TC01453

Appeal numbers: TC/2009/13893, 2009/14401, 2010/6763, 2011/682. 2011/683, 2011/ 926, 2011/00927, 2011/1074, 2011/ 1077

Income tax-partnerships engaging in sale and leaseback of one or two films - loss claimed by partners from film acquisition relief provisions of ss130-140 ITTOIA. Issues arising: (1) was partnership carrying on a trade-held no;(2) was business carried on on a commercial basis (ss380,381,384 ITTOIA)-held no; (3) was business carried on with expectation of profit –yes;(4) was the business the exploitation of films (s136(a) ITTOIA)-yes;(5)was the relevant expense incurred on the acquisition of films (s130(3))? (6) was it incurred wholly and exclusively for the business? (7) what was the effect of the "relevant period" provision in s 138? (8) what was the effect of the partnership loss rules in s 118ZE and the 2008 regulations? (9) were fees paid to an arranger of the transactions capital in nature? (10) were such fees paid wholly and exclusively for the purposes of the partnerhip business? (11)to what accounting period were such fees properly attributable?

FIRST-TIER TRIBUNAL
TAX

SAMARKAND FILM PARTNERSHIP No.3 **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

PROTEUS FILM PARTNERSHIP No.1 **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

THE PARTNERS OF SAMARKAND **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

THE PARTNERS OF PROTEUS **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

TRIBUNAL: CHARLES HELLIER (Judge)
JOHN ROBINSON

Sitting in public in London on 4-6, 9-13 and 16 and 17 May 201 Jonathan Peacock QC and Jolyon Maugham, instructed by Herbert Smith LLP for the Appellants John Tallon QC and David Yates, instructed by the HMRC, for the Respondents

I Outline

1. The partners in two partnerships, Samarkand and Proteus, claim the benefit of loss relief in respect of tax losses they say arise from (1) expenditure on the acquisition of films, and (2) certain other costs, incurred by their respective partnerships.

2. Samarkand acquired interests in the films The Queen and Irina Palm in 2006/7 and Proteus acquired an interest in Oliver Twist in 2005/6. In each case the films were acquired as part of a single transaction which encompassed their acquisition and their associated lease back in return for fixed, increasing, secured and guaranteed rental payments for a 15 year period.

3. The availability of relief for the losses of a partnership, and the allowability of deductions in computing partnership income for expenditure on films are dependent upon the satisfaction of a number of statutory conditions. HMRC say that many of those conditions were not satisfied and that consequently the partners were not entitled to the benefit of loss relief or that it should be limited. We set out in the following section the relevant legislation and indicate there the conditions which were debated before us.

The mechanics of the appeals and references

4. Proteus appeals against a conclusion in a closure notice issued by the Respondents for the year to 5 April 2006 that an adjustment was required to the losses claimed by the partnership to reduce them from £20,229,747 to nil.

5. Samarkand appeals against a conclusion in a closure notice issued by the Respondents for the year to 5 April 2007 that an adjustment was required to the losses claimed by the partnership to reduce them from £11,423,606 to nil.

6. Sample partner E appeals against a closure notice issued by the Respondents in relation to the year ended 5 April 2006 in which HMRC concluded that the losses claimed deriving from the Proteus partnership should be reduced to nil.

7. Section 28ZA TMA 1970 provides that when an enquiry is in progress a question arising in connection with the subject matter of the enquiry may be referred to the tribunal for a determination.

8. The partners in Samarkand made a referral to the tribunal under this section to determine the following questions:

(1) Does any restriction apply to the use of any trading losses by the members of Samarkand as a consequence of the amount of capital contributed, or treated as contributed, by those members for the purposes of ICTA 1988 118ZE and the Partnerships (Restrictions on Contributions to a Trade) Regulations 2005)?

(2) Did Samarkand (during 2006/07) trade:

(a) in or by the end of the year of assessment on a commercial basis and with a view to the realisation of profits (for the purposes of ICTA 1988 sections 380 & 384)?

(b) throughout the period in question on a commercial basis and in such a way that profits in the trade could reasonably be expected in the period or within a reasonable time thereafter (for the purposes of ICTA 1988 section 381)?

9. The partners in Proteus made a joint referral to the tribunal under section 28ZA in which the tribunal was asked to determine the following questions:

(1) does any restriction apply to the use of any trading losses by the members of Proteus as a consequence of the amount of capital contributed, or treated as contributed, by those members (for the purposes of ICTA 1988 section 118 ZE and the Partnerships (Restrictions on Contributions to a Trade) Regulations 2005)?

(2) Did Proteus (during 2005/06) trade:

(a) in or by the end of the year of assessment on a commercial basis and with a view to the realisation of profits (for the purposes of ICTA 1998 sections 380 & 384)?

(b) throughout the period in question on a commercial basis and in such a way that profits in the trade could reasonably be expected in the period or within a reasonable time thereafter (for the purposes of ICTA 1988 section 381)?

10. The tribunal directed that these appeals and referrals be heard together. Although there were some differences they raised common issues of fact and law. This decision is in respect of each of them.

Structure of Decision

11. The remainder of this decision is structured thus:-

II The statutory provisions and the issues arising

III The Evidence, the general factual findings, and the terms of the contractual documents

IV Further factual findings relevant to the trading issue and expenditure on the films and the Rights

V Were the partnerships conducting a trade?

VI If so was that trade carried on on a commercial basis?

VII If there was a trade, was that trade carried on with a view to profit?

VIII If there was a trade, was that trade the exploitation of films?

IX How much expenditure was incurred on the acquisition of films and film rights by the partnerships?

X If there was a trade, was that expenditure incurred wholly and exclusively for the purposes of the partnership trade?

XI The fees paid by the partnerships;

(a) findings of fact

(b) were the fees capital in nature?

(c) were they incurred wholly and exclusively for the trade (if there was one)?

(d) to what accounting periods were they correctly attributable?

(e) summary

XII Do the partnership loss rules restrict the availability of losses?

XIII In the case of Proteus is any loss to be restricted by the "relevant period" provision?

XIV Summary and conclusions

XV Rights of Appeal

12. We note that the Appellants maintain that in seeking to deny loss relief HMRC is traversing statements it made in its Business Income Manual on which the Appellants legitimately relied. The Appellants, we were told, had commenced judicial review proceedings which had been stayed pending these appeals. The Appellants did not ask us to address whether they had a legitimate expectation to which this tribunal should give effect.

II. <u>The Relevant Statutory Provisions</u>

(a) <u>Film acquisition relief</u>

13. ITTOIA 2005 contained in sections 130 to 144 provisions which afforded special reliefs for expenditure on (a) the production of sound recordings and films and (b) the acquisition of sound recordings and films. These provisions applied for 2005-06 and were relevant to Proteus' appeal.

14. s.47 FA 2006 withdrew these provisions so far as they related to films and replaced them with a new code of relief for expenditure on the production (and not the acquisition) of films. However so far as concerned expenditure on the acquisition of films s.47 withdrew the relief only where:

(i) the film commenced principal photography on or after 1 April 2006, or

(ii) the expenditure was incurred on or after 1 October 2007.

15. The Proteus appeals relate to 2005-06 and are unaffected by these provisions. The Samarkand appeals relate to the 2006-07 year and are therefore governed by the ITTOIA 2005 as amended by s.47 FA 2006. But the principal photography on all the films in question began before 1 April 2006, and its

expenditure was incurred before 5 April 2007. As a result the amendments made by s.47 do not affect the operation of ss.133 to 144 ITT0IA 2005 as regards the Samarkand appeals. We therefore consider those provisions without distinction between the relevant years.

16. The ITTOIA provisions give relief for “acquisition expenditure”: that is “expenditure incurred on the acquisition of the original master version of a film” (s.130(3)). By s.130(4) references to the “original master version” include any rights in the original master versions of a film that are held or acquired with it”. By section 132(1) the original master version is defined to mean the original master negative.

17. Expenditure on the acquisition of a film which a trader intended to exploit would normally be capital expenditure and not eligible for a deduction in computing his profits. Section 134 reverses that position by providing that such acquisition expenditure is of a revenue nature (and conversely treats related receipts as revenue).

18. That leaves the question of the period in which the deduction should be allowed. Section 135 provides a normal rule – allocation to such periods is just and reasonable – but sections 138 and 140 provide for what will usually be an accelerated recognition of the deduction. Each section applies only where “the trade consists of or includes the exploitation of films” (s.136(a)) and only where the original master version of the film is a “certified master version” (which by 132(3) means one certified under the Film Act 1985 as a qualifying film. Such certification was done by the Department for Culture Media and Sport (“DCMS”)).

19. Section 140 provided a regime for acquisition expenditure on limited budget films (where production expenditure was less than £15 million) and, section 138 on regime for such expenditure on other films.

20. The original ITTOIA provisions were however amended shortly after they were enacted by FA 2005. Schedule 3 of that Act amended section 138 and 140. The amendments however did not apply in relation to any film which was in production on 2 December 2004. Oliver Twist was in production on 2 December 2004. It was not a limited budget film. The original version of s.138 thus applied to Oliver Twist. The Queen and Irina Palm were both limited budget films. Their photography commenced in 2005: the amended version of s.140 thus applied to them. We therefore set out below the original version of s.138 and the FA 2005 version of s.140.

21. So far as relevant to those appeals the original section 138 provides:-

“(1) This section applies if –

(a) the person carrying on the trade has incurred … acquisition expenditure in respect of the original master version of a film in, or before, the <u>relevant period,</u>

(b) the film was completed in, or before, that period,

(c) the original master version is a certified master version [i.e. an original master negative certified under Sch 1 Films Act 1985] …

"(2) A deduction is allowed for the amount of the expenditure allocated to the relevant period, but this is subject to the application of any <u>prohibitive rule</u>.

"(3) The person carrying on the trade may allocate up to the permissible amount of the expenditure to the relevant period.

"(4) The permissible expenditure is the smallest amount given by the following calculations.

"(5) [These calculations for present purposes may be summarised as permitting ⅓ of the expenditure for each relevant period.]

"(6) If the relevant period is less than 12 months the above references to one-third are to be read as references to a proportionately smaller fraction."

22. Thus, broadly, for a non low budget certified film a trading deduction will be allowed to a deduction for ⅓ of the cost of the film in each of the periods starting with that in which the expenditure was incurred. We return to the underlined terms in a few paragraphs.

Section 140 as amended by FA 2005 provided:-

"(1) This section applies if –

(a) the person carrying on the trade has incurred acquisition expenditure in respect of the original master version of a film in, or before, the relevant period;

(aa) the film was completed in, or before, that period;

(b) the acquisition was [directly from the producer and the film had not been previously acquired from him];

(c) the expenditure was incurred before 1 October 2007 …

(d) the original master version is a certified master version …

(f) the total production expenditure in respect of the original master version is £15 million or less…

"(3) A deduction is allowed for the amount of the acquisition expenditure allocated to the relevant period, but this is subject to the application of any <u>prohibitive rule.</u>

"(4) The person carrying on the trade may allocate up to 100% of the expenditure to the <u>relevant period</u>.

"(5) But the total amount allocated under this section may not exceed the total production expenditure in respect of the original master version…".

23. Thus for a low budget film a deduction in computing trading profits of 100% of the production cost of the film was permitted in the period the expenditure was incurred. The relief under section 138 was not limited to production costs.

24. We highlighted two terms in the extracts from the legislation. The first was “relevant period”. This term plays a part in the arguments in relation to Oliver Twist and s.138. Whereas the relief given by s.140 permits 100% of the expenditure to be deducted however short or long the “relevant period”, the effect of s.138(6) is proportionately to reduce the (⅓) relief which would be allocated to a relevant period if that period is less than 12 months. HMRC assert in relation to Oliver Twist and Proteus that that period was less than 12 months. We shall address that issue at section XIII below when we set out the definition of “relevant period”.

25. The second highlighted term is “prohibitive rule”. That is defined by s.130(7) to mean any provision of the Income Tax Acts which:

(a) prohibits a deduction from being made, or

(b) restricts the extent to which it is allowed

in calculating the profits of a trade.

26. Among such prohibitive rules is that now found in s.34 ITTOIA:

> “(1) In calculating the profits of a trade, no deduction is allowed for –
>
> (a) expenses not incurred wholly and exclusively for the purposes of the trade, …
>
> “(2) If an expense is incurred for more than one purpose, this section does not prohibit a deduction for any identifiable proportion of the expense which is incurred wholly and exclusively for the purposes of the trade”.

27. As will be seen, one of HMRC’s contentions in these appeals is that the expenditure claimed was not or was not all incurred wholly and exclusively for the purposes of the trade.

28. We should also mention the rule in section 33 ITTOIA. This is not relevant to expenditure on acquiring the films, which by section 134 is deemed to be of a revenue nature, but may be relevant to expenditure on fees. It provides:

“…in calculating the profits of a trade, no deduction is allowed for items of a capital nature.”

(b) <u>Relief for losses</u>

29. A person who is a partner in a partnership which is carrying on a trade is himself carrying on that trade. Section 852 ITTOIA provides that he is taxable on his share of the profits of that trade as if they were profits of a trade carried on by that partner alone. We notice that this provision does not require an assessment of whether there is a trade to be made on the basis that the partner

carried the activities of the partnership on alone, but merely requires that, if there is a trade carried on by the partnership, his share of its profits and losses are assessed as if he carried it on alone.

30. Section 380 TMA 1988 permits a person who sustains a loss in any trade to claim relief by setting it against his other income of the year of the loss or the income of the preceding year. This was referred to as "sideways relief". But section 384 provides, so far as is relevant, that:

> "(1) … a loss shall not be available for relief under section 380 unless for the year of assessment in which it is claimed to have been sustained, the trade was being carried on on a commercial basis with a view to the realisation of profits in the trade …
>
> "(9) where at any time a trade is carried on so as to afford a reasonable expectation of profit, it shall be treated for the purpose of subsection (1) above as carried on at that time with a view to the realisation of profits."

31. Section 381 provides additional sideways relief for losses sustained in the early years of a trade. Such losses may be set against income of the three years before that in which the loss was sustained. But subsection (4), echoing the provisions of section 384, provides:-

> "(4) Relief shall not be given under subsection (1) above in respect of a loss sustained in any period unless the trade was carried on throughout the period on a commercial basis and in such a way that profits of the trade… could reasonably be expected to be realised within a reasonable time thereafter."

32. The requirement in these two provisions that the trade be carried on on a commercial basis for the period or year of assessment is the same. The requirement for an expectation of profit is arguably less onerous in s.384(1) since it is possible that there could factually be a view to profit without such a profit being a reasonable expectation. (One might buy a lottery ticket with a view of profit, but without a reasonable expectation of a win.)

33. In the argument before us the test imposed by this section was broken down into two limbs: the commercial limb and the profits limb. We follow that dichotomy in this decision but at para 257 and 258 below we consider the effect of that approach on the nature of the assessment to be made under them.

(c) <u>Restriction on the availability of partnership losses</u>

34. Sections 118ZE to 118Z0 TA 88 and the 2005 regulations made thereunder contain provisions which limit the amount of loss relief which a partner may claim under section 380 and 381. We deal with these provisions in a separate section of this decision (see section XII) and set out the relevant statutory provisions there.

<u>Questions arising from these statutory provisions in relation to film expenditure</u>

35. The provisions discussed above gave rise to a number of conditions which must be satisfied before a partner in a partnership can claim relief for a loss

created by expenditure in relation to the acquisition of rights in a film. Of these conditions the following were debated before us:-

(i) was the partner, through the partnership, carrying on a trade? – s.138(1) and 140(1)(a) ITTOIA;

(ii) if it was, was the trade one of the exploitation of films? – section 136(a) ITTOIA;

(iii) if so, was the relevant expenditure "incurred on the acquisition of the … film"? – s.130(3) ITTOIA;

(iv) was the expense incurred wholly and exclusively for the purposes of that trade? – s.34(1) ITTOIA;

(v) was the trade carried on on a commercial basis in the relevant year or period? ss.384 & 381(4) TA 88;

(vi) was the trade carried on with a view to the realisation of profits or with a reasonable expectation of profit? – s.384 & 381(4) TA 88;

(vii) do the partnership loss rules and regulations restrict the use of any loss? – s.118ZE and the 2005 Regs;

(viii) in the case of Oliver Twist, how long was the relevant period? – s.138.

(d) Relief for other expenses

36. In addition the partners claim trading deductions in computing their profits for fees paid by the partnerships to Future Capital Partners Limited ("Future"). The ability of the partners to claim loss relief arising from paying such fees is dependent on satisfying the following conditions which were debated before us:-

(i) that the partnerships were conducting trades (s.138(1) and s.140(1)(a) ITTOIA);

(ii) that that trade was carried on on a commercial basis (s.384 and 381(4) TA 1988);

(iii) that the trade was carried on with a reasonable expectation of, or with a view to, profit (s.384 and 381(4) TA 1988);

(iv) that the fees were an expense incurred wholly and exclusively for the purpose of the trade (s.34 ITTOIA);

(v) that the loss is not restricted by the partnership loss rules and regulations;

(vi) that the fees were not items of a capital nature (s.33 ITTOIA);

(vii) that the deduction of the fees in computing the profit of the trade in the relevant year is in accordance with generally accepted accounting practice (s.25(1) ITTOIA).

37. Of these issues (i), (ii), (iii) and (v) raise the same questions as are raised in relation to the expenditure on the film, and we deal with those under single headings for both types of expenditure. The issues in (iv), (vi) and (vii) are peculiar to the expenses. We deal with them in separate sections of this decision.

(e) The Partnership Act 1890

38. HMRC submit that no partnership came into existence until the investors adhered to the partnership deed. As a result they say that the nature of the partnership business is to be determined by reference only to the business which was conducted at that time, and that that business was at that time not a trade.

39. Section 1 of the Partnership Act 1890 provides:

"(1) Partnership is the relation which subsists between persons carrying on a business in common with a view of profit."

40. The Proteus and Samarkand partnership deeds expressed them to be subject to Jersey law. Neither party contended that Jersey partnership law differs from UK law, or that the execution of those deeds created, under Jersey law, a legal person different from the persons who were parties to that deal. We have thus assumed that to be the case. Further so long as Jersey law does not create a new legal person as a result of these deals, the question as to whether or not there is a partnership for the purpose of the UK statutes must be determined according to UK law. Thus the question which arises is whether at relevant times the persons who were parties to those deals were persons carrying on a business in common with a view of profit.

(d) Unit Trust

41. If the partnerships constituted (unauthorised) unit trust schemes, and the trustees of the scheme were UK resident, then, by section 469 TA:

> "(2) Income arising to the trustees of the scheme shall be regarded for the purposes of the Tax Acts as income of the trustees (and not of the unit holders) …"

42. A unit trust scheme for this purpose has the same meaning as in the Financial Services and Markets Act 2000 (see s.469(7)) namely:-

> 237(1) … "unit trust scheme" means a collective investment scheme under which the property is held on trust for the participators …"

Whilst it appeared from the Business Plans that the partnerships were viewed as collective investment schemes it was not contended that their assets were held on trust.

III The Evidence, the facts and the contractual documents

(a) The Evidence

43. There was a statement of agreed facts. In addition we heard oral evidence from: Tim Levy, the CEO of Future who was involved in the setting up of the

partnerships and their acquisitions of, and dealings with, interests in the films; Sirishkamur Malde of Malde & Co, chartered accountants, who provided an opinion on the purchase price of Oliver Twist; Terence Back of Grant Thornton who provided evidence in relation to the proper accounting for the fees paid by Samarkand and Proteus; Richard Cannon, a chartered accountant employed by HMRC who gave further evidence in relation to the proper accounting for those fees and of present value calculations; Paul Simpson of HMRC who gave evidence in relation to valuation; and Stephen Norris, a film producer, who gave evidence in relation to the UK film industry at the relevant time. When we refer in this decision to Mr Norris we mean Stephen Norris rather than Simon Norris (of Future).

(b) <u>The arrangements and the films: factual findings</u>

44. In this section we deal with facts that are general background, or relevant to all or most of the issues which are discussed in later sections. Factual issues principally relevant to the trading issue and to issues relating to the acquisition of the films we deal with in the following section. Other factual issues relevant only to a particular issue are generally dealt in the section dealing with that issue.

45. In the case of each of Samarkand and Proteus the broad pattern of events was this:

(1) A partnership agreement under Jersey law was executed by two persons, one of whom was designated as the managing partner;

(2) An agreement was signed between Future and the managing partner under which Future was appointed the agent of the partnership for finding films for it to exploit. That agreement contemplated that Future would receive a fee;

(3) A film was found by Future and Future made arrangements for a transaction comprising its sale to the partnership and its leasing by the partnership;

(4) A Proposal document (a Business Plan or an Information Memorandum) was issued to potential investors. (We generally refer to this document as the Business Plan);

(5) Bank of Ireland (the Facility Bank) produced letters to potential investors setting out the terms on which it could lend them up to 90% of their commitment to invest in the partnership. There was no limitation of the Bank's recourse to the partners' other assets;

(6) Either (1) a certificate of the production cost of the film was to be provided or (2) Malde & Co provided an opinion letter relating to the price to be paid for the film. In the case of Oliver Twist, which was bought at a price based on a valuation, this opinion was based on a valuation of the film prepared by the Salter Group LLC. In the case of The Queen and Irina Palm, which were bought at a price based on production costs, certificates were produced by Shipleys LLP and Stewart Gilmour & Co of the production costs of those films.

