

Not so Ingenious

On 2 August 2016 the First-tier Tribunal (**FtT**) dismissed in part the appeals of three Ingenious Media LLPs against HMRC closure notices.¹

The notices amended the partnership tax returns of the LLPs to deny their claims for trading losses incurred through their involvement in producing films and video games. The LLPs had claimed that the losses were available to be set against their investors' other taxable income. HMRC denied those claims, arguing that the LLPs were not carrying on a trade with a view to profit, but were financial vehicles operated for tax avoidance purposes. The appeals were the lead cases for a further five appeals by other Ingenious LLPs against HMRC, whose total value is in the region of £1 billion of tax and interest.

The FtT decided heavily in HMRC's favour. The appeal of the first appellant, Ingenious Games LLP, failed entirely, on the basis that it was not conducting a trade. The FtT accepted that the other two LLPs were conducting a trade with a view to profit. But their loss relief was, in effect, restricted to the cash capital contributed by the investors (rather than the leveraged element of the capital contribution), less sums paid to Ingenious by way of executive-producer fees.

Background

The appellants – Inside Track Productions LLP (**ITP**), Ingenious Film Partners 2 LLP (**IFP2**) and Ingenious Games LLP (**IG**) – are members of a family of LLPs. The LLPs were promoted by Ingenious Media Holdings plc to individual investors. Between them, the LLPs had, over the period from 2002 to 2010, been involved in producing a large number of films and video games, including high-profile releases such as *Avatar*, *The Best Exotic Marigold Hotel* and *Life of Pi*.

If certain conditions were satisfied, the LLPs would be treated as partnerships for income tax purposes, and their investors, as partners, would be taxable on their share of the profits and losses of the LLPs. During the earlier years, the appellants argued, those activities resulted in trading losses that investors could set against their other taxable income. The FtT was told that the losses amounted to some £1,620 million, that the tax reclaimed by the investors amounted to £620 million, and that, with interest and penalties (if relevant), the total amount at stake was some £1 billion.²

HMRC issued closure notices to the three appellants. The notices amended their partnership tax returns to deny their claims for trading losses. HMRC argued that the LLPs had operated in a manner that constituted tax avoidance, and that the investors should repay any tax relief they benefited from as a result of the losses generated by the investment schemes.

Structure

The investment structure of each LLP was similar: each LLP had a number of individual members and a single corporate member. The corporate member was, in two cases, a member of the Ingenious group. In the third case, it was a company wholly owned by a charity with no connection with Ingenious. Each LLP had an operator, another company in the Ingenious group, which managed each LLP's activities (for a fee).

The arrangements that the LLPs concluded for producing films and games all had the same or very similar structure, known as a "commissioning distributor model". This operated in the following way:

¹ *Ingenious Games LLP v HMRC* [2016] UKFTT 0521 (TC).

² *Ingenious Games*, para. 5.

- A commissioning distributor (**CD**) (usually a Hollywood Studio or vehicle formed by independent producers and other financiers) would commission the LLP to make a film or game in accordance with a detailed specification and budget.
- Each LLP would agree with a production services company (**PSC**) to fund 100% of the costs of a film or game. The PSC was an associate of the CD.
- The LLP's funding came from capital contributions from its members. Of a budget of 100, 30 (35 in the case of ITP) was sourced from the capital contributions of the individual investor members, and 70 (65 in the case of ITP) from the corporate member.
- The corporate member's funding was provided by the CD by way of loan repayable only from the corporate member's drawings from the LLP. The loan was made available by a direct cash payment from the CD to the PSC.
- Income was realised from the exploitation of the film or game and payable to the LLP, but distributed under the terms of an agreed "waterfall", which allowed funds to be retained by the CD.
- The LLPs claimed expenditure of 100 on the film or game and then wrote that expenditure down to a net realisable value of 20, giving rise to an accounting loss of about 80 in the accounting period in which the contract for each film or game was entered into.

