsurprisingly, the 30% investment was held to be the only economic burden suffered by the LLPs.

GAAP

For the tribunal, the 'true' transaction should ultimately have been disclosed in the accounts. The tribunal suggested that the appellants' accounting expert was 'blinded by the story the draftsman of the relevant agreements wished to tell', rather than looking at the legal obligations which arose (although, given the 342 page judgment, that would have been no mean feat).

In what is essentially a summary of the tribunal's previous findings, it was held that the LLPs should have recognised, on the one hand, a liability of 30% to the production company; and, on the other, an asset amounting not to rights in a film, but rights to payments from the distributor. Any writing down of the LLPs asset would be limited to 66% of cost.

Overall result

In sometimes trenchant terms, the tribunal rejected the LLPs' narrative. The 'true' transaction was a 30% investment and, whilst the tribunal accepted that this was a genuine investment, it leaves investors with very much reduced tax claims.

The scope of the decision – concerning the construction of documents and the operation of the LLPs that are not greatly distinguished from *Ensign Tankers* – will provide plenty of ammunition for the appellants.

In sometimes trenchant terms, the tribunal rejected the LLPs' narrative

However, if the LLPs succeed in treating the arrangements as a 100% investment, but without overturning the decision that such an investment lacked commercial substance, that could bar investors from any losses and might mean trading a few roses for something even worse. ■

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