(7) Persons who decided to invest signed deeds of adherence to the partnership;

(8) The partnership signed agreements to purchase films and related agreements to lease them to Haiku Releasing Ltd ("Haiku") for fixed but escalating rentals over a primary 15 year period. The purchase was conditional upon the lease agreement and vice versa;

(9) The investors paid their monies, and their loans from the Facility Bank were drawn down;

(10) The monies from the partners' aggregate contributions were paid by the partnership: (a) to the vendor of the film (or to the Lessee at the request of the Vendor), and (b) to Future by way of fees under the agency agreement, thus exhausting the partnership funds;

(11) Haiku placed on deposit an amount equal to about 80%of the sale price of the film. The deposit was charged as security for its rental obligations (which would be discharged from the deposit);

(12) Haiku licensed the film directly or indirectly back to the seller, for a sum equal to the amount it put on deposit;

(13) The partnerships charged their assets (including the interest in the Haiku deposit) to the Facility Bank to secure its lending to the partners;

(14) The Partners' loans and interest thereon were discharged from the rental payments emanating from Haiku's deposit.

46. The precise events and their sequence were different in each case. To the extent relevant to the appeal we set out the details in the sections of this decision dealing with the Partnership and Trading issues.

The films

47. The sale and leaseback agreements entered into by Samarkand related to the films The Queen and Irina Palm. Proteus' agreements related to Oliver Twist.

48. The Queen was nominated for six Academy Awards and Helen Mirren won a Best Actress award for her performance in it. Its principal photography started on 14 September 2005. It is a well known film and was released in the UK in September 2006.

49. Irina Palm starred Marianne Faithful and Jenny Agutter and was directed by Sam Garbarshi. It was nominated for eight major awards and won four, including the Golden Bear in Berlin. Its principal photography started on 10 December 2005. It was released in the UK in June 2008.

50. Oliver Twist was directed by Roman Polanski and starred Sir Ben Kingsley. Its principal photography started on 12 July 2004. It was released in September 2005. It cost some £25m to produce.

51. There is no doubt that these were real films intended for real cinematic audiences.

52. Each of the films was certified by the Department for Culture Media and Sport as a qualifying film within Schedule 1 Films Act 1985.

Acquisition of other rights

53. We describe the agreements under which The Queen, Irina Palm, and Oliver Twist were purchased and leased in the following section. The leases for The Queen and Irina Palm also bestowed on Samarkand certain rights in relation to the net takings of those films. In addition to the interests in these films there were the following acquisitions.

54. (i) On 5 April 2006 (11 months before the Samarkand investors completed their investment in Samarkand) Samarkand's managing partner entered into agreements in relation to the screenplay in a prospective film Grey Neon, and(ii) in December 2006 an agreement in relation to income from a film, Comme T'y es Belle, was signed on behalf of Samarkand

55. At some time in 2006 an agreement (the 'Rights Acquisition in Agreement') was made between Future and Proteus, which assigned to Proteus rights to share in income arising from Oliver Twist, in return for payments by Proteus to Future totalling £513,474 (which was expressed to be payable in three annual instalments starting on 13 January 2006).

(c) The Principal Contractual Documents relating to the Sale and Leaseback transactions

(i) Samarkand

56. Samarkand acquired its rights in The Queen under a Sale and Purchase Agreement with Pathé Slate Limited dated 11 September 2006. Samarkand entered into a lease agreement (impliedly with Haiku), in respect of The Queen on 12 December 2006. Closing of the Sale and Purchase agreement was conditional on the execution of the lease.

57. Samarkand acquired its rights in Irina Palm under a Sale and Purchase Agreement with Ipso Facto Films Ltd dated 22 December 2006. Closing was conditional on the execution of a Film Lease (impliedly with Haiku). Samarkand entered into a leasing agreement with Haiku in respect of Irina Palm on 9 March 2007. The Lease was conditional upon the sale and purchase agreement becoming unconditional.

58. On the day it entered into each Leasing Agreement, Haiku granted a sub-licence of the Rights back to: Pathé, in the case of The Queen, and Ipso Facto in the case of Irina Palm. The consideration for the sublease was an amount equal to the deposit Haiku made under the guarantee arrangement described below.

59. The agreements referred to one another and were part of a single arrangement under which (1) the film was sold to Samarkand and then indirectly licensed back to the seller, (2) Samarkand became entitled to receive secured rentals from Haiku, and (3) Samarkand paid a price. There was no doubt in our minds that the SPA agreement was not contemplated and would not have been completed without the lease and vice versa. The agreements

referred to each other, the completion of each was dependant on the completion of the other, and they completed on the same date. They were legally and commercially one transaction.

60. The Sale and Purchase Agreements provided:-

(1) that the film negative be sold and the "Rights" in the film be licensed for an amount equal to the certified cost of the film (cl.3.1);

The Rights were expressed to be with the benefit of and subject to Prior Agreements.

(2) that the completion of the agreement was subject to the satisfaction or waiver of certain conditions, including the provision of evidence of certification of the film as a certified master version, and the production of a statement of certified cost;

(3) that on or before the Closing Date the seller deliver:-

(i) "the Film lease duly executed by the Lessee". The "Film Lease" means the lease of the film by Samarkand to Haiku

(ii) Licences of the Rights and underlying rights, and

(iii) an agreement giving access to the negatives (Cl.4).

The payment of the purchase price (at financial close) was made subject to such delivery.

(4) that the seller should pay 1%, in the case of The Queen, and 2%, in the case of Irina Palm, of the net profits of the film received by the seller. We call these rights the Extra Net Profits. This net amount was to be computed after deduction of net profits payable to distributors and persons connected with the production of the film. (cl. 3.5).

(5) the agreement progressed towards completion in two stages. First there was a Closing. On the Closing Date the rights to the negatives would be conveyed, the licence agreement executed and the lease would be delivered. Then there was payment on the payment date. Closing and payment were subject to conditions precedent which included, for the SPA, the execution of the lease, and, for the lease, the execution of the SPA. The payment date was referred to before us as financial close. By that date the amount to be paid for the film would have been determined by a cost or valuation certificate and the rents payable under the lease set by reference to that price and prevailing interest rates. Payment was made on 9 March 2007.

The Leasing Agreement between Samarkand and Haiku for The Queen was signed on 12 December 2006. The versions signed on that date contained no schedule of rents. By a side letter it was agreed that they should be fixed on the Payment Date by reference to 14 year LIBOR on that date. They were eventually specified in an agreement of 9 March 2007. The rentals in the Irina Palm agreement were set out in that agreement of 9 March 2007. (The rents payable under the lease were set so that their present value at a discount rate related to prevalent 14 year LIBOR was equal to the deposit made by Haiku.)

61. Under the Leasing Agreements, which were conditional upon Haiku receiving a duly executed copy of the SPA:-

(1) Samarkand leased the film to Haiku for 15 years ("the primary period") with the option of continuing to rent thereafter (in the 'secondary period');

(2) Haiku agreed to pay fixed escalating rentals for the first 15 years, and if the lease extended for the secondary period, annual rentals thereafter of £100;

(3) Haiku agreed to furnish a guarantee by a Bank of its payment obligations. ABN Amro was that bank;

(4) there were provisions (cl.13.5) relating to the consequences of breach or repudiation ;

(5) the rights acquired by Samarkand, and then by Haiku, were subject to and with the benefit of the "Prior Agreements". These were agreements for the distribution of the film around the world and under which distributors were licenced rights in the film in their territory and paid, had paid, or agreed to pay sums to the producer. The advances which had been paid were in some cases recoverable and in others not. It seemed clear to us that the transfer of the benefit of the Prior Agreements did not confer on the recipient the right to receive amounts which had already been paid under them.

62. On 9 March 2007 Haiku deposited an amount equal to some 78% of the total sale price of The Queen and Irina Palm (being an amount equal to that which it received from the seller for the sub licence) on deposit with ABN Amro as security for the guarantee ABN Amro gave of the rentals.

63. On the same day Samarkand assigned the benefit of the ABN Amro guarantee and the right to receive rental payments to the Facility Bank as security for the partner borrowing from that bank.

(ii) <u>Proteus</u> (Oliver Twist)

64. On 21 June 2005 an agreement was signed between Proteus Film Ltd as managing partner of Proteus and R P Productions SA ("RPP") (R P being, we assume, Mr Roland Polanski) for the sale to Proteus of the negative of, and the licensing to it of the rights (subject to and benefitting from the Prior Agreements) in, Oliver Twist.

65. On the same day Proteus agreed to lease the Rights to Haiku for 15 years for fixed escalating annual rents. Haiku had an option to continue the leasing of the film thereafter; the schedule to the lease which should have specified rentals in our bundle was blank and the later side letter specifying the primary period rentals did not specify the secondary period rentals, but we concluded that it was likely that the secondary period rentals were the same as those under the other agreements namely £100 pa.

66. On the same day Haiku sublicensed to Runteam II Ltd, and Runteam II Ltd sub-sub-licensed to RPP the Rights in Oliver Twist for an amount equal to the

amount of the deposit Haiku was required to deposit with the guarantor of its lease payments (see below).

67. The agreements referred to one another and were part of a single arrangement under which: (1) the film was sold to Proteus and was indirectly licensed back to the seller, and (2) Proteus paid a price and became entitled to receive fixed secured rentals. We repeat the conclusions in para 59 above.

68. The material terms of the Sale and Purchase Agreement were the same as those described above in relation to Samarkand save that;-

(i) the price to be paid was the greater of the production cost of the film and the valuation of the film "approved and opined by Malde & Co";

(ii) no right to Extra Net profits was given to Proteus;

(iii) the Payment and Closing Dates were determined in a similar way to those in the Irina Palm agreement.

69. Payments under the agreement were made on 13 January 2006.

70. The material terms of the Leasing Agreement were the same as those for The Queen and Irina Palm. The agreement did not specify the rentals, but by a side letter these were to be fixed by reference to 14 year LIBOR on the payment date. They were fixed by an agreement of 13 January 2006. (Again, the rents payable under the lease were set so that their present value at a discount rate related to prevalent 14 year LIBOR was equivalent to the deposit.).

71. On 13 January 2006 Haiku placed £39,677,641 (being about 85% of the price paid to RP Productions by Proteus) on deposit with an HBOS subsidiary, and granted a charge over that deposit to HBOS to procure Bank of Scotland to issue a letter of credit to Proteus guaranteeing the payments due by Haiku under the leasing agreement and to secure its liabilities.

72. Proteus assigned the benefit of the leasing agreement, and the letter of credit to the Facility Bank and granted charges on its assets all to secure the payment obligation of the partners under that loan from the Facility Bank.

(d) <u>Cashflows</u>

73. Ignoring for the moment a loan of £2,200,000 made by Future to Proteus and its repayment (we shall deal with later) and bridging facilities provided to Proteus, the broad pattern of the cashflows on completion of each sale and leaseback transactions was of the following form (using arbitrary units of money rather than actual sums):-

(i)the partners paid 2 of their own money to their partnerships;

(ii) loans of 8 were made by the Facility Bank to the partners;

(iii) a fee of 1 was paid by the partnership to Future;

(iv) 9 was paid by the partnership to the seller of the film;

(v)the seller paid or procured the payment of 8 to Haiku (retaining a "producer's net benefit" of 1)

(vi) Haiku placed 8 on deposit to secure the guarantee of its rental obligations.

74. Thereafter it was intended that Haiku's rental obligations would be met in their totality by payments from the deposit (from the original 8 deposit and interest accruing thereon). Rental payments originating from the deposit would pass into an account of the partnership and thence to the Facility Bank and thereby discharge the loan obligations of the partners.

75. Since the first lease rental payment was due on the payment date the deposit and the Facility Bank loan were each reduced by the amount of that payment on that day.

76. The interest rate charged on the partners' loan accounts with the Facility Bank was marginally higher than the rate of interest paid on the deposit. In the case of Proteus/Oliver Twist the cashflow statements prepared by Future showed a lending rate of 4.38% compared with a deposit rate of 4.36%. As a result the payments of the lease rentals funded by the deposit plus interest would not precisely repay the loan plus interest. The difference was described as the Bank Margin. In the case of Proteus/Oliver Twist Future's calculations showed that the present value (at an appropriate discount rate) of that difference was £870,694. The cashflow evidence indicated that this cost was borne or paid by Future, effectively from its fee. As a result, taken with this receipt the leasing income fully funded the repayment of the partners' loans, but did not provide any additional payments to the partners above the repayment of their loans.

(e) Mr Levy's evidence

77. We note the following points from Mr. Levy's evidence:

(1) Future had developed a network of relationships with film producers and distributors, with banks (such as Bank of Ireland), and investment promoters (such as Chiltern Financial Services and Pegasus).

(2) Each year Future launched about 10 film investment vehicles. These took various legal forms and were vehicles for the production of films as well as for their financing.

(3) The Samarkand and Proteus partnership deeds were executed much in the same way that one might acquire or incorporate a company to keep on the shelf until needed. Once they were signed, an agency agreement with Future was generally also signed, but that agreement did not, as Mr. Levy put it "have real commercial meaning" until "we actually had identified and proposed films they might actually invest in". Those agency agreements might provide for a nominal fee, but it appears that Future did not collect it, rather it waited for the more substantial fee which accrued on the closure of a sale and lease back deal. The later agency agreements did not give a general power of agency to Future.

(4) The sale and leaseback transactions to which Samarkand and Proteus were parties had a structure common to many other such transactions which had taken place over the last 15 years. They had standard terms.

Under transactions such as these the seller receives X for the film and (directly or indirectly) parts with Y for the deposit to be made by the lessee. The difference of X-Y Mr Levy referred to as the Producer's Net Benefit. This was the lump sum cash benefit which accrued to the producer from the sale and lease back deal.

(5) The size of the Producer's Net Benefit was generally 10% to 20% of the cost of the film. The precise figure depended on the competition for finances and films. Some films had a certain dinner party cachet even via a sale and lease back where there was no real commercial interest in the success of the film. In such films investors might be willing to invest in a deal with a worse rate of return than they would accept for other films.

(6) Because the purchaser in a sale and lease back was taking no risks on the production of film if it obtained any interest in the box office and other receipts, it would rank far down in the chain of parties who took a share in those revenues. 2% of net revenues could be negotiated (as was the case for Irina Palm) but it could be less and even nothing.

(7) The greater the purchase price of the film in a sale and leaseback transaction, the greater in general would be the amount of the Producer's Net Benefit, and of Future's fee. Mr. Levy said that from the purchaser's perspective the purchaser had some motivation to negotiate a higher purchase price because the percentage return remained the same whatever the purchase price (given a fixed percentage Net Producer's Benefit and fee to Future) and the greater the purchase price the greater the tax relief. The limiting factor was not the value of the films but whether or not the price paid for a film attracted tax relief. Future's practice was to limit the purchase price in accordance with the guidance in HMRC's business income manual. As Mr. Levy said in a "famous e-mail":

"Sale and leaseback transactions are entirely artificial transactions, with no commercial rationale, other than the transfer of a tax asset from a party which cannot utilise the tax reliefs to another that can, in return for a stream of secured payments. As the level of commercial risk taken is negligible and there are no comparable examples of such transactions in the commercial film business, the Revenue's guidance must be prescriptive -- as there is no commercial justification for any aspect of the transaction."

(8) In the course of its dealings with the parties to sale and leaseback transactions, Mr. Levy and Future wore more than one hat and were subject to conflicting interests.

(f) the effects of film tax relief

78. Mr Norris told us that when he was British Film Commissioner he sought to sell the UK to foreign film makers by telling then about the reliefs which could be accessed by sale and leaseback transactions of UK films. We accept that these transactions led to an increased level of film production in the UK.

IV Further Facts relevant to the trading issue and expenditure on the films and the Rights

79. In this section we deal with the following issues:

(1) Samarkand: its formation and history;

(2) Proteus: history;

(3) Oliver Twist and the Rights: background, the Salter Valuation, the payment of the purchase price, and the Rights Acquisition Agreement;

(4) Pathé Slate and The Queen: Pathé s interest in The Queen, and payment.

(1) Samarkand

80. On 13 September 2004 Simon Norris (of Future) and Samarkand Films Ltd entered into a partnership agreement. (The agreement stated that it was under and subject to the laws of Jersey.)

81. The minutes of the Board of Samarkand Films Ltd (designated as the managing partner of Samarkand in the 13 September 2004 agreement) dated 5 April 2006 record a resolution to admit five new partners including Mr. Levy.

82. On 19 April 2006 Mr. Levy contributed £28,650, and on the following day £28,126 was paid for the screenplay in Grey Neon (under an agreement of 5 April 2006 in which Samarkand was required to use reasonable efforts to finance the production of a film from that screenplay).

83. On 23 June 2006 an agreement between (1) Perseus Films Ltd, (2) Simon Norris, and (3) Mr. Levy, records that Samarkand Films Ltd (the managing partner) had resigned on 15 June 2006; and makes amendments to the agreement of 13 September 2004 including a change in the name of the partnership to Samarkand Films Partnership No 3. The agreement also changed the business of the partnership from the production and exploitation of films to solely the exploitation of films.

84. On 23 June 2006 an amended and restated partnership agreement was also executed incorporating the changes set out in this agreement. It was stated as being between Perseus, Simon Norris and the parties specified in the schedule. It appears to have been signed by Mr. Norris and on behalf of Perseus but no other persons are named in the schedule and no further signatures appear.

85. The agreement appends an undated resolution of the partnership replacing Samarkand films Ltd with Perseus films Ltd as managing partner. The resolution is stated to be of all the partners at the date of the resolution and indicates that these were (1) Samarkand films Ltd, (2) Perseus films Ltd ("Perseus"), (3) Simon Norris and (4) Mr. Levy.

86. On 5 July 2006 Samarkand entered into an agreement with Future and Chiltern for the issue of the Business Plan to prospective investors. Recital (C) records that Samarkand “has not carried on business prior to the date of this agreement”.

87. Also on 5 July 2006 Perseus as managing partner entered into an agency agreement with Future under which Future agreed, inter-alia, to identify films and negotiate their acquisition in return for a fee.

88. At sometime in July 2006 Chiltern Corporate Finance issued a Business Plan for Samarkand, setting out its objective of completing sales and lease

backs of films and the acquisition of other rights, and inviting recipients to subscribe as partners.

89. On 11 September 2006: (1) a pre-release sale and purchase agreement for The Queen was signed by Perseus as managing partner of Samarkand and Pathé Slate limited, and (2) Pathé, Haiku and Samarkand entered into a Sale and Leaseback agreed form letter, following which, on 12 December 2006, a Leasing Agreement for The Queen was signed by Perseus and Haiku. The sale and purchase agreement provided that subject to certain conditions precedent, Samarkand should pay an amount equal to the certified cost of the film for the negative and rights in the film (we address later what rights Pathé Slate actually had in these assets). The rentals payable under the Lease were not specified in the Lease.

90. On 12 December 2006 Samarkand wrote to Pathé to confirm that the conditions precedent in the sale and purchase agreement for The Queen had been satisfied or waived.

91. On the same day, 12 December 2006, documents were executed licensing rights in The Queen to Samarkand and giving it rights and access to the negative.

92. On the same day Samarkand and Pathé entered into an agreement under which the rentals in the Lease could be amended to reflect LIBOR movements. (The rentals were not specified in the Lease but this document bore fruit in an amendment agreement noted below which specified the rentals.)

93. On 22 December 2006 Samarkand signed a sale and purchase agreement for Irina Palm with Ipso Facto for the purchase of the negative and rights in that film for an amount equal to the certified cost of the film. The agreement was subject to conditions precedent which included the completion of a Lease agreement with Haiku.

94. On 29 December 2006 Samarkand entered an agreement to acquire 8.57% of the revenue Future derived from the film Comme T'y Es Belle in return for an obligation to pay £58,890. This agreement, having been signed by an individual without authority was ratified by Perseus on 19 March 2007.

95. By January 2007 30 individuals had signed deeds of adherence to the Samarkand partnership deed.

96. On 9 March 2007 the transaction in relation to The Queen was completed. Partners subscribed, payments were made to Pathé and Future, and a lease amendment agreement was signed specifying the rentals payable under the Lease.

97. On the same day 9 March 2007, the transactions in relation to Irina Palm were completed. A licence was granted to Samarkand, it was given rights over the negative, it entered into a lease with Haiku and the monies due to Ipso Facto were paid.

(a) the partnership agreements.