Appeal

The issues in the appeal were as follows:

- *Carrying on a trade* – The LLPs argued that, under a complex structure of agreements, they conducted a trade that incorporated the production and sale of films. HMRC asserted that they were not carrying on a trade.
- *With a view to profit* – The LLPs argued that their trade was conducted with a view to profit. HMRC contended that the object of the LLPs was to make a tax loss that could be allocated to the individual investing members, that the terms of business were such that profits could not realistically be expected, and that the directing minds of the LLPs were, at best, indifferent to profit.
- *Expenditure incurred for the purposes of their trade* – The LLPs argued that 100% of their expenditure was incurred on the film: 30% (35%) from the individual members and the remaining 70% (65%) from the corporate member. HMRC maintained that this was not the case, and that at least part of the LLPs' expenditure was not incurred wholly and exclusively for the purposes of trade.
- *Correct computation of losses as a matter of GAAP* – HMRC also argued that the LLPs' computing of expenses, and other such accounting practices by the LLPs relating to the calculation of loss, were not in accordance with generally accepted accounting practice (GAAP).

Preliminary analysis of the structure

Before dealing specifically with the issues in the appeal, the FtT considered it necessary to determine the rights and obligations that arose between the parties to the investment structure and then

to characterise them. In doing so, the FtT cited a number of authorities on this point, including *Ensign Tankers*, the judgments in which were relevant to many of the arguments in the present case.³

The FtT's conclusion was that, contrary to the appellants' claim, the arrangements for the investment structure did not result in an investment of 100 by an LLP. In terms of the rights and obligations of the parties:

- The membership agreements of each LLP did not compel the corporate member to make a capital contribution to the LLP.
- Nothing required the LLP to pay (or to cause to be paid) any more than 30 to fund the production. In any event, that obligation only arose once the whole of the 70 was paid by the CD.
- Through the contractual waterfall mechanism, the LLP only had the right to receive a limited amount of the proceeds from exploitation: that entitlement was limited to 30 (or 35). The fact that the proceeds were nominally directed by the LLP to the commissioning distributor did not lead to the conclusion that the LLP received amounts that it then gave away.
- Any rights of the LLP in a film between signing and completion of the film were the rights of a trustee only for the true beneficial owner of the film, the CD.
- It was not completely clear that the corporate member had any right to receive any amount by way of drawings.

Accordingly, the commercial and financial consequences for the parties were as follows:

- The LLP had to pay 30 to the PSC, suffered no other cost and was entitled to 30% of the Gross Distributable Income (as defined in the agreements).
- The CD had to pay 70 and was entitled to 70% of the Gross Distributable Income.
- The PSC had to make the film. Once made, ownership transferred to CD. While the film was being made, the CD had, substantially, rights in the film equivalent to a beneficial owner.

The appellants had argued that such an analysis incorrectly relied on the cash-flows between the entities, and that the "cash shortcuts" taken did not affect the financial consequences for the parties. The FtT disagreed, saying that would "ask us to determine those rights by reference to a deal other than the one the parties actually agreed to", and that the FtT "must determine the rights and financial consequences of the parties from the deal they actually signed, not the one which they want to require the tribunal to think they signed".⁴

Additionally, the FtT found that the control over the creative content of each film was held by the CD: the LLP had a right to be heard, but was incentivised not to interfere.

Those conclusions formed the foundation stone of the FtT's judgment on the issues in dispute.

Decision on the issues

Carrying on a trade

³ *Ensign Tankers (leasing) Ltd v Stokes* [1989] STC 705, [1991] STC 136, [1992] STC 226.

⁴ *Ingenious Games*, paras 230-231.

The FtT determined what activity the LLPs conducted, reviewed the authorities, distinguished the cases of *Eclipse 35*,⁵ *Samarkand*⁶ and *Degorce*⁷ (all of which resulted in a finding of no trade), applied all relevant factors from the case law to the facts and concluded, on balance, that ITP and IFP2 were trading.

The FtT noted that, for independent films, there was more substance to the LLPs' activities whereas, for films where Hollywood studios were involved, the activities of the LLPs were more akin to arranging and monitoring investments in an income stream. Since, however, the two activities were part of one business, this did not affect the decision on this point.

