



## Ingenious Film Partners 2 LLP v HMRC

The First Tier Tribunal (FTT) has recently handed down its judgment in the high publicity case of *Ingenious Film Partners 2 LLP (IFP2) v HMRC*. While it was not an outright victory for HMRC, the success of IFP2 on some points may prove pyrrhic. Ultimately, when interest is included on late tax, most partners are expected to have to repay the bulk, if not all, of the purported tax saving. The appeal concerned 3 partnerships: Inside Track Productions LLP (ITP), Ingenious Film Partners 2 LLP, and Ingenious Games (IG). These three partnerships were lead cases in relation to a further 5 Ingenious LLPs. Between them, the LLPs claimed tax losses of £1.6 billion and the tax plus interest at stake was £1 billion.

The judgment itself came in at a hefty 350 pages which is one of the longest FTT judgments. This in itself makes reporting the details a bit tricky so in what follows, we focus on IFP2 which was by far the largest LLP.

The issues being appealed were common to all three LLPs and although there were some variations in what the LLPs actually did, focusing on IFP2 should not detract from the whole. Where there was a materially different point for IG or ITP, we have mentioned it. And we have focussed on what we consider the main points.

### What was the objective?

The FTT set out the intended consequences for the taxpayers who became members of IFP2 as follows (using indicative figures):

- The taxpayer contributed £36 of their own cash to the LLP;
- They then borrowed £64 and contributed that to the LLP as well;
- An Ingenious related company then contributed £100 to the LLP to match what had been contributed by the taxpayer;
- Of the £200, £112 was paid to a production service company (PSC) to produce a slate of films. The balance was used in non-production activities which are not relevant to this appeal;
- Those films were written down in the accounts of the LLP to 20 percent of the price paid due to how the accounting rules were said to work;
- This generated a loss of (broadly) £90 which was allocated to the taxpayer;
- The taxpayer then claimed tax relief of £36 (being 40 percent of the £90 loss);
- In later years if the film was successful monies would be paid to the taxpayer as a return on investment.

In effect, the taxpayer was made whole for their investment of £36 almost immediately by the tax refund of £36 and all future returns were being generated effectively risk free for the taxpayer.

### What did the LLP do?



In broad summary: pursuant to a suite of agreements entered into at the same time in relation to each film or game (with, say, a budgeted cost of £100):

- 30 percent of the budgeted cost of the films was sourced from the subscriptions of individual members of the LLP;
- 70 percent was sourced from a Commissioning Distributor (the CD), which was a normally Hollywood studio (a Studio). This was the money "contributed" by the Ingenious related company from the example above
- The combined 100 percent (being the £112 in the example above) was provided to a PSC, a special purpose vehicle which made the film or game in accordance with an agreed specification. The PSC appeared to have been an associate of the CD: the same lawyers acted for the CD and the PSC;
- When the film or game had been made it was distributed to the public (e.g. cinemas etc) by the CD and the proceeds of distribution divided in accordance with the terms of a "waterfall" which specified who should receive what and in what order, and which amounts were to be paid to the LLP and paid to, or retained by, the CD.

The waterfall was basically an agreement stating how income was to be divided. So for example, the first £20 of income goes to the CD, the next £20 is split 50:50 and the balance is split 30:70 say.

## What were the issues under appeal?

It was common ground that the issues in the appeal were:

- The Contracts: Did the LLP incur expenditure equal to 100 percent of the budget of the film or game?
- Were the LLPs carrying on a trade?
- Were they doing so "with a view to profit"?
- Was their expenditure incurred wholly and exclusively for the purposes of their trade?
- Were their losses computed correctly as a matter of generally accepted accounting practice (GAAP)?

The FTT looked at each in turn but the starting point was the suite of documents that the LLP signed and it was here that things started to not go according to plan for the LLP.

## The Contracts - Did the LLP incur expenditure equal to 100 percent of the budget of the film or game?

The complex suite of contracts were all signed together and referenced each other. Following Lord Templeman in *Ensign Tankers (leasing) Limited v Stokes* (ironically itself a case concerning films and the *Ramsay* principle from the early 1990s), the FTT treated the suite of contracts as a single composite contract and in determining their effect, looked only at the rights and obligations which remained after they had all been signed and ignored all the intervening cross cancelling effects.