98. Mr. Tallon points out that there are some difficulties in deciding who did or should have done what. If the board minutes of 5 April 2006 are to be believed, five new partners including Mr. Levy were admitted to the partnership. The minutes record that they had all indicated they were willing to join and had provided forms of adherence and that it was resolved that they be admitted as partners. Yet, by 23 June 2006 it appears that the only partners were Samarkand, Perseus, Mr. Levy, and Mr. Simon Norris. What happened to the other four?

99. The original partnership deed provided that an amendment to the partnership could be made by Partner Consent (clause 23) which is defined as agreement by partners holding at least 51% of capital contributions. On 23 June 2006 when the amendment agreement was signed, the only partner who had contributed capital was Mr. Levy (£28,650 on 19 April). He signed that agreement. Thus in general the amendments would have been effective notwithstanding that the agreement was not signed by all the partners. (We say "in general" because we doubt that changes which would significantly adversely affect other partners were intended to be addressed by this clause, and because changes not associated with the intended business of the partnership may well have been outside its scope.)

100. It is clear that on 23 June 2006 there was agreement between the three parties to the amendment agreement. It is also clear that the 30 subscribing investors had adhered to that agreement by January 2007. The loss of the missing four partners does not affect that conclusion.

101. It is also clear that there was an agreement between Mr. Simon Norris and Samarkand films Ltd made on 13 September 2004, and in our view it is likely that Mr. Levy adhered to that agreement and made his capital contribution under it. That suggests that the missing four partners also became bound to that agreement and their subsequent loss or disappearance, we suspect, was due to administrative inefficiency. We make no finding as to whether they did adhere or when and whether they dropped away. We accept that there was some sloppiness in these arrangements.

(2) Proteus

102. On 19 November 2003 John Buchanan (a Future lawyer) and Phoenix Films Ltd signed a partnership agreement stated to be subject to Jersey law. The agreement stated that the object of the partnership was to conduct trade in "Films", "Films" being defined in the "Business Plan". No Business Plan was produced until 2005. Phoenix Films was to be the managing partner. Profits were to be shared by reference to capital contributed. No capital was contributed by John Buchanan or Phoenix Films limited.

103. On 30 March 2004 Phoenix as managing partner entered into an agency agreement with Future.

104. On respectively 24 and 25 November 2004 agreements relating to two films, Seven Seconds, and The Thief Lord, were entered into by the managing partner for the partnership.

105. On 1 December 2004 agreements relating to another two films, Palais Royal and The Trail were entered into by the managing partner for the partnership.

106. Also on 1 December 2004 agreements were made novating the rights and obligations in relation to Seven Seconds, Palais Royale, and The Trail to another Future entity. Mr. Levy said that Future had intended that a partnership would enter into sale and lease back transactions in relation to these films but that he had not intended that Proteus be that partnership -- hence the novations. He also explained that November 2004 was a very busy time because imminent changes to the tax legislation had been announced and they had to get agreements in place to the films being produced and acquired.

107. While Seven Seconds, The Trial, and Palais Royal were novated to other film investment vehicles, the rights in the Thief Lord lapsed in March 2005 because a condition precedent relating to financing failed and sufficient money was not raised for the deal.

108. On 10 March 2005 Proteus Films Ltd was replaced by Phoenix as managing partner, and the partnership assumed the name Proteus Film Partnership No.1. On 15 March a new partnership agreement was signed inter alia modifying the stated business of the partnership to exclude film production. On 20 June 2005 John Buchanan resigned and Mr. Levy took his place. Crills, Jersey lawyers, advised Future that this sequential execution of these changes was the best way to preserve the continued existence of the partnership and to avoid the danger that a new partnership would be treated as coming into effect in March 2005.

109. In June 2005 Future agreed with RPP to arrange a sale and lease back for Oliver Twist: it guaranteed a Net Benefit to RPP based on a minimum valuation of £41m. On 21 June 2005 Future lent £2.2 million to Proteus which Proteus used under an Escrow Agreement to provide security for the Producer's Net Benefit it had assured to RPP (see also 119 below). On the same day there was a legal closing of the Oliver Twist sale and lease back documents.

110. In September 2005 the Business Plan was issued, and by 2 December 2005, 44 partners had adhered. As contemplated by the March 2004 agency agreement, a new fuller agency agreement was entered into between Proteus and Future on 8 December 2005.

Discussion: Proteus

111. Mr. Tallon says that until the investors signed the deeds of adherence and paid their contributions there was no partnership. No capital had been contributed before that time and there was no business being conducted in common with a view to profit.

112. Mr. Peacock says that on any view the borrowing of £2.2 million and its use to ensure or secure the Producer's Net Benefit in June 2005 was a serious business with a view to profit. He also argues that there was a partnership in existence from, at the latest, the beginning of April 2005 to which the 44 new partners adhered in December 2005.

113. It was clear to us that by June 2005 Mr Levy and Proteus Films were engaged in a serious undertaking which could properly be described as a business. It was also clear that from that time they intended that profits should arise from that business. But in our view they intended those profits to arise directly to the adhering partners and not to themselves, and to arise indirectly to Future.

(3) Oliver Twist and the Rights.

114. HMRC raise two preliminary issues in relation to Oliver Twist in the Rights. These issues related in each case to the price paid which they say was excessive. We start by setting out the relevant background.

Background

115. Future became involved in Oliver Twist at an early stage. In 2004 it was instrumental in arranging a Distribution Agreement of 12 July 2004 between Oliver Twist Productions LLP ("OTP") and RPP. Under that agreement OTP agreed to complete the production of Oliver Twist and to transfer the negative and to grant exclusive rights throughout the world for 21 years to RPP. RPP undertook distribution of the film and agreed to pay adjusted Gross Receipts to OTP until it recouped certain costs and thereafter 10% of those receipts (subject to a minimum), and in addition 2% of gross receipts up to gross receipts of €77 million and thereafter 4% of such receipts (together its "Gross Participation"). An advance of €744,000 was payable in relation to this participation. The figures of €77 million, 774,000 and the minimum amounts were subsequently changed by an agreement of 21 June 2005.

116. The photography started on the date of this agreement (12 July 2004). The film was completed a year later on 25 July 2005. The DCMS certificate was issued on 23 August 2005.

117. Future then negotiated a sale and lease back arrangement with RPP. These negotiations included the settlement of a "Producer’s Net Benefit" for RPP of some £4 million. As a result of this arrangement a Sale and Purchase Agreement was signed on behalf of RPP and Proteus on 21 June 2005 (a month before completion of the film). This agreement was subject to conditions precedent and provided for Proteus to purchase the film for the greater of (A) the certified cost of the film and (B) "a valuation of the film as approved and opined by Malde & Co". The Lease to Haiku to which completion of the agreement was subject was executed on the same day. Payment under the agreement was to be made no later than 210 days after 31 July 2005, thus no later than the end of February 2006. Payment was eventually made on 13 January 2006.

118. The conditions precedent were waived by Proteus on 21 June 2005, the same day as the agreement.

119. At this stage however Proteus had no external investors: its only partners were Mr. Levy (or possibly Mr. Buchanan) and Proteus Films Ltd. It had no money. As noted above Future had decided to risk its own money and had lent £2.2 million to Proteus on 21 June 2005. Under an Escrow Deed Proteus paid £2.2 million to a deposit account and agreed that payment from

that account should be made to RPP on the receipt of the DCMS certificate. Thus RPP would retain the £2.2 million if Proteus did not complete the sale agreement. Mr. Levy frankly said that this represented a considerable risk for Future.

120. RPP were also at some risk. If Proteus could not raise the funds, RPP would lose out on the £4m Producer's Net Benefit which Future had assured to it (apart from the £2.2m it would retain under the Escrow agreement). Its position was protected by a misleadingly entitled Put Letter under which RPP was entitled to *call* for the film if the purchase price was not paid by 8 February 2006.

121. Thus from 21 June 2005 the pressure was on for Future to procure the requisite finance by February 2006.

122. On 7 July 2005 Salter Group LLC wrote to RPP with their estimate of the fair market value of Oliver Twist. They provided an estimate of $79 million-$82 million.

123. Oliver Twist was completed on 25 July 2005 (18 days later) and DCMS issued a certificate on 23 August 2005. The film was released in the US on 25 September 2005, in the UK on 7 October 2005, and later elsewhere.

124. In September 2005 Pegasus Financial Services Ltd issued a proposal advertising investment in Proteus to potential partners.

125. On 17 November 2005 Malde & Co wrote to Proteus confirming (a) a production cost statement showing costs of £25,532,780, and (b) that acquisition expenditure of £45,760,000 "as per the attached valuation from The [Salter] Group" would qualify under section 42 F(No 2)A 1992. On 13 January 2006 RPP invoiced Proteus for £46,975,000 for the film which Proteus paid on that date.

The Salter valuation and payment for the film

126. Salter Group LLC were accepted by Mr. Norris as the leading film valuer. Mr. Levy attested to their eminence. We accept that they were a reputable and competent valuer.

127. RPP had appointed Summit to arrange distribution in all territories other than the US, Canada, UK, France and Benelux. It had appointed Pathé Renn to distribute in the UK, France and Benelux. It appointed Tri-Star in the Americas. By the time Salter came to do its valuation distribution agreements were in place in most developed countries (other than the Americas) which provided for advance payments to be made to RPP at certain dates. The total of the advance payments was in the order of $41 million, but the arrangements with Tri-Star did not provide for advance payments. A major part of the Salter valuation was an estimate of the revenues which would emanate from Tri-Star.

128. Under the distribution agreement with Tri-Star, Oliver Twist was to be released on a minimum of 1500 screens in the Americas including the top 25 cities (Mr Levy told us that this implied expected box office takings of $75m to $90m). This indicated that at an early stage Tri-Star expected the film to be

successful. Mr. Norris said that, once finished, a film would be shown to a private audience at a number of preview screenings before it was generally released. Soundings from those audiences would generally determine the number of screens on which would it be later released. The film was released in late September 2005. Tri-Star then released the film at 800 screens only, despite a commitment to 1500 screens. On 3 October 2005 Mr Levy sent an email in which he said that the previous week's preview openings were good and that Sony (Tri star) had expanded to 800 screens but that take up was poor and he suspected that the film could not sustain a wider release in the US. Mr Margolis replied that there might be a good DVD market for this type of film. We conclude that its rollout in the Americas was restricted to 800 screens. Mr. Norris told us that the ultimate US box office take with not more than $2.5 million; a result he described as fairly catastrophic. Mr. Levy said that by August 2006 the run of Oliver Twist at cinemas had pretty much run its course and that it had not performed as well as had been expected. We conclude that it is likely that by early October 2005 an informed observer would have concluded that Oliver Twist would not be as great a financial success as had been anticipated.

129. The valuation method adopted by Salter was in outline as follows:

(1) they reviewed information on pre-sales and forecast sales from Summit;

(2) they discussed with RPP and others the marketing plans of Tri-Star in the Americas;

(3) they identified other films which they viewed as comparable and collected data on their revenues and costs;

(4) from the comparable films' data they estimated low, medium and high out-turns in Tri-Star's territory breaking the figures down into different types of sales revenue and expense; and

(5) in each case they added $41 million for the Summit area pre-sales and an estimate of $10.3 million for second cycle sales in those territories;

(6) the elements of these figures were then allocated to the periods in which they would arise and a discount rate applied to determine the net present value of the expected cash flows.

130. The valuation concluded by exhibiting three different values each by reference to a different discount rate:

(1) 14.5%: $82 million

(2) 15.5% $81 million

(3) 16.5% $79 million

131. From the underlying calculations it appeared that these valuations were based on the medium out turns.

132. A number of points were made in relation to this valuation:

(1) the valuation assumed that the purchaser would be entitled to all the presales payments of $41 million. An analysis of the agreements showed that by 26 July 2004 advance payments by the distributors of some $8m

had become payable; the remaining $33m was due within 14 days of delivery of the film; of the $8m some $6m was

repayable, but the circumstances which triggered repayment were the failure to complete or deliver the advertised film on time. The film was completed two weeks after valuation. It seemed to us that the contingency of repayment was sufficiently remote in the context of a valuation of this sort to ignore.

(2) No contact was made by Salter with Tri-Star. Mr. Levy told us that there was a person at Summit who was the guru on the US market. Mr. Norris considered it odd that Tri-Star were not approached. We agree with Mr. Norris.

(3) the valuation failed to deduct the 3.5% fee due to Summit. That was the case;

(4) the valuation fails to include "overrages": the receipts which would accrue when box office receipts were sufficiently large for distributors to have recouped the cost of their initial advance payments;

(5) the discount rates applied were high: lower rates would have resulted in a higher valuation;

(6) the valuation letter contained an inflated figure for net receipts on page 4, confusing net with total receipts, but the mistake was not reflected in the valuation calculations.

133. The sale and purchase agreement provides that the purchaser shall take subject to and with the benefit of Prior Agreements, These distribution agreements would have been Prior Agreements. It seems to us that where, at the time the sale agreement was made, and payment had been made under a Prior Agreement, the benefit of that payment had been taken and was no longer a benefit available to the purchaser. However of the $41 million, $33 million was due within 14 days of delivery of the film. Thus at the date of the valuation (and at the date of the SPA but perhaps not at the date of financial close, when final payment was to be made) the major part of the benefit of the advance payments was still to accrue.

134. We conclude that there were faults with the valuation. But they did not seem to us to make it wholly unreliable as an estimate at 7 July 2005 of the value of the film.

The Payment of the Purchase Price

135. Malde & Co's letter of 17 November 2005 states that the acquisition expenditure of £45,760,000 “as per the attached valuation report from the [Salter] Group” will qualify under section 42. The valuation in the Salter report was in US dollars.

136. Mr. Malde's e-mail correspondence with Future indicates that he applied an exchange rate of 1.77 (the rate applicable on 31 October 2005) to translate the middle figure of Salter's valuation of $81 million in reaching the sterling figure in his letter of 17 November 2005. Mr. Malde explained to us that in his discussion with Future it had been agreed that £45,760,000 was the price agreed in November or December 2005.

137. Then on 10 January 2006 Mr. Malde had a call from Gavin Harrison at Future telling him that they needed to agree the price at £4**6,975**,000. Mr. Malde reported this to RPP. This was the amount paid on 13 January 2006.

138. It was clear, both from Mr. Malde's letter and from his oral evidence that he was not certifying in his letter that the film had a particular value. Instead he was certifying that the price stated would qualify for section 42 relief. And in so doing he was relying on HMRC's Business Income Manual which he interpreted as meaning that if an independent valuation had been obtained it could be relied upon. Although the valuation had been commissioned by RPP, Mr. Malde was content that it was an independent valuation.

139. Mr. Malde explained that the discount rates used by Salter were considerably higher than the relevant forward rates at that time. He was happy however to rely upon Salter's independence in this matter. (Higher rates mean a lower value.)

140. We recall that the SPA requires that the Purchase Price be paid on the Payment Date. The Purchase Price is defined as the higher of the cost of production and "Valuation". "Valuation" is defined as "the valuation of the film as approved and opined by Malde & Co.". It is not immediately clear to us that the amount of this price is the £45,760,000 set out in Malde & Co's letter. That is because what Malde & Co appeared to do in that letter is to approve Salter' valuation of $81 million rather than a sterling figure. It seems at least arguable that a US dollar liability was created under the agreement.

141. However one thing is clear and that is that the amount actually paid was not that specified in Malde & Co's letter.

142. Mr. Levy's evidence on this issue was not particularly clear cut. He gave two possible reasons for the increase in the amount paid over that set out in the letter from Malde & Co. The first one is that it was due to exchange-rate fluctuation between the date of that letter and financial close. A Future e-mail of 10 January 2006 gives some credence to this in that it calculates the price eventually paid using the *higher* Salter valuation to which the average exchange rate in the months prior to closing is applied. The second explanation was that the price was increased because the amount of capital raised for Proteus was greater than the Malde original price, and that the view was taken within Future that the agreement gave some scope for flexibility in the price because Salter had given a range of values and not a single figure.

143. We think it is likely that on 10 January 2006 Future discovered that it had more capital subscribed than the amount set out in the Malde opinion. Mr. Levy told us that by 2 December 2005 44 investors had adhered to the deed. Mr. Malde's e-mail of 10 January indicated that Future needed to agree a slightly higher price. That fits in with preparations being made for financial close and a slight surplus being discovered. The idea of using the higher Salter valuation and an average exchange rate looks like an arguably good fix to the problem. That seemed a more likely conclusion than one that Future suddenly thought that the agreement required a price fixed on that basis whatever the capital raised.

144. But we draw the following conclusions from this episode:

(1) although Salter produced a valuation, Malde's concern was whether its nature satisfied the Business Income Manual criteria, not with whether or not it was correct;

(2) the parties' lack of attention to the currency of the price indicated the degree of sloppy practice and at least some lack of concern about precise costs;

(3) Future was prepared to arrange for Proteus to pay a higher price if by doing so more capital could be accommodated and the expected tax relief preserved.

145. All in all the episode is consistent with Mr. Levy's general evidence that the limiting feature in relation to how much should be paid for a film was not its value but whether tax relief could be obtained on the amount paid. The higher the price the better for all concerned.

The Rights Acquisition

146. As explained above at para 115, OTP had acquired the right from RPP to a percentage Gross Participation in the receipts from Oliver Twist.

147. By a Film Consultancy Agreement of 21 June 2005, OTP agreed to pay LM Investments Ltd (LMI), a company associated with Future, 15% of its Gross Participation over a minimum level, rising to 30% of its Gross participation after OTP had received an amount equal to 2% of its capital (which was about £32 million). (The drafting is not quite as clear as it could be.)

148. Mr Levy explained that discussion in relation to the nature of the Rights which Proteus might acquire continued between April and September 2005.

149. Oliver Twist Information Memorandum (Business Plan) states that a Rights Agreement had been negotiated on behalf of Proteus under which Proteus would receive:

(1) in respect of receipts from the film of up to £25.5 million (the budget for the film), 7.5% of 2% of gross revenues;

(2) for receipts between £25.5 million and £51 million, 22.5% of 2% of gross revenues; and

(3) for receipts above £51 million, 22.5% or 4% of gross revenues.

It is explained that about 1% of the capital raised by the partnership offering would be used to purchase these rights.

150. The Information Memorandum then estimates the value which would be received from this Rights income based on potential performance levels for Oliver Twist. The comparatives used are the Pianist and Oliver!. If the film performed in the same way as the Pianist, a small loss would be made (i.e. the receipts from the Rights would be less than the amount paid them); if the film performed in the same way as Oliver! a profit of four times the cost of the Rights would be made.

151. The Information Memorandum does not state the name of the seller of the rights, and at the time of its publication and until sometime after April 2006 Future held no income rights in relation to Oliver Twist. See below.

152. By a Rights Acquisition Agreement stated to be effective as of 13 January 2006 although likely to have been signed in August 2006, Proteus agreed to pay Future £513,474 for the right to receive 7.5% of the gross participation. The agreement was ratified by the board of the managing partner of Proteus on 10 August 2006.

153. It appears from this Rights Acquisition Agreement that sometime before the agreement was signed and after April 2006 LMI novated its rights under the film consultancy agreed to Future. We saw a draft of the novation agreement in which LMI would assign its rights to Future, and Future agreed to perform LMI's obligations, but the draft was defective because Proteus, rather than OTP was treated as LMI's counterparty to the Consultancy Agreement. It is possible that this glitch was fixed in any agreement actually executed.

154. There are some difficulties in fitting these documents together: the Rights Acquisition Agreement defines Future's entitlement as 7.5% of the gross participation; the Film Consultancy Agreement provides for different percentages and levels; the Information Memorandum provides for amounts which are yet different again.

155. Mr. Levy told us that the Rights Acquisition Agreement did not record the terms which had been agreed: the percentages were wrong. He said that he believed that the Information Memorandum recorded an agreement between Proteus and Future made at the date of that document by which Future and Proteus were bound notwithstanding (a) its later documentation, and (b) that at the time of the Information Memorandum it was LMI, and not Future, who held the relevant rights. He regarded Future as bound by the statements in the Information Memorandum.

156. Mr. Tallon says:

(1) that by 13 January 2006 there was no agreement between Future and Proteus;

(2) the only agreement that was made was made in August 2006;

(3) at that time it was known that Oliver Twist was a flop and that the Rights being acquired were worthless. Even Mr. Levy had said that in August 2006 he would probably not have agreed to pay £513,474 for the rights;

(4) even in September 2005 the only reasonable comparator for Oliver Twist was the Pianist, and the Information Memorandum itself showed Proteus would lose money even if Oliver Twist was as successful as the Pianist. Mr Norris had said that Oliver! was not a good comparator.