The FtT's analysis on this point turned substantially on its view of the rights and obligations of the LLPs as part of the legal structure, and in particular its view that the LLPs invested 30 for a 30% share in the Gross Distributable Income. If the FtT was wrong on this point, it said, and instead the effect of the agreements was that the LLP invested 100, then that would, in the FtT's view, change things substantially. The conclusion in such case would be that the transactions lacked commerciality, and that the clear fiscal motive of the LLPs would tip the balance on this point to a conclusion that the LLPs were not trading.

A different conclusion was reached for IG, the LLP specialising in games, for which "there was no evidence of creative input ... no pulling together a financial package, but instead the insertion of IG into an existing project".⁸ IG could step in after development had started, and a publisher had already committed funds to the development of a game. In that sense, IG's activities shared many of the characteristics of the other LLPs' businesses in relation to Hollywood studio films. Unlike the other LLPs, however, IG did not have any part of its business that could be considered a trade, and so the FtT considered that it could not be treated as conducting a trade. IG's appeal failed on this basis alone.

With a view to profit

The FtT's decision on this point mirrors its finding in relation to the issue of "carrying on a trade".

In summary, the FtT was not persuaded that it was the intention of those managing the LLPs to conduct their business so as to make a profit on the basis that the LLPs invested 100 in the projects for a return of 54.45% of the Gross Distributable Income (the so-called "Ingenious" basis).

Still, the FtT considered that an expectation of profit calculated on the basis that the LLPs invested 30 for a 30% share of the Gross Distributable Income (the "30:30" basis) "was realistic and not fanciful".⁹ It also found that the participants knew that the economic effect of the transactions was 30:30, and that the LLPs' business was carried on with a view to obtaining that result and with a hope of a profit on that basis. So the FtT concluded that "if profit is properly to be calculated on the 30:30 basis, the LLPs conducted their business with a view to such a profit; but if it is calculated on the Ingenious basis, they did not".¹⁰

⁵ *Eclipse 35* [2012] SFTD 823, *Eclipse Film Partners No 35 v HMRC* [2015] EWCA 95.

⁶ *Proteus and Samarkand* [2012] SFTD 1.

⁷ *Degorce* [2013] SFTD 806 FTT.

⁸ *Ingenious Games*, para. 1224.

⁹ *Ingenious Games*, para. 830.

¹⁰ *Ingenious Games*, para. 834.

The fact that the LLPs were managed with the intention of securing tax benefits for the investors and in the knowledge that the structure provided substantial benefits for Ingenious did not preclude the FtT from finding that the LLPs (operating on a 30:30 basis) could also have had a view to profit. This was because the statutory test does not require the view to be the only or paramount object of the taxpayer.

Expenditure incurred for the purposes of their trade

Expenses are deductible for income tax purposes only if they are incurred wholly and exclusively for the purposes of the trade. The relevant statutory provisions were TA 1988, section 74 and its replacement ITTOIA 2005, section 34.

The FtT considered that an expense is “incurred” in the sense that “the legislation had in mind if the taxpayer bears the economic or financial consequences of the expenditure”, and that the “reality of the legal obligations incurred by the taxpayer determines the financial consequences”.¹¹

In line with its analysis of the investment structure, the FtT found that “the only economic cost borne by the LLP for the purposes of its business was 30 (35)”. In the FtT’s view, therefore, only 30 (35) was incurred.

In considering whether expenses were “wholly and exclusively” incurred, the FtT found that, even if it could be said that the LLPs incurred expenditure of 100, at least 70 (65) of that expenditure was not wholly and exclusively incurred. There were two main reasons for this.

- First, it seemed to the FtT that “70 (65) of that expenditure was not incurred for the purposes of the LLPs’ business but for the purpose of providing a benefit to the CD of enabling the CD to reap a share of the benefits from the exploitation of the films”.¹² So the expenditure was simply not incurred for the purposes of the LLPs’ trade.
- Secondly, “to the extent 100 was expended ... part of the purpose of that expenditure was to secure the enhanced loss for the investor, and part of the purpose of the debit was the same”, and that was “not a trading purpose; as a result, unless the debit can be severed, none of it is deductible”.¹³ In other words, the expenditure had a dual purpose – partly for the purposes of the LLP’s trade, and partly for the purpose of enhancing losses for the investors. On the other hand, “if the relevant debit is 24 (28) representing expenditure of 30 (35) the position is different”.¹⁴ The 30 was expended to yield a profit – the fact that investors would still make a tax loss in this analysis is incidental.