This approach meant that the suite of contracts did not do what the LLP claimed and the FTT concluded that the effect of the composite contract was that the LLP was only ever obliged to pay 30



percent of the film cost with the Studio paying the balancing 70 percent and each sharing in the future income in the same ratio 30:70.

This is important because, in our example above where the LLP paid 100 percent of the film cost (being £112) to the PSC to produce the films, it was the write-down on this £112 by 80 percent that generated the loss of £90 which the taxpayers used to generate their tax refunds. The FTT's finding that the effect of the composite agreement was that the LLP only ever paid 30 percent of the film cost to the PSC meant automatically that the loss available was much smaller than claimed.

The FTT also found that the rights of the LLP to the end product (i.e. the completed films) were negligible under the composite contract.

### Were the LLPs carrying on a trade?

The FTT concluded that the LLPs were carrying on a trade notwithstanding the fact that the transactions were "dressed up to look like 100 percent investment [by the LLP] for a share of [future income]". The FTT went on:

"Once the clothes are removed, the ordinary transaction is revealed [30 percent investment by the LLP for 30 percent income share]. If that ordinary transaction is a trading transaction then attempts to dress it differently do not prevent it from being a trading transaction". HMRC had tried to argue that the principle in *Lupton* applied and the tax considerations had so skewed the transaction that the trading aspect had been denatured.

### Was the trade "with a view to profit"?

The FTT concluded that if it was wrong in treating the contracts as a composite and the LLP had in fact paid for 100 percent of the film then it had not done so with a view to a profit. This was because the LLP appeared to be willing to green light films where the projected success of the films was not enough to return a profit *to the LLP*. While it may seem strange to differentiate between a film being profitable and the LLP being profitable but the distinction is warranted because of the waterfalls; the LLP's share under the waterfalls was not enough to make it profitable even if the films made a moderate profit overall.

On the other hand however, the FTT found that if they were correct and the LLPs paid only 30 percent of the film costs then they did do so with a view to a profit. Obviously having a considerably lower cost of sales makes it easier to show a profit and so the FTT was content that if the LLP was only putting up 30 percent of the cost, then the LLP had a reasonable chance of profit.

### Was the expenditure incurred wholly and exclusively for the purposes of their trade?

The FTT concluded that if it was wrong in treating the contracts as a composite and the LLP had in fact paid for 100 percent of the film then 70 percent of the write-down (which was £90 in the example above) was not incurred wholly and exclusively for the purposes of the trade but rather was incurred "to deliver tax relief to the investors".

On the other hand, if the FTT was right in concluding that the LLP only paid 30 percent of the film costs, then it was content to accept that the 30 percent was wholly and exclusively incurred.



## Were their losses computed correctly as a matter of generally accepted accounting practice (GAAP)?

In a quite technically involved discussion about accounting practices, the FTT concluded that the accounts were not GAAP compliant because:

- The LLP only acquired a right to payments of the future income from the film. It did not acquire an asset (i.e. the completed films);
- As such, this asset should be treated as an intangible fixed asset (IFA) not stock as it was originally treated in the accounts;
- The IFA should be accounted for at cost and reflect the fact that the LLP only paid 30 percent of the film costs and not 100 percent;
- The IFA should then be impaired to NRV so generating a loss (in a similar fashion that the original loss was generated); and
- The NRV should be 66 percent of cost.

The consequence of restating the GAAP in this way is that the loss available to the taxpayer was considerably reduced from the original claim as the write down was of a much smaller number (30 percent of film costs not 100 percent) to a NRV of 66 percent.

The FTT then adjourned the appeals for IFP2 and ITP to allow HMRC and Ingenious to agree revised figures.

## Ingenious Games

Unlike IFP2 and ITP, the FTT actually found that IG was not trading. Primarily this was due to how IG conducted itself; it had no real expertise in computer games and there was “no evidence of creative input, evaluation of the merits of potential games..., no pulling together a financial package, but instead the insertion of IG into an existing project. Further, whereas in the film LLPs, the LLPs stepped in generally before filming began, IG could step in after development had started and a publisher had already committed funds to the development of the game. There was none of the more complex involvement which ITP and IFP2 had with Independent films.”

So in the case of IG, the FTT dismissed the appeal outright with no loss available to the taxpayers.

We await further developments.

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