157. Mr. Peacock says that the Information Memorandum promised to deliver a share of gross participation in Oliver Twist in return for 1% of the capital put into the partnership. When the investing parties adhered they had to confirm that they had read and understood the Information Memorandum. The legal effect of that memorandum and the deeds of adherence was that Proteus

and Future were contractually bound - or at any rate that Future was bound by the representations it had made to potential investors. It did not matter whether Future had the rights at that time: it was still bound to make payment. Further he said that a bad deal did not mean no deal.

158. We asked ourselves first whether at any time before August 2006 Proteus was bound to acquire the Rights from Future on the terms of the Rights Acquisition Agreement.

159. We accept that Future may have considered itself bound to make payment in the terms of the Memorandum. It had been a party to its issue. It had arranged the deals. If no one else paid, it would have found itself in an embarrassing position. But its moral commercial or even legal obligation to make payment, does not carry with it a corresponding obligation of Proteus to pay unless it had through some agency agreed to do so.

160. The agency agreement between Proteus and Future appoints Future to identify and recommend films and Rights but does not confer any general agency on Future. Clause 3.2 says that once a film recommendation has been accepted by the partnership and "provided the managing partner ... has provided the agent with a power of attorney”, Future is authorised to enter into the Transaction Documents (including a Rights Acquisition Agreement) on behalf of the partners. There is no other express agency. There is no express agency to reach agreements on behalf of Proteus and other than in writing. We do not construe the agreement as giving an implied agency in view of the drafting of Clause 3.2. Future would have known this: it was party to that agreement, and could therefore not rely on holding itself out as Proteus' agent for the purposes of agreeing with itself the Rights Acquisition Agreement. Thus no informal contract could have been made under the powers of the agency agreement between Proteus and Future.

161. The Information Memorandum was issued by Pegasus. But we have no doubt that it was approved by the managing partner of Proteus and by Future, whose name appears on the front cover. The memorandum describes the Rights Acquisition Agreement as "an agreement entered into by the partnership to acquire rights", but later says that "the partnership will purchase Rights for certain films", and in relation to Oliver Twist it says "the partnership has negotiated a Rights Income position ..." and sets out the relevant percentages.

162. We do not believe that investing partners' deeds of adherence constituted the transmission to Future of an acceptance of an offer made by it in the terms of the Information Memorandum. The deeds bound the partners to each other, they were not communications to Future. If Proteus was already bound to Future the incoming partners became bound; if Proteus was not already bound, the deeds made no difference.

163. Had the Information Memorandum specified Future as the counterparty to the Rights Acquisition Agreement (and perhaps if it had been clearer as to whether the agreement had been made or was to be made), we would treat that memorandum as creating or recording an agreement between Future and Proteus acting by its managing partner: for each of them would then be assenting in a published declaration to that agreement. But given that, at the time of the Information Memorandum, it was LMI and not Future which held

the rights in relation to Oliver Twist the Information Memorandum could equally be regarded as describing an agreement between LMI and Proteus. Nor was Mr. Levy in his evidence to us able to say that he was clear that at the time of the Information Memorandum that it was Future rather than LMI which had come to an agreement with Proteus: indeed he indicated that he viewed them very much as one and the same entity. For these reasons it seems to us that:

(1) the Information Memorandum does not, on balance, record and evidence an agreement made between Proteus and Future; and

(2) the Information Memorandum does not constitute the mutual public conveyance by Proteus and Future to each other of their assent to the contractual terms described in that Memorandum.

164. We therefore find that no agreement between Future and Proteus existed until August 2006.

165. Mr Norris and Mr Peacock provided calculations of the return which might be expected from the Rights on varying assumptions of the success of the film; the Business Plan contained estimates too:

(1) Mr Norris used the three Salter performance estimates and their categories of low, medium and high. On these bases he calculated Proteus' share of net receipts would be between £5k and £144k; significantly below the purchase price;

(2) The Business plan estimated Proteus' revenues as £346k on a "Pianist" scenario, and £2.2m on an "Oliver!" scenario. One above, the other below the purchase price;

(3) Mr Peacock produced estimates both on the basis of the Salter outturns and explained the figures produced by the comparators used in the Business Plan. Using the Salter outturns he estimated receipts of between £126k and £637k after including "overages" from non American sales; his calculations also showed that gross revenues would have to exceed 357% of production cost before Proteus broke even.

166. Various criticisms were made of these estimates. Mr Norris included nothing for "overages" – the amounts which would be received if the film performed sufficiently well for the non US distributors to be required to pay additional amounts over the advances they paid at the outset; he included nothing in respect of the value of the film after the 15 year period of the lease; and there was some dispute about his treatment of the total amounts advanced; Mr Peacock's calculation included an estimate for overages but if the estimation was to be treated as done in August 2006 it was then known that the film had not been successful; the Business plan use of Oliver! as a comparator was in our view justly criticised by Mr Norris.

167. We conclude that it was highly unlikely that a reasonable person would have concluded in August 2006 that Proteus would have broken even on its purchase of the Rights, and unlikely that such a person would have reached that conclusion in January 2006.

168. If we are wrong and there was an agreement between Future and Proteus at the time of (or occasioned by) the Information Memorandum, then it seems to us that the evidence does not clearly show that Proteus overpaid for its

rights under that agreement. Until late September 2005 the film had not been released. There may have been some doubt as to its prospects (see the discussion in relation to Tri-Star and 800 rather than 1500 outlets above) but, despite vagaries in the calculations of the film's prospects, the amount paid did not seem to us wholly unreasonable for a chance of a great gain.

169. On the other hand if the agreement was made in August 2006 it was plainly at an overvalue.

(4) Pathé Slate and The Queen

(a) Pathé *'s rights in The Queen*

170. The Respondents say that the evidence shows that such rights as Pathé had in the Queen were of no economic value. As a result they say that when Samarkand agreed to pay and paid Pathé some £8 million for these rights it paid them more than they were worth: it paid £8,162,791 for nothing. Mr. Peacock says that Pathé owned the rights it licensed to Samarkand.

171. Under the pre-release sale and purchase agreement (the "PRSPA") dated 11 September 2006 Pathé Slate agreed to deliver the master negative and to license the Rights in The Queen to Samarkand.

172. The Rights are defined to mean the exclusive right to deal with the film and include a non-exclusive license to use the copyright in the film, but the license to be granted is made subject to and with the benefit of the Prior Agreements. Schedule 4 to the agreement is headed "Prior Agreements". Unfortunately it is blank. But it is provided that terms defined in the Lease shall have the same meaning in that agreement. The Lease, which is dated 12 December 2006 (thus executed somewhat after the PRSPA), defines Prior Agreements as those listed in schedule 5 where 36 agreements are listed covering most of the developed nations of the world. In clause 2.2 of the PRSPA Pathé warrants that it is the exclusive owner of the negative and the owner or licensee of the Rights free from encumbrances but subject to the Prior Agreements.

173. The PRSPA was given effect in relation to the Rights by an exclusive licence dated 12 December 2006 by which Pathé exclusively licensed the Rights (subject to and with the benefit of the Prior Agreements) to Samarkand to hold in perpetuity.

174. By clause 3.5 of the PRSPA Pathé Slate agreed to pay Samarkand 1% of the share of the net profits of The Queen "accruing to and actually received by" Pathé Slate after deduction of amounts payable to others for services in connection with the production of the film.

175. Two questions arise in relation to this agreement: (1) what rights did Pathé Slate have, and (2) what was their value?

176. So far as the first issue is concerned the evidence before us consisted of the following:

(1) an attestation of title signed on behalf of Granada Screen and bearing no date other than the year 2006;

This recites that Granada television commissioned the screenplay for The Queen and then assigned it to Pathé Slate on 1 September 2005. Then on 2 September 2005 Pathé Slate granted an exclusive licence to Granada Screen to produce and exploit the film. Then under a coproduction agreement between Granada Screen, Pathé Renn Production SAS, BIM, and Pathé Slate (the "co-producers") the parties agreed to produce the film and Granada Screen assigned to them the benefit of the rights in the proportion 70% Granada Screen; 20% Pathé Renn; 10% BIM. By the same agreement the coproducers assigned their rights in the film to the same parties in the same proportions.

(2) the Coproduction Agreement dated 12 September 2005;

(3) a Production Financing Distribution Agreement ("PFDA") dated 12 September 2005. Under this agreement Pathé Slate commissioned the coproducers to produce the film, and the coproducers assigned to Pathé Slate the right to distribute and exploit the film (apart from in France). Under the PFDA Pathé Slate agreed to appoint Pathé Distribution to exploit the film in the UK and French territories and to appoint Pathé Pictures the sales agent;

(4) a financing agreement dated 21 September 2005. Under this agreement of 21 September 2005 between Granada Television and Pathé Slate, Granada agreed to forward its contribution to the film to Pathé Slate which in turn agreed to forward it to the production account. Pathé Slate then agrees to proceed with commissioning the film. By clause 5.1 of the agreement Pathé Slate assigns to Granada the ITV television rights, and by clause 5.2:

> "Pathé Slate ... assigns to Granada with effect from Vesting Date 2...by way of an assignment of present and future copyright the bare copyright in and to the film and all underlying material in relation thereto ...including…all sequel, prequel, remake and television spin off rights… to hold the same unto Granada absolutely throughout the world for the full period of copyright…For the purposes of this clause 5.2 "bare copyright" shall mean the entire copyright in the film and the Underlying Material excluding only the distribution and exploitation rights in the Film and the Screenplay." ;

(5) accounts of Pathé Slate for the years ending 31 December 2005 - 2009, and minutes of a board meeting ratifying those sale and lease back agreements to which Pathé Slate was a party;

(6) Mr. Levy's evidence that the Pathé group were large, reputable and responsible.

177. The documents in (1) - (4) above indicated to us that that by the time of the financial close of the sale and lease back agreements Pathé Slate was entitled to: (1) the negative of the film (assigned to it under the PFDA), and (2) the rights to distribute and exploit the film other than in France and other than in relation to sequels and spin-offs (the other rights having been assigned to Granada).

178. Under the agreements agents were appointed to enter into distribution agreements for the exploitation and distribution of the film throughout the world (other than the UK and France for which distributors were separately appointed). The Prior Agreements listed in the Lease of 12 December 2006 indicated that by the time of financial close, distribution rights (likely to have been exclusive in relation to particular territories) throughout the developed world would have been ceded to others.

179. There was no evidence before us as to the effect in other jurisdictions of prior intellectual property licences on the rights of subsequent holders of the original right. We have assumed that in those jurisdictions, as would be the case in relation to a UK copyright by virtue of section 90(4) Copyright Designs and Patents Act 1988, licenses granted for such distribution would be binding on any successor in title to the rights in the film with notice of the rights of the distributors, and thus would be binding on Samarkand. Thus the rights that Pathé Slate had and Samarkand acquired were effectively subject to the rights licensed in those distribution agreements (but with the benefit (if any) of those agreements).

180. The evidence of Pathé Slate's accounts called the conclusion that Pathé owned those rights into question. Those accounts showed that in each of the years ending 31 December 2005 - 2009 the company had been dormant and had had no assets. That was despite (1) it having been a party to the agreements discussed above and to sale and lease back arrangements in this period, and (2) having been invoiced by Samarkand in 2008 for net profits due under the 1% arrangement in the PRSPA. That suggested that Pathé Slate had no assets to sell or license to Samarkand under the PRSPA. We concluded that since the effect of the agreement was that no money was to be received by Pathé Slate under the arrangements (see below) it was possible that its accounts would not reflect the transactions. Taking that together with our acceptance of Mr. Levy's proposition that Pathé were a respectable group, and the acknowledgement of the sale and lease back arrangements in the agreements we concluded that we should accept the evidence in the documents at (1) - (4) above and conclude that the rights described above were vested in Pathé Slate that at the time of the sale and lease back agreements and their financial close.

181. On the second issue the evidence before us consisted of:

(1) the PFDA;

(2) an interparty agreement dated 22 September 2005; Under this agreement:

(a) Pathé Slate and Granada Television each agreed to make a contribution of £4 million; Pathé productions agreed to procure that Pathé Slate funds its contribution;

(b) Pathé Pictures, the sales agent, agreed to procure that all distributors shall pay sums due from them into a collection account;

(c) Granada agreed not to hinder the Pathé sale and lease back transaction, and

(d) the parties agree to the application of the monies in the collection account in accordance with the collection account agreement

(3) a collection account agreement dated 22 September 2005;

(4) e-mails indicating that a cheque had been received by Samarkand in respect of the 1% share from Pathé Productions;

(5) the absence of any reference to Pathé Slate in the DCMS certificate and in Shipley’s report. We accepted the evidence that it would be expected that if Pathé Slate had produced the film it would normally be referred to in this certificate;

(6) a Distribution Agreement dated 22 September 2005 under which Pathé Distribution was licensed rights in the film in the UK in perpetuity. (Payments arising under this agreement were to be made to the collection account.);

(7) a Sales Agency Agreement dated 22 September 2005 under which Pathé Slate appointed Pathé Pictures as agent to appoint distributors for a 25 year term. Appended to that was a standard form distribution agreement requiring distributors to make payments to the collection account.

(8) the accounts of Pathé Slate;

(9) Mr. Levy's evidence to the effect that the Pathé group would honour the commitment to make payment of the 1% share.

182. The effect of the agreements in (1)-(3) above was that all receipts from the distribution of the film and the sales agents were to be paid into a collection account out of which monies were to be paid to listed parties in order. None of those listed parties included Pathé Slate. Monies which were described as being to reimburse Pathé Slate for its expenditure on the production of the films were paid to Pathé Productions, and the residual monies, after paying the other persons in the lists, was split 25% to Pathé Productions and 75% (less 11.5% to certain individuals) to Granada.

183. Mr. Peacock says that Pathé Slate's agreement as to the allocation of future receipts is simply a divestment of certain of its entitlements to receipts from the film. It is not an assignment or a divestment of PSL's rights in (i.e. the distribution rights) in the film itself and that tells us nothing about the entitlement to the rights. He says that it was in anticipation of the leaseback element of the contemplated sale and lease back transaction which contemplated the transfer of the rights and therefore the parties intended Pathé Slate to have the rights. As a result he says that both on 12 December 2006 and 9 March 2007 (the date of financial close) Pathé Slate owned the rights which it licensed to Samarkand.

184. The PFDA required the sales agents (excluding the UK and France) and Pathé distribution (the distributor for UK and France) to direct distributors to pay, or to pay, all relevant monies to the collection account. The agreements reached with the distributors by the agents would have bound Pathé Slate, and since Samarkand took subject to and with the benefit of such agreements it would not have been able to require the diversion of those funds elsewhere because it was not able to amend those agreements.

185. Yet in 2008 an e-mail records that a cheque had been received from Pathé Productions in relation to Samarkand's 1% right (and that an invoice was thereafter issued by Samarkand to Pathé Slate).

186. It seems to us that the agreements make clear that Pathé Slate had no right to receive any monies representing net profits from the film. If it had a right against Pathé Productions to some form of payment one would have expected to see some assets representing income in its accounts. It is possible that Pathé Slate was simply a nominee for Pathé Productions and had signed the relevant agreements as agent for Pathé Productions - in which case the obligation to make the payment would have been binding on Pathé Productions and would have been of value to Samarkand. However the only things in the evidence before us relevant to that issue were the minutes of Pathé Slate in relation to the sale and leaseback arrangements. Had the company been a nominee we think it likely that that would have been noted in the minutes in these circumstances. We conclude that it was not a nominee and had no right to receive, and did not actually receive, any monies in respect of the film.

187. It seems likely that the payments made to Samarkand in respect of the 2008 1% rights was made by Pathé Productions recognising a moral obligation at the least to do so. We conclude that Samarkand had no enforceable right to the 1% payments since no payments were "actually received by" Pathé Slate.

Payment for The Queen

188. Samarkand was invoiced for £8,162,791 for The Queen. It paid that invoice. HMRC say that the circumstances of this payment show a lack of regard to legal niceties and commercial organisation. The circumstances are these:

(1) At some stage Future wrote to Pathé offering to arrange a sale and lease back of The Queen on terms that the purchase price would be the allowable costs of production under section 140.

(2) In the sale and purchase agreement of 11 September 2006, Samarkand agreed to buy the film for a purchase price equal to the "certified cost of the film, as evidenced by the production cost statement delivered pursuant to Clause 2.1(viii)". That clause related to DCMS certification. But the preceding paragraph, 2.1(vii), which must have been the intended reference, refers to a certified statement showing

> "a production cost being the total production expenditure in relation to the Film not less than the Purchase Price together with written confirmation from the production accountant that such production cost statement has been prepared in accordance with Revenue Guidance and section 130."

From these words we would have concluded that the purchase price was to be the amount of the *allowable* production cost (because of the reference to preparation in accordance with section 130, and because of Pathé 's warranty see the next sentence), but Mr Levy said, and Mr Tallon accepted that what was intended was the *total* production cost; we continue on that basis.

(3) In that agreement Pathé warranted that the total section 140 production expenditure was greater than or equal to the purchase price.

(4) On 11 September 2006 Shipley's certified that the *allowable* production cost was 7,926,232, and that the *total* production costs were 8,198,179. The difference related to costs such as staff parties which were not allowable under section 140. The amount Samarkand later paid fell between the two figures.

(5) Thus Samarkand paid a higher price than Future had offered Pathé, and a higher price than justified by Pathé's warranty (which conflicted with the agreement to the extent that the purchase price exceeded the section 140 allowable production costs), but a smaller amount than the amount of the total production expenditure.

(6) On 7 March 2007 (two days before financial close) Mr. Harrison of Future e-mailed Pathé setting out the additional benefit arising from "acquiring most of the non-production costs". (By that we take him to mean paying an amount which exceeded the allowable production costs: but it is an interesting insight into the nature of what Future’s employees thought was being acquired: not a film, but costs.) He asks Pathé to note that the calculations share the benefit of the higher purchase price equally between Future and Pathé. He contrasts a purchase price of £7,926,222 (production costs) with £8,119,240.

(7) Later the same day Mr. Harrison asks Pathé for payment instructions and an invoice for £8,127,394.

(8) On 14 March 2007 Mr. Harrison e-mails saying that he had made a mistake in the purchase price of the Queen and it should be £8,162,791. He had "inadvertently excluded Pathé’s defeasance adjustment” of £35,000 odd and he asks for a new invoice for £8,162,791 and a credit note for the old one.

189. Mr. Tallon asks: (i) how was 8,162,791 the purchase price when the total cost was certified at £8,198,714 and the allowable production cost £7,926,222? (ii) why was an amount more than the allowable production costs paid given the offer letter between Future and Pathé, and also Pathé's warranty; (iii) what did the defeasance costs Mr Harrison added have to do with the certified cost of the film anyway?

190. We note the flexibility of approach to Samarkand’s obligation to pay the purchase price and its change to benefit Pathé and Future. That points to decision making on behalf of Samarkand which had at least half an eye on Future's benefit.

191. On the basis that the agreement, properly construed, required a purchase price equal to the *total* production cost, Samarkand did not pay more than it was required to pay under the agreement.

V Trade.

192. The relief under section 138 is available only if "[a] person carrying on [a] trade ... incurred...acquisition expenditure." Section 140 is in similar terms. Sideways loss relief under section 380 is available only if "for the year of assessment in which [the loss] is claimed ... the trade was being carried on".

Each provision directs attention to the question of whether at a particular time, or in a particular period, a person was trading.

193. "Trade" is defined by section 832 TA 1988 to include every adventure or concern in the nature of trade. It is clear that one off transactions, for example the acquisition of an asset and its later sale, are capable of being trading transactions.

194. Mr. Peacock says that it is clear that what the partnerships did was trading: the legal effect, the shape and the nature of their transactions were in the nature of trade. In particular he makes the following points.

(1) The acknowledged fact that the transactions had a tax saving motive did not prevent them from being trading transactions. He referred us to Lord Templeman in *Ensign Tankers v Stokes* [1992] STC 226 at 241h:

> “Victory Partnership expended capital of $3,250,000 for the purpose of producing and exploiting a commercial film ... The production and exploitation of a film is a trading activity ... it is true that Victory Partnership only engaged in the film trade for the fiscal purpose of obtaining a first-year allowance but that does not alter the purpose of the expenditure.”.

And, at 243j

> “in the present case the legal effect of the transaction, whatever its design, was a trading transaction whereby Victory Partnership expended $3,250,000 towards the production of the film ...”

In the High Court [1989] STC 705 Millet J had come to the same conclusion. He said:

> “the production of the film, or the completion of an uncompleted film (or, I might add, the purchase of a completed film) in each case with a view to its distribution and exploitation for profit are all typical (though highly speculative) commercial transactions in the nature of trade".

(2) A tax relief could make the difference between a commercially attractive and economically unattractive transaction. That was not objectionable. Mr. Peacock quoted Lord Millet in *Peterson v CIR* (2005) STC 448 at [44]:

> "tax relief often makes the difference between profit and loss after tax is taken into account and a transaction does not become tax avoidance merely because it does so."