The result was that the LLPs could not claim a deduction for the 70 (65).

There was further bad news for the LLPs and their investors. As part of the arrangements, the PSC appointed an Ingenious company as Executive Producer (**EP**) in relation to each film. The EP was paid an EP fee equal to 5% of the budget (that is, 5 on the 100 of capital contributed by the LLP to the PSC). This was a significant amount of money in the context of the funds raised through the LLPs.

¹¹ *Ingenious Games*, para. 871.

¹² *Ingenious Games*, para. 883.

¹³ *Ingenious Games*, para. 890.

¹⁴ *Ingenious Games*, para. 891.

Under the agreements, the obligation to make the payments was expressed to be the PSC's responsibility. But the actual cash was paid by the LLP direct to the EP and deducted from its 100 capital contribution to the PSC.

The FtT found that the LLP had, as a matter of fact, imposed on the PSC (through the agency of the Operator) the obligation to pay the EP fee. The LLP had itself agreed to this fee for the benefit of the EP. So it was not part of the film budget, but an expense incurred by the LLP itself. As to whether that fee was incurred wholly and exclusively in the LLP's trade, the FtT held: "We conclude that the obligation to pay the fee was not incurred for the purpose of making the film or arranging for the LLP's contract for the film, but to provide cash for Ingenious. We therefore conclude that it was not incurred for the purposes of the LLP's business."¹⁵

That had the effect of reducing the deductible expenditure from 30 to 25.

Correct calculation of losses as a matter of GAAP

ITTOIA 2005, section 25 requires that "the profits of a trade must be calculated in accordance with generally accepted accounting practice [GAAP] subject to any adjustment required or authorised by law in calculating profits for income tax purposes". So the accounting treatment is important in assessing the profit or loss accruing to the LLP in any period. The parties differed in their views on a number of aspects of the accounting treatment.

In resolving the issues, the FtT referred back to its analysis of rights and obligations of the parties under the relevant agreements and concluded that the accounts of the LLPs did not comply with GAAP. In the FtT's view, GAAP required that the accounts show the true nature of the transaction. In coming to this conclusion, the FtT said that the LLPs' accounting expert was "blinded by the story the draftsman of the relevant agreements wished to tell". This was not the correct approach; instead he should have considered "the legal obligations which arose after [the agreements] had all been executed, not how the agreements described the obligations as having arisen".¹⁶

Comment

This judgment represents a significant victory for HMRC. The appeal of IG failed entirely on the basis that it was not trading. The relief claimed by the ITP and IFP2 was significantly reduced: effectively, the FtT has disallowed the element of the LLP's investment (the 70 or 65 as appropriate) that was "circular" – that is, the sum that flowed through the structure from and back to the CD.

Commenting on the decision, an Ingenious representative said that "we have consistently maintained that our film production partnerships were bona fide businesses run for profit and we are pleased that the Tribunal has recognised this".¹⁷ It is true that Ingenious won the issue of trade in relation to ITP and IFP2, but only where it is accepted that the losses made by the LLP are no more than the cash capital introduced by the investors (that is, the 30 or 35 as appropriate). Add to this the disallowance of the deduction for the EP fee paid to Ingenious, and the result is that investor members' claims for tax relief are significantly reduced. In addition, they are likely to have a liability for interest.

This long and comprehensive judgment (running to 342 pages) is very thoroughly reasoned. The factual matrix was extremely complicated, and the FtT made many significant findings of fact. On the

¹⁵ *Ingenious Games*, para. 910.

¹⁶ *Ingenious Games*, para. 940.

¹⁷ <https://www.cchdaily.co.uk/hmrc-secures-partial-victory-tax-tribunal-over-ingenious-film-schemes>.

face of it, this may make the judgment difficult to appeal. But the case also dealt with a number of complex issues of law and the tax at stake is significant, and so there may be many Ingenious ways to found an appeal. The investors will be watching closely.

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