He referred to *Barclays Mercantile Industrial Finance limited v Melluish* (1990) S TC 314, a case about film leasing, in which Vinelott J says at 342j:

> "it is probable that BMI would not have been able to offer a lease back to the company ... at an acceptable rent unless it could obtain a capital allowance and unless it had spare capacity in the group sufficient to absorb it. But it does not follow that BMI's object was to obtain an allowance; BMI's object and purpose was to make a profit on the purchase and use of the plant."

(3) He says that where a person buys an asset, rents it out, generates rental income over 15 years, and has additional economic interests in the asset, those attributes are those of a trader.

(4) A commercial purpose, he accepts, is a requirement of trade. He accepts that generally that means making money. But he says that it is not for the tribunal to say "this is not a trade because it does not make enough profit". If it makes, or is expected to make, a profit it has a commercial profit purpose. These transactions made a profit: the rentals exceeded the cost. They were intended and planned to make a profit. The fact that the present values of the rentals on some discount rate reveal a loss is not sufficient to conclude that this was not a trade: the partners concluded that it was economically attractive. That was enough.

(5) In other cases courts and tribunals had accepted sale and lease back transactions with similar features as part of a trade.

In *Barclays Mercantile Business Finance Ltd v Mawson* 76 TC 446 (*"BMBF")* the sale and lease back was negative in present value terms (and the rents were less than the finance costs of the transaction) yet, despite this, it was accepted that there was a trade. In the House of Lords, [2005] STC 1, Lord Nicholls, having earlier acknowledged the fact that the rentals were less than financing costs and that the transaction broke even only because of the capital allowances, said at [41]:

> "Mr. Boobyer gave unchallenged evidence that from [BMBF]'s point of view the purchase and lease back was part of its ordinary trade of finance leasing. Indeed if one examines the acts and purposes of BMBF, it would be difficult to come to any other conclusion ... ".

He concludes that what happened to the purchase monies after their payment did not "affect the reality of the expenditure by BMBF and its acquisition of the pipeline for the purposes of its finance leasing trade.".

In the Court of Appeal Gibson LJ said at [46]:

> "In my judgement, the incurring by BMBF of the expenditure was wholly and exclusively the purposes of its trade of providing asset based finance. With respect to the judge, in the light of the evidence, and in particular that of Mr. Boobyer, I can see no basis for recharacterising the transaction in the way the judge did. It seems plain to me that BMBF incurred expenditure on the provision of the pipeline by a transaction which, despite having a fiscal element in it, in that capital allowances were to be obtained and passed on to the lessee in the form of lower rentals, was a genuine trading transaction. I would hold that the facts in the present case are far removed from the artificial structure employed in a dividend stripping scheme such as that used in the Lupton case."

(6) Mr. Peacock says that whether the tax relief is enjoyed inside or outside the trade is immaterial to the question of the existence of the trade.

(7) He says that in *HMRC v Halcyon Films* (2010) S TC 1125 it was common ground, and not challenged by the tribunal, that Halcyon was carrying on a trade for the purposes of section 42 FA (No 2) 1992.

(8) He agreed that the provisions of sections 259 and 260 Capital Allowances Act envisaged that it was possible to lease an asset otherwise than in the course of trade. These are the special leasing provisions which

entitle a lessor who was not conducting a trade to capital allowances which may be used in a limited number of ways. He argued that the divide between special leasing and leasing in the course of trade depended on six factors:

(a) the number of transactions undertaken,

(b) the monetary size of the transactions,

(c) the nature of the asset leased: private or commercial,

(d) the complexity of the transaction,

(e) the expectation of commercial profit, and

(f) the bearing of commercial risk.

In the present case these attributes pointed to trade, not leasing otherwise than in the course of trade.

(9) The leasing of a single asset could be a trade. That was shown by *Bennet v Rowse* 38 TC 476. There the House of Lords held that it was open to the Special Commissioners to conclude that the hiring out of one aircraft (after a second one had been destroyed) was the carrying on of trade.

(10) There were many single asset leasing companies which bought and immediately leased assets. They must have trades. It could not be the case that they were entitled to capital allowances only under the special leasing provisions.

195. Mr. Tallon puts his argument two ways. First, his "short route", under which he says that before the investors adhered to the partnership agreements they were not partnerships: they were simply agreements under which a number of people got the documents and agreements ready for the investors to invest in, rather like the actions of company promoters in cases like *Keith Spicer v Mansell*. Whilst that activity might be a business, it was not a business carried on for the profit of the then notional partners: rather it was a business carried on for the future benefit of the future investors. It was only when the investors adhered that profits could be made and shared: it was only then that there could be a view of profit. But when investors adhered they became partners in what was at best an investment partnership, putting in their money and enjoying a guaranteed rental stream. At that stage any real activity - the negotiating of the agreements and the identification of counterparties had been done. And it had been done by persons who were not in partnership because they had no view to their own profit.

196. Second, and in the alternative, Mr. Tallon says that even if there was an existing partnership which the investors joined, the business of that partnership was not a trade. That was because:

(1) the sale and lease backs were not commercial transactions. In each case, the present value of the rental stream fell short of the cost of the film; it was not permissible to take into account the tax benefits to the investors in assessing the commerciality of the transactions;

(2) the way in which the partnerships had conducted their businesses had been grubby and messy. It did not display commercial organisation: in particular:

(a) the Rights which Proteus acquired from Future were worth less than the amount paid to them. There was confusion as to whether LMI or Future had them available to sell;

(b) the rights which Pathé had in relation to The Queen appeared to be illusory;

(c) Grey Neon had been acquired by Samarkand and left on the shelf; likewise Comme t'y es Belle;

(d) the Samarkand partnership agreements were confused and partners seemed to have gone missing;

(e) the prices paid for the films had been determined by tax considerations not by the value of the films;

(f) The price paid for Oliver Twist was increased to allow for extra partnership subscriptions: that was not a commercial action of the business.

(3) Mr. Tallon relied on *Lupton v FA & AB limited* 57 TC 580. In that case the House of Lords considered whether a dividend stripping transaction undertaken with a fiscal motive was an adventure in the nature of trade. The House unanimously held that it was not. Lord Morris (at 620 D) expressed the view that the presence of a motive of securing tax recovery does not cause a trading transaction to ceased to be one, but (at F - D) he says that:

> "some transactions may be so affected or inspired by fiscal considerations that the shape and character of the transaction is no longer a trading transaction."

Viscount Dilhorne agreed with Lord Morris' earlier statement, and said that:

> "if a transaction as a whole is entered into and carried out for the purpose of establishing a claim against the Revenue ... I for my part would have no hesitation in holding that is does not form part of the trading activities of a dealer in shares. When I say "viewed as a whole", I mean that regard must be had not only to the inception of the transaction, to the arrangements made initially but also to the manner of its implementation."

Mr. Tallon says that getting tax relief was the holy grail of these partnerships: it shaped the form and implementation of their transactions. That was evident in Mr. Levy's evidence that the only control on the price paid was whether or not it would qualify for tax relief - otherwise the higher the better for all concerned; in fact, said Mr Tallon, tax relief was the essence of the business not just the control of the price.

(4) The essence of the business was not the risky production of a film, but the boring swap of a lump sum for a series of guaranteed payments over 15 Years. Realistically viewed that was not a trade. It might have been a trading transaction if done by an insurance company; it was not when it was the single transaction done by a business.

Discussion

(A) When Should the Question of Trading Be Assessed?

197. As we noted at the outset of this section, the statutory questions we have to answer are: (1) whether, at the time expenditure was incurred, the trade was being carried on, and (2) whether in the year of assessment of the loss a trade was carried on. These provisions direct attention to a particular time. As a result we reached the same approach to the question of trade as did Mr. Tallon (on his short route) but by a slightly different one. And we ask the question: “was the business conducted after adherence a trade?”: not because there was no partnership before adherence, but because the question is whether the trade was being conducted at that time and not whether what had been conducted was a trade. The question is not “what was the business of Proteus before financial close?”, but what was its business at financial close (or in the period of financial close).

198. In answering that question we bear in mind that a partnership is not a legal entity with a continuous life which starts with its incorporation; instead it is a "relationship between persons". That relationship changes when the persons change: if one contracts with a partnership one contracts with the persons who are at the time of the contract its partners (as section 17(1) Partnership Act 1890 says, "a person who is admitted as a partner into an existing firm does not thereby become liable to the creditors of the firm for anything done before he became a partner".) When one speaks of the firm one means the partners from time to time in that firm.

199. If a company is carrying on a business it may be possible to assess the nature of its business over a tract time beginning before the time of assessment (and possibly ending after it), since the activities and purposes will have been those of a single legal person. For a partnership what is to be assessed is the business carried on in common by the partners. If a new partner is admitted the business to be assessed is the business he carries on after admission, not the business previously carried on in common by the previous partners. That is not to say that that business must necessarily be different, or that its nature may not be affected by the acts of the old partnership, but it does mean that it is not necessarily the same business, and that the acts of the old partnership cannot colour the business of the new partnership save to the extent that they give rise to liabilities or activities of the new partnership.

(B) What principles should be applied in assessing whether the partnerships were trading?

200. We agree with Mr. Peacock that what has to be assessed is the activity of the partnership. The fact that it was the intention of the partners and of almost all others concerned that tax relief should accrue cannot prevent activities which are otherwise trading in nature from constituting a trade.

201. However in our judgement that assessment must be of the business of the partnership, not that business aggregated with the separate individual affairs of the partners. As a result neither is any borrowing undertaken by a partner to fund his interest in the business, nor is any tax relief or liability of a partner, or the way in which that partner might use the benefit of such relief relevant to determining whether that business is a trade.

202. It seems to us that the position of a leasing company such as BMBF is distinguishable from that of a partnership. The business of BMBF would

encompass its financing arrangements and the use of tax reliefs and the payment of tax. As Vinelott J made clear in the quotation from *Barclays Mercantile Industrial Finance*: the leasing at an acceptable rent was contingent on the company or a company in the group having spare capacity (i.e. taxable profits) sufficient to absorb the allowances. The use and surrender of losses to other group companies was part of its business. There would be a parallel with Samarkand and Proteus only if there was evidence that the benefits of tax reliefs (and possibly the cost of tax liabilities) were intended to be and were transferred to the partnership business. There was no evidence to that effect.

203. We did not find the acceptance in *BMBF* that the transactions were part of its finance leasing trade helpful. In that case there was unchallenged evidence to that effect; there was nothing parallel in these appeals. In that case it appears that there was an established trade into which the transaction fitted; in this case the question is whether there is a trade at all. In that case the finance and tax position was part of a company's business; in this case it was not part of the business to be assessed. The only conclusion we can draw from that acceptance is that sale and lease back transactions may be of a trading nature.

204. Peter Gibson LJ in *BMBF* was addressing the question of whether expenditure had been incurred on the pipeline. His remarks were in the context of Mr. Boobyer’s evidence that the sale and lease back was part of BMBF’s trade. In that context he says it was a genuine trading transaction despite the fiscal element. We are not asking whether the fiscal element denatures a trading transaction. Nor are the sale and lease backs in these appeals acknowledged to be part of a continuing trade. We are considering instead whether on their own these transactions were adventures in the nature of trade. We have no doubt that, just as the deposit of cash at interest is part of the trade of a bank but normally a non-trading transaction of an individual, these transactions could be trading transactions when conducted by particular businesses. Nor do we doubt that the single purchase and leasing of an asset can be a trade. But we do not believe that these transactions in these appeals which were the businesses of the partnerships were trading in nature despite the fact that they were created in the form of the sale and leaseback of an asset.

205. Nor did we find the remarks of Millet J in *Ensign* in the High Court clearly pointers towards a trade in these appeals. Millet J said that the purchase of a completed film with a view to its distribution or exploitation for profit was a typical commercial transaction of a trading nature. But in so saying he was clearly dealing with the case where the later distribution or exploitation was a hope or intention and not an integral part of the transaction of acquisition: He had in view a speculative venture; not a transaction of the sort in these appeals.

206. We accept that Lord Templeman described Victory Partnership’s activities as a trade, but the question of whether or not it was a trade was not argued before him. It was taken to be a trade: the question was whether the expenditure had been incurred.

207. Nor do *Halcyon (*or *Micro Fusion)* help. First the legislation being applied by the tribunal was section 42 F (No 2) Act 1992, and subsection (1) of that section provided that:

"in computing for tax purposes the profits or gains accruing to a person in a relevant period from a *trade or business* ...".

Likewise section 40B(3) defines "relevant period" by reference to the accounts of the "trade *or business*". The tribunal was thus not called upon to differentiate between a trade and business in its deliberation. Nor does the decision of the tribunal reveal any material consideration of the issue. Whilst it is true that at [108] the tribunal phrases its conclusion in terms that Halcyon commenced its trade on 9 October, in the summary at [8] the phrase "trade or business" is used.

208. We accept that the leasing of a single asset can be a trade. In *Bennett v Rowse* that asset was an airplane owned by the appellant and hired out to a company called Fairflight limited. The aircraft had been acquired at an earlier date and initially hired to a company participating in the Berlin airlift. Then it was hired out to Fairflight Limited. The material difference between the transactions in that case and those in the present appeals is that in these appeals the acquisition and hiring out were accomplished by a single composite transaction.

209. In *Ensign* in the High Court Millet J set out nine principles relevant to the determination of whether a transaction associated with the obtaining of a tax advantage was a trading transaction. In our judgement of particular relevance to these appeals were the following:

(1) in order to constitute a transaction in the nature of trade, the transaction in question must possess not only the outward badges of trade but also a genuine commercial purpose;

(5) the test is an objective one;

(6) in considering the purpose of a transaction its component parts must not be regarded separately and the transaction must be viewed as a whole.

210. The last of these principles finds authoritative voice in the judgements in the *Ramsay* line of cases. In determining whether a transaction is a trading venture regard must be had to the purpose of the statute and the transaction must be viewed realistically. In the case of a statutory provision which requires an answer to the question of whether something is a trade, it is clear to us that a broad commercial approach to the facts is required, and transactions executed as composites of linked parts should be viewed as a whole rather than piece by piece. Trade is not a narrow legal concept but a broad commercial one: connected transactions planned and executed as a single transaction must be viewed as a whole.

The application of these principles

211. Subject to two points we do not find that Mr. Tallon's attack on the organisation of the partnerships' businesses persuasive. There was some sloppy execution; some initial muddle about Samarkand's partners. Grey Neon was acquired and forgotten and Proteus was used as temporary storage for some film contracts. But the central transactions under which substantial sums were to be paid and received were subject to tightly drawn agreements. There was no sloppiness in ensuring the receivabililty or receipt of rentals. The core of the business (the exchange of cash today for cash over the next 15 years) was not so slapdash as not to be a trade.

212. The first caveat relates to the title in The Queen. We discuss that at IV(4) above. There we conclude that Pathé owned the negative in the film and some film rights but that those rights were shorn of value. But it was those rights which, however poor they were, Haiku agreed to take and for which it agreed to make payment. That points to the irrelevance of the real rights in the film in the sale and leaseback arrangement, but it does not indicate to us that for that reason the arrangement was so uncommercial as not to be a trade; instead it indicates that in assessing whether or not it was a trade the lease and acquisition must be viewed as one transaction whose material features were the payment and receipt of monies.

213. If we are wrong and Pathé had no assets at all to convey to Samarkand, that indicates that Haiku were also in some way deceived, but nevertheless that does not indicate such a lack of commerciality on Samarkand's part as to prevent its activities from being a trade: a handler of stolen goods may possibly not trade, but only because he can convey no title and make no profit. .

214. For present purposes we assume that Pathé had the asset it purported to convey to the partnership.

215. The second point relates to the prices paid for the films. This is discussed later, but in view of the approach we take to the transactions in question it is not relevant. Indeed because the transactions were composite sale and lease back transactions, the price paid had little commercial effect: the greater the amount paid the correspondingly greater the rentals which would be received (as Mr. Levy said: "the essence is-rather confusingly, the more I pay for the film, the more I'm going to get in lease rentals."). The only commercial loss was that the fee paid to Future (being a percentage of the capital raised) would be higher.

216. Once the investing partners adhered, what did the partnerships do? The answer is:

(1) they received certifications such as that from DCMS for Irina Palm;

(2) through Future they set the levels of rental payments by reference to LIBOR and the amount eventually agreed as the price of the film; and

(3) they completed the sale and lease back agreements by making payments under them.

217. The activities were confined to and centred on the financial closing of the sale and lease back agreements. Thereafter for 15 years the activities of the partnerships were to be limited to the management of their fixed guaranteed receipts under those agreements.

218. In our view this activity cannot be treated, for the purpose of assessing whether it was a trade, as a separate acquisition of the film and its later leasing. These transactions were part of a whole, and the whole was different from the sum of its parts.

219. Save for partners' personal cachet and interest in individual films ("I've invested in the latest James Bond film"), and their tax considerations - both of which were not part of the partnership business - and the value of the Rights and Extra Profits, it mattered not what asset was being bought and leased

back: it could have been a computer program, a painting or a patent. It mattered not what profits might be made by distributing or hiring out the film because the major returns were fixed by the sale and lease back transaction and were unaffected by the film's performance.

220. The commercial nature of these agreements was the payment of a lump sum in return for a series of fixed payments over 15 years. That type of transaction carried out on its own is not in our view an adventure in the nature of trade.

221. If one considers this composite transaction against the "badges of trade" (described in *Marson v Morton* [1986] STC 463 at 470-471) these are the results:

(1) Repetition. There was no (Proteus) or only one (Samarkand) repetition of the transaction. In the case of Samarkand the repetition was a contemporaneous similar transaction. This is a particular distinguishing feature from the transactions in *BMBF* where the business of the company was finance leasing and the transaction in question was part of that business.

(2) An existing trade. Neither taxpayer had an existing trade of which the transaction was a part.

(3) The subject matter - it was commercial;

(4) The way the transaction was carried through. In our view the transactions could be viewed as being carried out in the manner of an investor seeking to obtain a return on an investment as well as they could be viewed as being carried out by a trade.

(5) The source of finance. Finance was provided by partnership capital not short-term borrowings;

(6) Work done on an object. The transaction did not involve work done on a resold object. To the contrary, the composite whole had little to do with the acquisition of an asset other than the 15 year rental stream;

(7) Breaking down into lots. The composite transaction did not involve any breaking down of any asset into lots.

(8) Whether the purchaser intended to sell at the time of purchase. If the transactions are analysed as comprising a sale and later leasing that points to trading. But properly viewed (in accordance with the terms of the documents and the commercial reality that no real risk was being taken on the film) these transactions were composites in which there was no relevant acquisition or sale of an asset for the purposes of this test but rather the payment of the purchase price in return for the stream of payments;

(9) Did the asset provide income pending resale? Viewed as composite transactions this is precisely what the sale and lease back agreements provided: rental income. Selling that income would be, given the other contractual documents, very difficult.

222. In summary, of these badges only (3) points towards trading and only then because the subject matter was commercial. Overall these considerations

indicate to us that the shape and character of the composite transactions was not of a trading nature.

223. We reached this conclusion without reliance on Mr. Tallon's *Lupton* argument. The essence of that argument is that the mere presence of elements of trading will not suffice to translate a transaction, the greater part of which is explicable on fiscal grounds, into the realms of trading (see Lord Morris quoting Megarry J). We have not got even that far. Looking at what the partnership did we do not see elements of trading: there is no need therefore for us to consider whether the transaction can be viewed as a whole as entered into for the purposes of establishing a claim against the Revenue.

224. We were grateful for Mr. Peacock's list of criteria distinguishing special leasing from leasing in the course of trade. But the first question is not "is something special leasing?" It is "is it a trade?". If it is not a trade then it may be special leasing. The normal principles must apply to determining whether what is done is a trade, not a subset of these principles.

225. We should record that on balance we also accepted Mr Tallon's argument that before the investors adhered the nature of the relationship between the parties to the partnership deed was not one of partnership because they did not have a view of profit for themselves as parties in the venture. It is true that they were not acting altruistically, but what they had a view to was profit for Future, and a business for the investing partners.

226. If we are wrong in approaching the question of trade by reference to the activities of the business conducted by the partnership encompassing the investing partners, and if Mr. Tallon is wrong in his submission that the partnerships began only on adherence - so that in either case the business must be assessed by reference to earlier acts - what difference would it make to our conclusions?

227. The answer is that the activity of Future as agent of the partnership in sourcing and negotiating the sale and lease back transactions would have to be taken into account. That activity is more speculative but (ignoring for the moment Proteus' £2.2m Escrow for Oliver Twist) until complete it did not involve the partnership in any material additional financial reward or risk (since Future's fees seemed to be dependent upon results and were not collected where there were no results, because Future knew that until then there would be no money to pay it). Indeed Mr Levy's comment that the agency agreements did not have commercial effect until a film was identified was relevant in this regard. "Trade" is suffused with commerciality. If a commercial man like Mr Levy did not regard the earlier agreements as having a commercial effect, it would be odd to regard the actions of Future in seeking a transaction as part of a trade of the partners. Indeed Samarkand stated in the agreement relating to the Business Plan that it did not trade before 5 July 2006. Before the agreements were signed the partnerships engaged Future to set up a transaction if it could. But until the agreements were signed all the partnerships did was to retain Future: that was not a trade. The real business started when the agreements were signed. Those agreements were single composite transactions which would complete with payment. We cannot see how an extension of the horizon to encompass both the signing and completion of those agreements can turn

activity of making payment under the agreements into part of an adventure in the nature of the trade.

228. In that conclusion we ignored the £2.2m Escrow for Oliver Twist. It seems to us that when it borrowed and paid that money Proteus became involved in a serious business venture. It put down a non returnable deposit on its intention to complete the sale and leaseback. But that was part of the acquisition of the sale and leaseback and does not seem to us to change the nature of Proteus' business and make it a trade.

229. If it were impermissible to consider the shape and character of the sale and lease back transactions by reference to the composite transaction, and instead we had to consider its elements separately we may have concluded that the elements taken individually had a trading nature, but Millett J in *Ensign* (as quoted above) suggests that the transaction may be a transaction in the nature of trade only if it has a commercial purpose. If we were wrong in our evaluation of the features of the sale and lease back above, do the sale and lease back transactions exhibit the requisite commerciality?

230. We discuss in Section VI below whether the business of the partnership was carried on on a commercial basis. There we conclude that, principally because the present value of the composite transactions was negative (on the application of a reasonable commercial discount rate), they were not carried on on a commercial basis even though in pure arithmetic terms, they yielded an excess of income over expenditure over their 15 year period. It seems to us that the "commercial basis with a view to profit" test should not preclude, in an appropriate case, the consideration of the net present value of the businesses' transactions. Whilst we find some difficulty in treating a transaction which has a negative present value on a realistic discount rate as commercial, we accept that the requirement of profitability in assessing whether a transaction has a trading nature may be properly addressed by the simpler question of whether it results in an excess of income over expenditure. These transactions did. If we were wrong in our assessments of the sale and lease back transactions they would not in our view be prevented from being part of a trade because they were uncommercial in the sense used by Millet J.

231. In the discussion so far we have excluded the effects of (1) Rights in the films after the 15 year period; (2) the Extra Profit rights and (3) the rights in relation to Oliver Twist. Although these rights raised the prospect of a speculative trading style profit - froth on the top of the rather boring fixed guaranteed secured rental patents - they did not in our view convert what was not a trading activity into one which was. That was because they were, for the following reasons, immaterial.

(1) Rights after the end of the 15 year period

232. The leases provided* for secondary periods (after the first 15 years) at a rental of £100 per annum (unless an event of default had occurred). If the films had any value at that stage it is likely that the lessor would have elected to continue to pay the £100 per annum. At the end of the lease the lessor is entitled to receive only 1% of the sale proceeds of the negative (clause 15). E-mail traffic suggested that the general expectation at the time the leases were entered

into was that the films would have a nominal value at the end of the 15 year period.

(* This is explicit in the Samarkand leases; the Proteus Lease does not appear to specify the secondary rental but we believe it would have been agreed to be £100 per annum.)

233. We therefore conclude that the residual value of the rights at the end of the 15 year period was negligible.

(2) the Extra Net Profits

Oliver Twist

234. The Lease of Oliver Twist provided for no Extra Profits. Any additional receipts deriving them from the performance of the film were receivable by Proteus as only via the Rights agreement with Future.

The Queen

235. The Lease of The Queen provided for Samarkand to receive 1% of the net profits of The Queen accruing to and actually received by Pathé Slate. For the reasons discussed at para 181 to 187 this right against Pathé Slate was in our view a right to nothing since Pathé Slate actually received no monies. We accept that Pathé Productions appears to have accepted Pathé Slate’s obligation and made the payments which Pathé Slate would have made had it received net profits. But the value of the expectation that Pathé Productions would continue to pay would have been considerably less than the value of an enforceable right.

236. Mr. Levy told us that Pathé thought that The Queen would be a successful film and that 1% would be valuable. It was because of the expectation of success that he was unable to negotiate a 2% figure for the money he was prepared to pay.

237. The contracts for The Queen were entered into on 11 September 2006 (subject to conditions precedent) and completion (financial claims) was on 9 March 2007. The film was released in the UK in September 2006. By 1 May 2009 Samarkand had received £15,892.79 from Pathé Productions and in the following year it received £1,337.87.

238. Mr. Norris told us, and we accept, that his educated guess was that about one in 10 films break even. We find that the chance of a film doing very well was moderately small.

239. The nature of the calculation of the net profits that Pathé Slate (or Pathé Productions) would reap and out of which Samarkand was to receive a 1% share, was difficult. That is because of the amount of those profits depended upon the deductions of other parties' remuneration and benefits, the amounts of which were not available to us. However, given that The Queen was successful and over the three-year period; Samarkand received some £17,000, it seems to us that it was unlikely that over a 15 year period it would receive more than about £60,000 and that the prospect in 2007 of a substantially greater sum was

very slight. Set against the cost of the film and the lease rentals the possibility of a material windfall seems to us to be sufficiently small as to be irrelevant.

Irina Palm

240. Under the Lease of Irina Palm, Samarkand was entitled to 2% of Ipso Facto's share of the net profits of the film. As with The Queen the quantification of this amount or the proportion it might represent of gross takings was not possible on the evidence before us.

241. The Irina Palm agreements were signed on 22 December 2006 and completed (financial close) on 9 March 2007. The film was released in the UK in June 2008 but was premiered at the Berlin Film Festival on 13 February 2007 and put on general release in Belgium on 18 April 2007. It seems to us unlikely that its potential would have been apparent at 22 December 2006 although there may have been some inkling of it by 9 March 2007.

242. No payment had been received by Samarkand under the Irina Palm 2% rights.

243. Given the size of the payments which Samarkand received from the 1% share in The Queen and the comparative success as we understood it of the Queen, and also Mr. Norris's evidence about the general success rate of films, it seems to us that it was extremely unlikely that a substantial sum would be received by Samarkand under the Irina Palm 2% rights. And any sum received would be highly likely to be immaterial in relation to the amounts spent on the film and received under the lease.

(3)The Rights in relation to Oliver Twist

244. We have concluded that Proteus did not acquire any rights in relation to Oliver Twist until August 2006, seven months after the sale and leaseback transaction had closed, and that at that time it was known that Oliver Twist was not a success so that there was no real expectation of valuable fruition of this agreement. The acquisition of the rights in August 2006 did not therefore turn the acquisition of Oliver Twist into part of a trade.

VI <u>On a Commercial Basis</u>

245. Sections 381(4) TA 88 and 384(1) TA 88 deny loss relief if the trade was not carried on on a commercial basis. We assume in this section, contrary to our conclusion above, that the partnerships were conducting a trade.

246. The ‘trade’ in these appeals is the trade carried on by the relevant partner as a partner in the relevant partnership. In our view this confines attention to the activities carried on in common by the partners in the partnership. The activities which the partner carries out in association with his participation in the partnership are not activities of the trade he carries on in common with the other partners and are not relevant to the assessment of the business of the partnership.

247. The activity of a partner in investing in a partnership may well be part of a commercial enterprise, but if it is that does not mean that the partnership

business is necessarily carried on on a commercial basis. It may well be that a partner's borrowing, investment in the partnership and use of tax reliefs is as a whole commercial, but that is irrelevant to the assessment of the commerciality of the partnership's business.

248. Thus the question for us is whether the activities of the partnership were carried on on a commercial basis.

249. In *Brown v Richardson* [1997] STC (SCD) 233 the Special Commissioner held that the letting of a holiday home effected with a view to generating revenue to offset costs rather than with a view to the realisation of overall profits was a commercial letting (see [13]). He reached that conclusion (at [11]) having regard to the engagement of a competent agent and the letting at a commercial rent.

250. It seems to us that this decision does not compel the conclusion that profitability is irrelevant to whether a venture is commercial. The Commissioner described the letting, not the activity of the purchase letting and use as a holiday home, as commercial. The letting taken on its own could well have been analysed as profitable.

251. In *Wannell v Rothwell* [1996] STC 450 Robert Walker J considered whether an individual dealing in commodities from home was carrying on a trade on a commercial basis. He held that an activity carried out on an uncommercial basis could still be a trade and, when discussing what was meant by "on a commercial basis" said at 461b:

"A trade may be conducted in an uncommercial way either because the terms of the trade are uncommercial (for instance, the hobby market gardening enterprise where the prices of fruit and vegetables do not realistically reflect the overheads and variable costs of the enterprise) or because the way in which the trade is conducted is uncommercial in other respects (for instance, the hobby art gallery or antique shops where the opening hours are unpredictable and depend simply on the owner's convenience). *The distinction is between the serious trader who,* whatever is shortcomings in skill, experience or capital, *is seriously interested in profit* and the amateur or dilettante …" [our italics].

252. Robert Walker J then decided that he would not be justified in overturning the Special Commissioner's decision that the taxpayer's lack of commercial organisation meant that he was not conducting a trade on a commercial basis, although he did not fully understand that conclusion.

253. It seems to us that the serious interest in a profit is at the root of commerciality. Christmas is commercialised when it is used for profit. The hobby art gallery is not run with a serious eye to making money; nor is the loss making market garden.

254. But a serious interest in profit does not to our mind mean simply an interest in an excess of receipts over expenditure especially where longer term cashflows are involved. In those cases the well known and well understood technique of discounting future cashflows to derive their present value would be used to evaluate the project or investment. Those techniques are demonstrated in a different form in the cash projection for the licensing transactions in these appeals: the amount of the deposit provided by Haiku is the discounted present

value of the lease payments it will make at a set interest rate. The same discounting technique was used by Salter to produce valuations of Oliver Twist which formed the basis of the Malde opinion. The accounts of the partnerships use the same technique to value the asset shown in the accounts which represents the future rental stream under the lease (the accounts do not show any value for the films but only a value for the rental streams).

255. The commercial reality that £100 in a year's time is worth less than £100 today is reflected in the determination of a present value. It is also seen in the pricing of gilt edged securities. If prevailing low risk deposit interest rates are 5% a government security of principal amount 100 payable in 5 years time carrying an annual 2%, coupon will not trade at 100 but at about 90. If a person bought such a security at 100 it is true that he would over the five years receive a total of 110, and so have an excess of income over expenditure but such a transaction could not in our view be called a commercial one because it has not a serious interest in profit: a greater amount of money could be obtained by placing 100 on deposit at prevailing interest rates. Likewise a loan to a person's child at market interest rates might be commercial, but one made at a nominal or nil rate may well not be so. Clearly there may in any particular business be reasons for undertaking a transaction with a negative net present value, but if the business is truly one conducted on a commercial basis those reasons will be that collateral business profits are hoped for or expected whose value is expected to outweigh the negative effect of the transaction.

256. It seems to us that if an entity enters into a transaction which has a negative net present value the transaction cannot be descried as commercial unless there are other collateral benefits expected or hoped for which are expected to outweigh the negative effect of the transaction. If you buy an asset for £10 and exchange it for something worth £7 that is not a commercial transaction unless you have a collateral hope for at least £3 profit elsewhere.

257. Mr Peacock says that the "commercial" limb of the statutory test focuses not on a serious eye to making real money but on the manner in which the trade is carried on, the quality of its organisation and whether it seeks to produce a commercial outcome. He says that a commercial outcome must mean something different from a taxable or accounting profit otherwise the second, "profit" limb of the test is redundant. By this means if "with a view to profit" is confined to achieving an excess of income over expenditure considerations of the net present value effects of transactions would be excluded from a consideration of the statutory tests.

258. We accept that lack of organisation or a happy go lucky approach may indicate that the commerciality test is not satisfied but we do not believe that the parliament thus intended to exclude a major commercial technique where its application was relevant. Redundancy is not a good guide in the construction of tax statutes, but even if it were, the fact that the breadth of an assessment of commerciality might include an appraisal of profitability does not mean that the specific test is made redundant. To this extent the tests should be considered as a whole.

<u>The Queen</u>

259. Samarkand paid Pathé Slate £8,162,791 +VAT for the rights it acquired in The Queen. It leased the film to Haiku for rentals payable on 9 March 2007, 31 December 2007 and thereafter yearly until 31 December 2020. The rentals grew at 5% p.a. The first rental payment was £448,898.

260. The total rentals receivable amounted to £9,686,582 in the period to 31 December 2020.

261. Haiku placed £6,359,688.18 on deposit with ABN Amro. The deposit earned interest at 5.055% p.a. The Deposit agreement provided for it to be repaid in 14 instalments from 31 December 2007. The instalments were equal to the rental payments due on each 31 December (bar a few pence).

262. Thus the present value of the lease payments from 31 December 2007 to 2020, using a discount rate of 5.055% p.a. was at 9 March 2007 the value of the deposit, £6,359,688. Adding the payment of £448,898 made on 9 March 2007 that means that the present value of all the loan payments up to 31 December 2020 was £6,808,586. (This differs by an immaterial amount from Mr Cannon's calculation using the same discount rate of £6,766,632.)

263. Lease rentals of £100 p.a. were due after 31 December 2020. Their effect is negligible.

264. Thus, looking solely at the rental rights and the cost of the film, Samarkand made in present value terms (by reference to a 5.055% discount rate) a loss of £1,354,205 on the acquisition and leasing of the film.

265. The discount rate of 5.055% is the rate of interest ABN agreed to pay Haiku. The rate of interest on the partner borrowings was 0.25% above the bank's cost of funds, and, because the rental payments amortised the partner borrowings, was just above 5.055%.

266. It seems to us that at a time when borrowing and lending rates were at or above 5%, a discount rate of 5.055% properly reflects the cost of money at that time. The use of a higher rate would result in a greater loss for Samarkand in NPV terms. The use of a lower rate reduces the loss, but a fairly simple calculation (but one which the tribunal chairman initially got wrong) shows that it is not until a rate of less than 2.3% p.a. is used before Samarkand breaks even.

267. On its own therefore the sale and leaseback was not in our view a commercial transaction.

<u>Irina Palm</u>

268. Samarkand paid £3,002,834 for its rights in Irina Palm on 9 March 2007.

269. It leased the film to Haiku for a rental payment of £166,081 payable on 9 March 2007 and 14 payments on each subsequent 31 December starting at £174,385 and escalating at 5% p.a. (A £100 p.a. rental was payable thereafter which we disregard for present purposes).

270. The total rentals receivable by the partnership were therefore £3,583,787.

271. Haiku placed £2,351,807 on deposit with ABN Amro to secure (and pay) its lease rental payments. The deposit carried interest at 5.055% p.a. and was repayable in instalments which matched in amount and time the lease rental payments.

272. The present value of the rental payments discounted at 5.055% was therefore £2,351,807 and £166,081 = £2,517,880. (This again differs from the Mr Cannon's calculation using the same discount rate by an immaterial amount).

273. As a result therefore of the sale and leaseback transaction Samarkand paid £3,002,834 for an asset with present value £2,517,880, a loss in commercial terms (at that discount rate) of £484,954.

274. As is the case for The Queen the use of a lower discount rate reduces the commercial loss but it is not until the discount rate reaches about 1.5% that Samarkand could be said to have broken even. In times when deposit rates were 5% or so the use of a discount rate of 1.5% or less to value an income flow would show scant regard to making profit.

275. As a result in our view it would be only if the partnership expected or hoped for collateral benefits outweighing this commercial loss that the sale and leaseback transactions could be called a commercial one.

Oliver Twist

276. On 13 January 2006 Proteus paid £46,975,000 for its rights in Oliver Twist.

277. It leased its interest to Haiku for 15 rental payments starting on 13 January 2006 (of £2,706,635) and escalating at 5% p.a. until 13 January 2020. The total rentals receivable were £58,405,303.

278. Haiku placed £39,677,641 on deposit with HBOS Treasury Services Plc at an interest rate of 4.36%. The deposit was repayable in 14 instalments which matched in time and amount the lease rental payments from 12 January 2007.

279. The present value of the rental payment at a discount rate of 4.36% was therefore £39,677,641 + £2,706,635 = £42,384,276. (Again the difference between this amount and that of Mr Cannon's calculation at the same discount rate is immaterial).

280. Proteus thus acquired for £46,975,000 an asset which it effectively disposed of for £42,384,276, a commercial loss (using a 4.36% p.a. discount rate) of £4.5m.

281. The Facility Bank lent to the parties at about 4.38% p.a. It seems to us that the use of a 4.36% discount rate to value the loan rental flow is about right. A fairly simple calculation shows that not until the discount rate is lower than about 2.9% would Proteus have broken even. That rate was not a commercial rate at that time.

282. As a result in our view the sale and leaseback transaction was not a commercial transaction unless there were expected or hoped for collateral benefits to the business which outweighed the commercial loss.

283. Mr Levy told us, and we accept, that Future was competing with Matrix for Oliver Twist. That may suggest that Proteus paid a market price for the film. It may also be the case that Samarkand paid a market price for the films it acquired. But paying a market price does not make the leasing of the film for rental payments of value less than the price of the film a commercial transaction.

Generally

284. This can be looked at another way. Mr Levy explained that in a sale and leaseback deal the Distributor would normally place a large proportion of the proceeds of sale on deposit to secure future loan payments. However, he said, "the Distributor benefits by being able to keep the difference between that security deposit and the amount paid for the film by the Partnership (less administration and arrangement costs). In the film finance industry this difference is often referred to as the "Producer's Net Benefit".

285. The Producer's Net Benefit (after adding back admin costs etc) is the net commercial cost of the sale and leaseback to the partnership. It is in commercial terms the loss the partnership suffers in the deal.

286. In our view it will be only if the partnership business expected or hoped for other benefits from the transactions which outweighed the cost of providing the Producer's Net Benefit that the sale and leaseback could be called a commercial transaction.

287. Mr Levy said that in all film leasing deals the present value of the rentals would be less than what was being paid for the film "unless one ended up being spectacularly successful and you negotiated an attractive profit share." That underlined the point that the sale and leaseback on its own (without consideration of the profit share) was not a commercial transaction.

288. We should make clear here that we distinguish the position of a company whose business may include taking the benefit of tax allowances either against its own profits or by seeking payments for group relief from that of these partnerships which does not include dealings in the tax benefits which may accrue to its partners. In the case of such a company the expectation of the benefit from such allowances may be taken into account in assessing its business; we do not believe that the tax reliefs which may accrue to the partners may be so taken into account in these appeals.

289. The Proposal documents inviting investors to become partners in Samarkand and Proteus describe a hurdle rate. Mr Levy explained that this was the post tax return that an investor had to earn on the initial positive cash flow generated by the advertised tax reliefs in order to allow him to break even over the life of the transaction. Thus from an investor's perspective his participation delivered an economic benefit only if he used that cash flow benefit to create a return. In other words if one were to broaden one's horizon in assessing the nature of the business to look at the tax position of the investor, one would also

have to conclude that he used the tax advantage profitably before the overall result would make commercial sense. That moves too far in our estimation from the activities of the partnership.

290. [Blank]

Other factors: profit rights

291. At various times Mr. Levy explained that investors in the partnerships were investing in sale and lease back transactions for the tax relief and were not investing because they were expecting significant additional film profits. Such profits were "gravy" or "pixie dust". That conveyed to us the impression that one might hope, but only in the manner of a raffle ticket holder, for such profits, but that one would not reasonably expect them.

292. We examined the Rights in relation to Oliver Twist, and the Extra Net Profit rights in relation to The Queen and Irina Palm at paras 234 to 243. We concluded that it was very unlikely that they would have produced any significant sums, and we do not believe that there was any real chance or expectation that they would deliver a return big enough to compensate for the net present value losses. As Mr Levy said in relation to the Oliver Twist Rights, they were not “the most massively important item in the whole transaction” (and as a result less attention was paid to their documentation). The addition of the prospect of collateral benefits from these rights did not turn the lease and purchase transactions into commercial transactions.

293. The statutory test is by reference to the trade carried on, not by reference to individual transactions. But if the partnerships were trading (either generally or because these transactions were adventures in the nature of trade) these transactions were the substance and essence of that trade. If they were uncommercial then those trades were in our view not carried on on a commercial basis.

294. Mr. Tallon argued that the way in which Proteus and Samarkand operated was uncommercial in the sense that it was careless or amateurish. He said it was grubby and messy. In relation to Proteus he pointed to:

(1) the sorry saga of the Rights Acquisition agreement;

(2) the price rise asked for by Future on behalf of Proteus before financial close;

(3) faults in the Salter valuation: the absence of overages, and the use of unexplained discount rates;

(4) the less than perfect partnership documentation.

295. In relation to Samarkand he points to:

(1) what happened, or didn’t happen, with Grey Neon and Comme T’y es Belle;

(2) the lack of apparent concern over the existence or value of the rights Pathé owned in The Queen;

(3) the muddle over £35,928 of the purchase price for The Queen.

(4) that fact that the price paid for a Irina Palm was its production cost: no attention was paid to its value. And a contractual warranty that the price paid would be less than the net production cost was ignored;

(5) generally lack of regard to Future's failure to source films on the best terms available.

296. In this context we also note Mr Norris' evidence (i) that it was unusual to agree to buy at an unknown valuation. But we do not see that doing something unusual makes doing it uncommercial; (ii) that it was difficult but not impossible to value a film weeks before its completion and that there were dangers both of over and of under valuation and (iii) from his acceptance during his cross examination by Mr Peacock that such was his assumption, that sale and leasebacks were normal commercial transactions in the film world. We also note what Mr Levy said in his "famous email" described at III(e), para 77 above: that these transactions were artificial and without commercial rationale.

297. It seems to us that a business might well be disorganised: it might have too few staff, or its premises might be too small, it could be late in putting in its VAT returns, or it might concentrate on sales but not invoicing; but it could nevertheless be called a commercial enterprise. Disorganisation does not in our view make something necessarily uncommercial. What many of Mr. Tallon's complaints point to is that the partnerships were not seriously interested in making profits. Instead the business focus was on ensuring that investors got tax relief and Future got its fee. Those were not serious financial benefits to the business of the partnership. That is another aspect of the lack of commerciality displayed in the purchase of a rental stream for more than its value.

VII Was the Trade Carried on with a View to the Realisation of Profit?

298. We assume in this section that the partnerships did carry on a trade.

Proteus

299. The principal transaction of Proteus' business was the acquisition and leasing of Oliver Twist. Under that transaction:

(1) it received total minimum rentals of	58,405,000
(2) and paid a purchase price of	<u>46,975,000</u>
(3) giving a gross excess of	11,430,000
(4) out of which it paid fees to Future of	<u>4,734,265</u>
(5) so in broad terms an excess of:	<u>6,695,735</u>

300. In addition Proteus acquired the Rights for £513,474 under which it had an entitlement (under the agreement) to 7.5% of Future's share of "gross participation".

301. Even if one assumes that no income could reasonably be expected from the Rights, it is clear that these transactions created a reasonable expectation that over a 15 year period Proteus would have an excess of cash received over expenditure.

Samarkand

302. Samarkand's principal transactions were the acquisition and leasing of The Queen and Irina Palm. Under these transactions:

(1) it was entitled to aggregate minimum rentals of			
	(a) the Queen	9,686,582	
	(b) Irina Palm	<u>3,583,787</u>	13,270,369
(2) and paid purchase prices of:			
	(a) The Queen	8,162,781	
	(b) Irina Palm	<u>3,002,834</u>	<u>11,165,625</u>
(3) giving a gross excess of:			2,104,744
(4) out of which it paid fees to Future of			(<u>553,485)</u>
(5) so in broad terms an excess of			<u>1,551,259</u>

303. In addition on 5 April 2006 Samarkand acquired rights in Grey Neon for £28,126 and, later, income rights in relation to Comme T'y Es Belle (CTEB) for £87,016.

304. As a result even if one assumes that Grey Neon and CTEB were destined for failure, and that no payment could be expected under the Extra Net Profit provisions or any value at the end of the Leases, the transactions created a reasonable expectation that Samarkand would have an excess of cash receipts over expenditure over a 15 year period.

The partnerships' accounts

305. Note 1 (Acounting Policies-Amounts recoverable on contracts) in each partnerships' accounts explains that the accounts treat each sale and lease back as resulting in the accretion of an asset whose "value is the net present value of the minimum receipts under the relevant lease" and that "Each year the net present value is recomputed and the reduction in value of the lease is set off against the rental income and treated as the recovery of the leasing debt" . The turnover and gross profit is thus ascertained by deducting from the rentals received in the period the reduction in the net present value of those rentals over the period. The discount rate used is not disclosed but where the same rate is used each year the result is to give a constant periodic rate of return on the investment in the lease. Unless a discount rate had been chosen which resulted in the net present value of the rentals equalling the purchase price a loss would have arisen in the period of the sale and lease back. In that period the partnerships expense the agency fee paid to Future, expenditure on the Rights and any amounts paid as interest.

306. Samarkand's accounts show the following profits and losses

(1) nine months to 31 December 2006	(611,856)
(2) three months to 5 April 2007	43,473
(3) 12 months to 5 April 2008	257,756
(4) 12 months to 5 April 2009	237,303
(5) 12 months to 5 April 2010	178,305.

307. Proteus' accounts show a similar picture with a first period acquisition loss of some £5m.

308. Given the security of the rental payments and the fixed amounts, these results could in our view have reasonably been foreseen at the time of the transactions. They indicate that at that time it would have been reasonable to suppose that over the 15 year term an aggregate accounting profit would have been made by each partnership. That aggregate profit over that period arises because, as a matter of arithmetic, whatever the discount rate applied in determining the net present value of the rentals at the end of any period, over the period the rentals received exceed the amount paid for the film or the amount recognised as the net present value of the receipts under the lease in the first period.

"Profits"

309. As this term is used in sections 381 and 384, it is not in our view intended to refer to a taxable profit. The excess of a business' income over its expenditure would generally be regarded as "profit" for these purposes (although if inflation was at 10% per annum and an asset were bought at 100 and sold a year later for 101 we doubt whether everyone would concur that the business had made a real profit -- many would say that it was a "technical" profit, and doubt whether that had been intended by the legislation).

310. Subject to the possibility (which we have rejected) that an appraisal of commerciality should not include a consideration of commercial tests of profitability (in which case we would find that an appraisal of “profit” requires such an investigation) we believe that the cruder everyday meaning does not embrace the more technical commercial approach of examining the net present value of the results of the business' transactions. We conclude that the business of Samarkand and Proteus from the time they entered into the sale and lease back agreements was one which was carried on so as to afford a reasonable expectation of profit or in such a way that profits could reasonably be expected to be realised, and so carried on with a view to the realisation of profits. We therefore find the profit conditions in sections 381 and 384 satisfied.

VIII **Was the trade the exploitations of films?**

311. We assume in this section that the partnership did carry on trades.

312. Sections 138 and 140 apply only where “the trade consists of or includes the exploitations of films.”

313. In *Revenue & Customs v Micro Fusion* [2010] EWCA CIV 260 the Court of Appeal considered the ambit of the words “a trade or business which consists of or includes the exploitation of films” as it appears in section 42 FA(No2) 1992. We can see no context which requires a different meaning of the phrase “exploitation of films” in sections 42 and 136 ITTOIA and none was suggested by the parties.

314. In that case Micro Fusion had acquired the rights to the screenplay in a film, entered into an agreement (the “PSA”) under which it

financed the production of the film by a production company, and under a Distribution and Commissioning Agreement ("DCA") sold the negative of the film to Pathé and licensed to Pathé all distribution rights for a 21 year period in return for a guaranteed series of payments and a percentage of the receipts.

315. In the High Court Davis J considered that the effect of the DCA was that "the substantive reality was that Micro Fusion has entirely disposed of [the] negative and copyright rights for the 21 year term … those payments in truth are the consideration for the sale" ([68]). He held that an outright sale could not be exploitation. "Exploitation carried with it the notion of a transaction designed to derive income from an asset on a continuing basis."

316. In the Court of Appeal Sir Andrew Morritt C said ([43])

"… did the business of Micro Fusion constitute or include [the] exploitation [of the film]? There can be no doubt that Micro Fusion acquired the film under the PSA, but did it exploit it under the DCA? … For my part I see no reason why the concept of exploitation must exclude an outright disposal.

"[44] It is only necessary to go that far if I conclude that the transaction affected by the DCA did involve an outright disposal … In my view, whatever the position is in relation to the original master negative it is quite clear that Micro Fusion had not made an outright disposal of the copyright …"

317. He then explains that

(i) the licence was limited to 21 years

(ii) the copyright remained vested in Micro Fusion

(iii) the licence was terminable in certain events

(iv) although Pathé had an option to acquire the copyright at the end of the term, it was not obliged to do so.

318. Then, at [45] he says "In my view these arrangements do constitute the exploitation of the film".

319. We do not believe the reasoning of the Court of Appeal can be distinguished on the basis that in these appeals Proteus and Samarkand bought a film which had already been made rather than acquiring a film by commissioning its production. It is clear that both the High Court and the Court of Appeal concentrated on the question of whether the film had been exploited "under the DCA". The question is thus how was the film dealt with once it had been acquired.

320. Mr Tallon suggested that the difference between this appeal and *Micro Fusion* was that in the latter case Pathé went on and did the exploitation - by distributing the film and selling DVD rights and such like, whereas in these appeals the real exploitation had already been done in the pre-sale agreements. Yet Mr Tallon accepted that if the producer of the film received a sum in return for <u>not</u> distributing it that could be exploitation of the film.

321. Mr Tallon makes this point with force in relation to The Queen. He says that it looks as if Pathé had given away all the valuable exploitation rights before it sold The Queen to Samarkand so that the rights Samarkand got from Pathé gave it no right to exploit the film. Pathé could transfer no more rights than it had because the arrangements it undertook before the sale to Samarkand encumbered the copyright in the film.

322. Mr Tallon suggested that "exploitation" connoted a connection with some sort of distribution of the film because the legislation was concerned with acquisition relief. It seems to us however that the legislation's principle object was to encourage the making of film in the UK rather than to ensure their distribution.

323. We can see nothing in the judgements of the High Court or the Court of Appeal in *Micro Fusion* which suggests that for there to be exploitation of a film there must be some link to its distribution as a film. Davis J's encapsulation of exploitation made no reference to the distribution of the film and was made against the background that the DCA delivered a stream of guaranteed payments unaffected by distribution activity (albeit with some contingent share in receipts). Sir Andrew Morritt's statement that there was no reason that exploitation must exclude outright disposal contained no caveat that such disposal must be to a distributor.

324. We do not consider that the question of whether or nor the leasing agreements provided for Extra Net Profit or other froth makes any difference. The question is whether the asset has been turned to account not what form the payments took or what underlying source they represented.

325. We find that the leasing of their rights in the films by Proteus and Samarkand was the exploitation of those rights. It was not argued that these rights did not constitute "films" for the purpose of section 136 and indeed *Micro Fusion* makes clear that they did. We thus conclude that Proteus and Samarkand were exploiting films under the lease agreements, and so, if they were conducting a trade, that it was a trade which consisted of or included the exploitation of films.

IX What expenditure was incurred on the acquisition of the films?

326. Mr. Tallon says that:

(a) Pathé slate had no valuable interest in The Queen. That means that the £8,162,791 was paid for nothing at all;

(b) in each case a large proportion of the purchase price was paid, not for the film, but for the lessee's provision of the deposit. That proportion was the amount which represented the loan by the Facility Bank to the partners which was secured on, and paid from that deposit. Thus the only amount paid for the film was that equal to the Producer's Net Benefit.

(c) *Tower*, and *BMBF*, require an answer to the question "what did the taxpayers spend his money on?". The reality was that part of the price was spent on the defeasance arrangements.

(d) In relation to Proteus and Oliver Twist, the nature of the arrangement under which Proteus borrowed some £24m from Bank of Ireland, was such that it could not be said that that £24m had been incurred by Proteus

327. Mr. Peacock says that:

(a) as a matter of construction of the agreements the price was paid for the film;

(b) one is not entitled to look at what the recipient uses the receipt for in seeking to determine what the expense was incurred on. He relies on Peter Gibson LJ in *BMBF* and *Icebreaker v HMRC* 2010 UK UT 477 (TCC) at (68).

Discussion

328. We agree with Mr. Peacock that the question is what the money was paid for, and not how the proceeds were used by the vendor.

329. In *Tower* individuals put up 25% of the consideration expended in acquiring rights to software. The remaining 75% was provided by interest free uncommercial non-recourse loans to the LLP members (the monies in relation to which moved in a loop between the parties). HMRC's case was that there was a single composite transaction under which, and realistically assessed, much less than the full 100% was paid for the software. The market value of the software was materially below the price paid, and there was little chance that the full amount of the loan would be repaid. The Supreme Court found:

(1) that the market value of the software was not irrelevant to the question of the quantum of expenditure incurred [67];

(2) the transfer of ownership in the rights to the software was indicative that <u>some</u> expenditure had been incurred, but not conclusive as to whether the whole of the monies had been expended on the software [76];

(3) assistance in making the appraisal could be drawn from the terms of the borrowing [76];

(4) the circumstances in that case were not such that there was no meaningful loan (as had been the case in *Ensign*) but that there was not in any meaningful sense an incurring of the expenditure of the borrowed monies on the software [75] and [88].

330. At [77] Lord Walker said:

"one of the lessons of *BMBF* is that it is not enough for HMRC, in attacking a scheme of this sort, to point to the money going round in a circle. Closer analysis is required. In *BMBF* the whole £91 million was borrowed by Barclays Finance from Barclays bank on fully commercial terms ... and Barclays Finance's acquisition of the pipeline was on fully commercial terms. BGE had the whole £91 million at its disposal, and though it was disposed of at once under further prearranged transactions, those transactions were entirely for the benefit of BGE. BGE had no pressing need for upfront finance ... in the present case by contrast, the borrowed money did not even go to MCashback, even temporarily ..."

331. For the moment we consider the simple case where there is no issue as to whether the amount paid under the sale and lease back agreement exceeded the value of the film. In this case free from authority we would find that the expenditure was incurred on the acquisition of the films subject to the lease, and with the benefits of the lease (including the benefit of the deposit arrangements). That is because the partnerships never acquired the film without the burden and the benefit of the lease. Without the film they would never have had the lease, but also without the lease they could and would never have acquired the film.

332. In this respect we note the misleading nomenclature "sale and lease back". That phrase suggests that there is a sale and that *then* there is a lease back. Whereas in fact the two transactions are concurrent: they could fairly be described as “lease and purchase” instead. The danger is that the short description implies a temporal order which did not exist and which produces an analysis which ignores the actual pattern of transactions, namely the reality that there was never a time when the film was owned unencumbered by the lease.

333. But the transaction in *BMBF* displayed similar features. The House of Lords cannot have been misled by a clever description. The acquisition of an asset encumbered on acquisition by a lease cannot therefore prevent the expenditure being treated as incurred wholly on the asset unless other features so dictate. They may so dictate where they are such as to lead to the conclusion that there was no real expenditure, or where they lead to the conclusion that the expenditure was not really on the asset.

334. In these appeals the financing for the transaction does not suggest to us that there was no real expenditure. The loans to the partners were full recourse. It is at least theoretically possible if enough banks defaulted the partners would be left with a real liability. Nor was the cash movement immediate and wholly circular.

335. Rights in the films were acquired (but see the later discussion in relation to The Queen). We have assumed at this stage that the payments made did not represent gross over payments. Leaving aside the concern that what was acquired was a film subject to and with the benefit of the leases, we conclude that the full amount of the expenditure was incurred on the relevant film.

336. We now turn to the individual films

(A) Irina Palm

337. So far as concerns Irina Palm, the evidence did not indicate that it was acquired at an overvalue, merely that it was acquired at production cost without apparent reference to its value. We conclude that the price paid was incurred on the acquisition of the film.

(B) Oliver Twist

338. We have discussed the valuation for Oliver Twist. We concluded that it was not unreasonable at its date, or at the date of Malde's opinion. The delivery of that opinion fixed the price payable under the Sale and Purchase agreement. The partnership was bound from that date. To the extent that it paid what it was bound to pay it cannot be said that it thereby paid an excessive price. Mr. Tallon

suggested that by January 2006 a different price could have been negotiated because of the failure of the film, but what Proteus paid (bar the extra amount we shall come to) was what it had contracted to pay. We conclude that that amount was expenditure incurred on the film.

339. So far as the extra £1.1 million is concerned, this was not an amount which the vendor had required to be paid or an amount which Proteus was bound to pay, rather it was an extra amount volunteered by Future on behalf of Proteus. We find that it was not incurred on the acquisition of the film.

340. Whilst HMRC did not contend that the loans by the Facility Bank to the partners were limited recourse, they raised concerns about the loans made by Bank of Ireland directly to Proteus. Under the three-year structure designed by Future (see para 368 below) Bank of Ireland lent some £23 million to Proteus. This loan was intended to be repaid from later years' capital contributions or converted into capital in later years. The terms of the loans provided that "the Bank shall have recourse only to the Rental Payments and Guarantees for the repayment of the loan" It was of limited recourse. HMRC said that this was not a commercial lending arrangement and that as a result it could not be said that Proteus incurred expenditure on Oliver Twist to the extent of these loans.

341. We disagree. These were loans made under commercial arrangements with Bank of Ireland. The evidence showed that Bank of Ireland regarded itself as at risk in relation to them and the possibility of their conversion. They had a commercial rate of interest. The monies were received by the partnership and did not go round in an immediate circle. Any limitation of recourse benefited the partners in terms of their ultimate liabilities, but also deprived them of real income arising from the lease. Later capital subscriptions would go to repay the loans. In our judgement these loans were not so ephemeral as to deprive a payment of the monies received under them of the quality of being "incurred" on the film.

(C) The Queen

342. We have found that Pathé Slate transferred to Samarkand the negative in The Queen and certain rights to distribute and exploit it, but we found that the value of those rights was nil because the rights had been encumbered by prior agreements which directed all payments away from Pathé Slate or Samarkand. Thus the value of what Samarkand acquired was substantially less than what it paid.

343. In *CIR v George Guthrie and Son* 33 TC 327, the taxpayer expended £1,144 to acquire a car. But the seller was fraudulent and the taxpayer did not obtain a car. The question was whether he had incurred capital expenditure on plant and machinery for capital allowance purposes even though the plant did not belong to him as a result of the expenditure. The Court of Session held that the expense had been so incurred. The Lord President, said "significant in the section ... the direction is not that the benefits shall be claimable by the person who provides the prescribed improvement, but by the person who incurs expenditure on its provision. When as in this case, there has been bona fide expenditure of capital for an approved purpose I conclude that the Special Commissioners were justified in concluding that their concern was with the fact and the object of that expenditure and not with the subsidiary question whether

the money was well spent or ill spent, or whether (bone fides being always assumed) the intended object was or was not not actually realised.".

344. This case would be persuasive authority for the proposition that if Pathé Slate did not have any title to convey to Samarkand, that fact should not cause it to be treated as not to have incurred expenditure on the film, but it provides little guidance in a case where an asset is acquired and is acquired at a gross overvalue: when it might be said that there had not been the type of bona fide expenditure the Lord President had in mind.

345. Mr Peacock says that whatever else it acquired, Samarkand acquired the master negative of The Queen. The acquisition of the negative was the acquisition of the film for the purposes of the relieving provision even if no other asset was acquired. We agree that Samarkand acquired a film for the purposes of the provisions. Mr Peacock then says that the Sale and Purchase agreement is clear: the film was sold to Samarkand for the price. Samarkand paid the price it paid for what it got under that agreement.

346. However, *Tower* indicates that the value of what is received is not irrelevant to the question of what the expenditure was on; if, as seems likely, Samarkand, through Future knew or had means of knowledge that Pathé Slate had no right to receive income in relation to The Queen then we find it difficult to resist the conclusion that Samarkand's expenditure was not really on the film, but instead on the benefits of the leasing arrangement because that was the only thing it received which had real value. It was not as if the ownership of the negative and the residual rights conferred any economic power on Samarkand. This is not to ignore the terms of the agreement but to recognise that the lease agreement was part of the contractual arrangement, and that because the film was worth very little, the expenditure must have been to obtain some other benefit from that arrangement, albeit that the agreement expressed the payment as being for the film.

347. We therefore concluded that Samarkand did not incur expenditure of £8,162,791 on The Queen. There may have been a very small part of that figure which could have been attributed to the limited rights it obtained, but we would not consider it to have been more than 1% of the total sum.

X Was that expenditure incurred wholly and exclusively for the purposes of the trade?

348. In this section we assume that each partnership was conducting a trade.

349. Mr. Tallon says that the only realistic appraisal of these transactions is that only a proportion of the money ostensibly paid for the films was paid for the purposes of the trade, the balance being paid for the defeasance arrangements under which the lessee provided a deposit equal to the partners borrowings and from which they would be paid.

350. Mr. Peacock accepted that if 100 of expenditure had been incurred on A that did not preclude that expenditure also being incurred on B, so that the wholly and exclusively question was not automatically determined by decision that the relevant sums had been expended on the films. He says that although you could say that the partnership's immediate purpose was to buy an asset (or

as he said "more realistically …to buy the film to licence the rights to generate a rental stream") and that it also had an ulterior purpose of supporting the borrowing by getting rental income, the second is a consecutive and not a concurrent purpose and section 34 is not concerned with the former but with the latter. He says that the evidence of Mr. Levy and the Business Plans shows that the purpose of the expenditure was to purchase a film for leasing to generate rental. He accepts that *Mallalieu v Drummond* requires the subjective purpose with which the section is concerned to include matters which were inherent in expenditure (in Miss Mallalieu's case for warmth and decency) but he says that it was not any inherent part of the purchase of the films that some other benefits should accrue to partners.

351. He says that the provision of the security by the lessee (the making of the deposit) was not inherent in the payments made under the combined transactions.

Discussion.

352. As we have said before, each leasing and acquisition was a single composite transaction. It is unrealistic to regard the parties as first acquiring a film and then leasing it. The two transactions were one. As part of that single transaction a sum was paid. What was the partners' purpose in paying that sum?

353. We do not regard that purpose as being solely to acquire a film: that seems to fly in the face of the reality of the transaction; rather like saying that one's purpose in applying a match to a firework is to see the blue touch paper glow. The money (the match) applied by the partnership was applied to set the whole transaction going, not part of it.

354. The question is whether the purpose was limited to acquiring the lease rentals and the film (i.e. for the business of the partnership) or extended to acquiring the benefit of the charges which secured the partners' borrowings, that borrowing itself or the hoped-for tax benefits.

355. It seems to us that where real assets of substantial value in the form of income flow are obtained for a payment, as was the case here, it is not an exercise in realism to regard the payment as being for the purpose of getting tax relief even where the value of the income exceeded what was paid for it. Further to the extent that the payment could be regarded as having a purpose extending to the obtaining of a security to the partners borrowings, those borrowings were themselves for the purpose of funding the partnerships' business and thus themselves had a trading purpose.

356. We conclude that the monies paid under the sale agreements were paid for the purpose of the partnerships' businesses (or trades). In particular, in the case of Samarkand and The Queen, although we have found that the £8m it paid was not expenditure incurred on the film, it was incurred for the business of the partnership because it was incurred to set the income stream going.

XI <u>The Fees payable to Future under the Agency Agreements.</u>

357. In this section we assume that the partnerships were carrying on a trade.

(a) The relevant facts and agreements

358. On 5 July 2006 an agency agreement was signed between Samarkand and Future.

359. On 8 December 2005, six months after the sale and Leaseback agreement was signed, an agency agreement between Proteus and Future was signed.

360. Under each agreement Future agreed to provide services in relation to "the identification, negotiation and recommendation of films and/or Rights for acquisition and exploitation by the Partnership". The services to be provided were divided between "Administration Services" and "Agency and Consultancy Services" ("A&C" services). The Administration Services were defined as these reasonable "administration and secretarial facilities in respect of the conduct of the trade of the partnership" and included the provision of office facilities, accounting help and liaising with partners. The A & C services were defined as "all services of a first class business affairs consultant for feature films" and included:

"1.1 identifying and sourcing films for acquisition and assisting the Partnerships in agreeing terms for the acquisition and exploitations of the Films …

1.2 monitoring the performances of Films acquired and exploited …

1.3 locating and recommending Rights for acquisition and exploitation …

1.9 engaging

(a) accountants and lawyers … to advise on the Partnership's arrangements in respect of the Film.

(b) banks to provide loan facilities to the Partnership's members if they require them …"

361. Under the Samarkand agency agreement, Future was to be paid the fee contemplated in the Business Plan issued by Chiltern Corporate Finance but not exceeding 7% of the total capital contribution by the parties or "9% of any single film".

362. That Business Plan indicated that Future was to be entitled to a fee of 6% of the capital contribution to the partnership. On 12 March 2007 (three days after financial close of the Samarkand Sale and Leaseback transactions) Samarkand paid £553,485 to Future (which for some reason is only 4.7% of the capital introduced as shown in Samarkand's accounts).

363. Under the Proteus agency agreement, Future was entitled to the fee contemplated in the Business Plan issued by Pegasus Financial Services and in addition 20% of the Extra Net Profit received by Proteus under the lease transaction.

364. That Business Plan indicated that Future would be entitled to a fee equivalent to approximately 9% of the capital contribution to the Partnership

(out of which Future was required to pay all advisory and banking costs included in the arrangement). On 13 January 2006, the date of financial close, Future invoiced Proteus for £4,734,265 for its fees, which Proteus paid. (We note that the business plan refers to 9% of the capital contribution to the Partnership, and defines capital contribution (p5) to be "an amount equal to the total capital contribution contributed by a Partner". At 5 April 2006 the Partnership accounts show that the capital contribution by partners at that date was £20,204,408; 9% of that figure is only £1,818,396. But at that date Proteus also had borrowings of £26,948,855 which were intended to be replaced in subsequent years by partners' capital. Treating these borrowings as capital gives total capital of £47,153, 263, of which 9% is £4,243,793 – an amount which is a little short of Future's invoice but comparable.)

365. *Mr Levy's evidence*

366. Mr Levy's evidence was that the fee payable to Future in such transactions was typically between 6% and 10% of the total purchase price of the film. The fees charged however were by reference to capital contributions to the partnerships.

367. Mr Levy said that Future's role was about being embedded in the film industry. The advisory services were a combination of its IP and film expertise. We accept that a significant part of the service provided was the use of this combination.

368. Mr Levy told us that in the case of Proteus, Future "was able to charge a very high fee because of the IP introduced by us in relation to the partners' ability to invest year on year." This was a reference to a structure designed to enable the benefit of the annual (limited) deduction of $^1/_3$ of the acquisition expenditure prescribed for expensive films by section 138, to be taken in each year in full by the class of partners who subscribed capital in that year (thus, if the cost of the film was £12 so that £4 deduction would be allowed each year, then each year £4 of capital would be subscribed and the partnership would allocate its losses so that the £4 deduction would be allocated to the new partners (or new subscription) each year). Mr Levy explained that since the price of the film had to be paid at the start it was arranged that the partnership would borrow more than half the cost of the film from Bank of Ireland (BOI), and that that borrowing would be repaid out at later years' partnership subscriptions (in the absence of sufficient other subscriptions, by subscription by BOI). This was the origin of the £27m or so of Proteus' borrowing described above. Mr Levy told us that in the case of Proteus the advisory services Future was "providing were a combination of the IP together with our film expertise combined."

369. Although at one point Mr Levy said that Future provided services to the partnership which were wholly and utterly connected with securing the film or films for the partnership and nothing else, he did not take exception to Mr Tallon's suggestion that part of what was provided was negotiating with the Facility Bank on behalf of potential backers, nor in our view could he given para 1.9(b) of sch 1 to the Agency Agreement (produced above).

370. Mr Levy was asked whether he could apportion the fee charged by Future between the services it provided. He declined to do so saying the fee was for a composite service.

371. Mr Levy said that it was likely that the Bank's Margin and fees paid to Banks and to IFAs for introducing subscriber partners, were paid by Future out of the fees it received for the partnerships. The Bank Margin, was the (relatively small) difference between the interest charged to the partners on their loans and the interest paid on the deposit made by Haiku to secure (and pay) its rentals.

The date of the Proteus agency agreement

372. Under a (fairly sparse) agency agreement dated 30 March 2004 between Future and a partnership described as Phoenix Film Partnership No.3 (which appears later to have changed its name to Proteus) Phoenix engages Future to act as its agent "with regard to the sourcing and acquisition of films". Future is entitled to a fee "to be negotiated in good faith", and the agreement envisages a replacement agreement being made at a later date. The agreement was signed by John Buchanan as a founding partner of Proteus and was ratified a year later by the managing partner.

373. Mr Levy explained that the practice was to establish partnerships and for each of these partnerships to enter an agency agreement at an early stage with Future. He said that the partnerships understood that their agreements "would only have real commercial meaning … when we actually identified proposed films that they might invest in …. The form of the agency agreement only became sensitive as when we approached the financial closure of the transaction.". The terms and execution of the agency agreement support that evidence.

374. No fee was sought or paid, although under the agreement with Proteus an annual fee of £30,000 was payable for Future's services.

375. No further written agency agreement appears to have been made until 8 December 2005.

376. The Proteus Business Plan issued by Pegasus in 2005 contains the indication quoted earlier that Future would be paid approximately 9% of the Capital contribution to the partnership.

377. The Proteus agency agreement with Future was signed on 8 December 2005 after the execution of the Sale and Leaseback transaction in June 2005, and, by 2 December 2005, about a month before financial close, 44 individuals had signed deeds of adherence to the Proteus partnership deed.

(b) Were the fees capital in nature?

378. To the extent that the expenses incurred were capital in nature section 33 ITTOIA prevents their deduction.

379. It is clear to us that some of the benefits derived by the partnership from Future's services were not of a capital nature. The administration services secured no enduring benefit and their cost was of a revenue nature.

380. In determining whether an expense is of a capital nature there is no single test. Instead many factors need to be considered but two matters are of particular importance: the nature of the payment and the nature of the advantage obtained by the expense. When expenditure is made not only once and for all, but with a view to bringing into existence an asset for the enduring benefit of trade that will be a good reason for considering the expense as capital. The cost of creating, enlarging or acquiring the permanent structure of a business of which income is the fruit is to be distinguished from the cost of earning income or of income earning operations.

381. It seemed to us that there were four aspects of what Future provided which might be said to be capital in nature: (i) structuring (in particular in relation to Proteus), (ii) arranging finance for the partners, (iii) identifying a film to acquire and a counter party to which it would be leased, and (iv) negotiating the terms of the sale and leaseback. They were all were activities acknowledged in the agency agreements and by Mr Levy.

382. The negotiations with the Facility Banks enabled the partners to contribute 80% of their capital to the partnerships. There was no direct evidence that without such lending the partners could not have contributed but given that all drew down the loans it seems unlikely that the partnerships could have received more than 20% of the eventual subscription without the loans. The related expense was therefore, in our view, incurred with a view to the bringing into existence of an enduring benefit – the partnership's capital. This was in our view an expense of a capital nature.

383. The identification of a film and of the parties to the sale and leaseback also appears to us to be a benefit of an enduring nature for any trade conducted by the partnership. Without the film and the leaseback there would have been no Business Plan, no investors, and also no fee. The benefit of the film (and its leaseback) was plainly a capital asset: we see no distinction between the direct cost of purchasing it and the direct cost of identifying it. These were not businesses consisting of the buying and selling of assets in relation to which scouting for something to buy (and for someone to sell it to) would be a recurrent expense, but businesses which bought one or two big assets at the same time and where the only substantial activity was the acquisition and leaseback of those assets. The identification of the leaseback counterparty is the other side of the same coin: it was likewise needed to create the injection of capital and the activity of the business. We conclude that the expenses of identification of film and lease counterparty were of a capital nature.

384. Normally we would regard the expense of negotiation as being of a revenue nature. Normally such expenses are recurrent and do not create any permanent asset. But in this case this expense was not recurrent and produced a bundle of rights and obligations which secured value to the partnership over 15 years. In our view it was of a capital nature.

Section 134 ITTOIA

385. We then asked ourselves whether section 134 ITTOIA meant that even if any of those expenses were of a capital nature they should be treated as “acquisition expenditure” and thus of a revenue nature. Section 130(3) provides that acquisition expenditure is “expenditure incurred on the acquisition of the original master version of the film”.

386. Section 130(5) provides that: "references ... to acquisition expenditure do not include (a) interest ... or (b) the incidental costs of obtaining finance.”

387. Mr. Peacock says that the specific exclusion of the finance costs by subsection (5) was designed to limit the breadth of the types of expense which would otherwise qualify. He says that the decision of the House of Lords in *Ben-Odeco Limited v Powlson* 1978 1WLR 1093 determined that finance costs associated with the acquisition of an asset were not expense "on the provision" of the asset, but that other expenditure which is not indirect or remote - such as legal fees and professional costs - would be “on the provision" of the asset.

388. He says that this is recognised by section 130(5), absent which the incidental costs of finance would be deductible. He notes that this is consistent with HMRC's published practice of treating the legal costs of drafting agreements as costs which qualify for capital allowances, and that for the same reasons the legal costs of agreements to acquire the films would fall within s130 and thus should be treated as revenue in nature.

389. Mr. Tallon draws our attention to Lord Wilberforce's remark in *Ben-Odeco* that the UK legislation "focus[es] on expenditure directly related to plant" and draws a limiting curve around the plant. He quotes Lord Russell at 1106, where he says:

> "in my view the question to be asked is what is the effect of the particular capital expenditure? Is it the provision of the finance to the taxpayer or is it the provision of plant. In my opinion the effect of the expenditure was the provision of finance and not the provision of plant. I would add that I do not seek to confine the qualifying capital expenditure to the price paid to the supplier. I should have thought, for example, that if the cost of transport to the place of use is directly borne by the taxpayer it would be expenditure on the provision of the plant ... and then there may well be other examples of expenditure ... which would qualify on such grounds. But such matters are not under consideration in this appeal"

390. Mr. Tallon says that this is not authority for the proposition that incidental costs can form part of the expenditure within section 130. He contrasts the provisions of TCGA, which, in section 38, provide expressly for specified incidental costs to be deductible and notes the absence of such provisions in section 130. He also notes the restriction in section 140(5) to production costs, which he says is another indication that the statute is looking at the money spent in acquiring the plant and not at incidental expenses.

391. In *Ben-Odeco* Lord Russell made it clear that he did not confine expenditure "on the provision" of the plant to the price paid for the plant. But this is different from saying that all expenditure incidental to the provision of the plant qualifies. The test in each case must be whether it can be said that the expenditure was "on" the plant, or on the film.

392. Section 38 TCGA, as Mr. Tallon said, permits the deduction of monies given "wholly and exclusively *for* the acquisition of the asset" together with incidental expenditure. There is a difference between what is given "for" an asset, and what is expended "on the acquisition". The latter is wider and is apt to include costs other than the price. Section 38's widening to include incidental costs reflects to our mind the narrowness of its principal words.

393. We note that 134 is not confined to expenditure "on the asset" but applies to expenditure "on the *acquisition"* of the asset. The natural meaning of that is to include costs directly related to the acquisition.

394. If we apply Lord Russell's test: "what was the effect of the expenditure?", in relation to the cost of negotiating and preparing the agreements, it seems to us that the answer is not that the effect was the production of a piece of paper, but was the acquisition of an asset.

395. For this reason we find that expenditure on the negotiation and drafting of the agreement to acquire the films (but not their leasing) would be expenditure on the acquisition of films, and thus deemed to be a revenue nature by section 134.

396. For the same reasons, but on balance, that we find that expenditure on identifying the films was expenditure "on the acquisition" of the films.

397. On the other hand, expenditure in arranging finance for the partners was not in our view expenditure on the acquisition of the film. Applying Lord Russell's test its effect was the provision of finance to the partners, not the provision of the film: in ordinary language expenditure on getting a mortgage would not be regarded as expenditure on acquiring a house. The exclusion in 130(5) of interest and incidental costs of finance also makes this clear: we do not regard it as otherwise extending the ambit of section 130(3).

398. Nor, for the same reasons was expenditure related to the structuring of the partnerships (particularly in the case of Proteus) expenditure on the acquisition of the film.

399. Thus, to the extent that the relevant parts of the expenditure on Future’s fees can be identified, some of those parts are to be taken as revenue as a result of section 134 and are thus capable of deduction. Therefore even if the whole of Future's fees were on general principles capital in nature, those parts of it would be potentially deductible as revenue expenses. That leaves the question as to whether any other identifiable parts of the fee may be treated as revenue in nature or whether for the purposes of section 33 one must view it as a composite single item.

400. In this context we note that section 34 expressly permits the deduction of an identifiable portion of an expense, and that this wording is absent in section 33.

401. It seems to us that if it were factually impossible to split a payment into different items, then one must regard the payment as one ‘item’ and determine for the purpose of section 33 whether that item is of a capital nature. The section merely asks whether any ‘item’ is of a capital nature.

402. If we were not able to split Future's fee we would conclude that the whole amount was of a capital nature: on Mr Levy's evidence its principal feature was the capital identification of a film, and in our estimation its overwhelming purposes were the four aspects we have discussed above, all of which were capital in nature.

403. In that case apart from any of the costs (rather than items) which are expressly treated as revenue as the result of section 134, the whole fee would be capital and not deductible

404. It seems to us that both for the purposes of section 33 and for section 134 it is factually possible to split Future's fee into different elements. In conducting this exercise, however, we note that we must start from the proposition that all the fee is capital and then examine the evidence produced by the Appellants which indicates otherwise; for the onus is on the Appellants to disprove the Respondents' stance.

405. The specific evidence from Mr. Levy on this question was not helpful in this exercise, but generally he indicated the relative importance of different parts of the work Future did.

406. Mr. Peacock and Mr. Maughan produced a useful paper in which they considered, among other things, the division of the documentation between documents relating to the exploitation (leasing) of the films and their acquisition. That paper suggested a 50:50 split between acquisition and exploitation in relation to legal and negotiation costs. We thought that was about right.

407. Taking all the evidence together it seems to us on balance that the following apportionment is indicated:

Type of expense	Proteus	Samarkand
Admin services (items out with section 33	5%	10%
Structuring (bearing in mind that it was particularly high for Proteus)	20%	-
Finance	15%	20%
Identifying – a film	15%	17.5%
…………..- a lease party	15%	17.5%
Negotiating – a purchase	15%	17.5%
………….- a lease	15%	17.5%

408. Accordingly 35% of the fee Proteus paid to Future, and 45% of the fee Samarkand paid to Future is to be treated as revenue in nature. The remainder is capital and not deductible.

409. Mr Levy pointed out during his cross examination that in *Micro Fusion* the Special Commissioners had found that similar fees paid by Micro Fusion itself were deductible. There it was urged on the tribunal that the fact that Future had used the fee it received to pay certain structuring costs affected the nature of the expense. The Special Commissioners did not accept that (see [224]). They concluded [226] that no part of Micro Fusion's expense was attributable to those structuring costs and found that the expense was deductible.

410. Our conclusion is on different grounds. We have not been concerned with how Future used the fees it received, but with the benefits the partnership acquired.

(c) Were the expenses incurred wholly and exclusively for the purpose of the trade?

411. Mr Peacock says that (1) the fees were paid for the services of Future under the agreement and were necessarily incurred to enable the partnerships to carry out their trade, (2) the fact that the partners intended to seek loss relief does not affect the purpose of the expenditure, (3) the fees were accounted for in accordance with UK GAAP as current year expenses, and (4) in *Micro Fusion* the Special Commissioner held the fees deductable in similar circumstances, and in *Icebreaker1 LLP v HMRC* [2010] UMUT 447 (TCC) the Upper Tribunal endorsed the Special Commissioners approach.

412. We can deal with points (3) and (4) shortly. First the proper accounting for the expenses does not provide on its own any evidence as to their purpose, and none of the experts concluded that an investigation of the purposes of this expenditure had been necessary to determine the proper accounting.

413. Second, the principle applied in *Icebreaker* was that in approaching s34 (the equivalent of s74(1)(a) in Icebreaker) the focus should be on the taxpayer's trade and the question did not require consideration of how the recipient of a payment dealt with it (see for example [54]). That was the approach adopted by the Special Commissioner in *Micro Fusion* (see [225] and [226]). That is the approach we shall adopt. But we need to determine what the purpose of the partnership was in incurring the expense. That is the statutory test.

414. The Respondent says: (1) There was no proper negotiation of the fees, (2) the fees are excessive, particularly in Proteus' case, (3) the Agency Agreements were a device to obtain a tax deduction for commissions paid to enter the tax avoidance scheme, (4) the level of the fee payable is unclear: "approximately 9% etc, and, (5) the Proteus agreement was entered into after the sale and purchase agreement had been signed and bank facilities had been signed. Why was Proteus willing to enter into agreements then to pay significant fees to Future – it cannot have been for the purpose of the business.

<u>Discussion</u>

415. Well known authorities make it clear than in determining the purpose of an expense what is relevant is the subjective purpose of the taxpayer, although that may not be limited to his conscious purposes. Where should we look for that purpose here? The agreements were signed by the managing partners on behalf of their partnerships. Acting as agent of the partnership its subjective purposes are therefore those that are relevant - as there was no suggestion that the adhering partners had expressed any requirement on the question.

416. What evidence was there of the managing partners' purposes It was limited to:

(i) the terms of the agreement (which express no purpose but may convey evidence of at least part of what was sought),

(ii) the terms of the Business Plans – for one would expect the managing partner to act in conformity with expectations created by the marketing material,

(iii) the position at the time the agreement was made,

(iv) the degree of closeness between Future and the managing partner. Mr Levy had told us that Future had a close relationship with the financial advisors,

(v) Mr Levy's evidence as to the fee obtained, and

(vi) the existence of earlier agency agreements.

In addition we note an email from Gavin Harrison of Future which encloses an investor model for Oliver Twist. This shows the amounts Future would pay from its fee for items such as commission to IFA, bank fees and admin costs. We note this not because the partnerships purposes are to be determined by how Future spent its money, but because these costs would affect any negotiation between Proteus and Future as to how much the fee should be.

Samarkand: A&C fees

417. So far as Samarkand is concerned the fee paid was clearly due under the agency agreement (though less than was paid seemed to be due). That agency agreement was signed before the investing partners adhered to the partnership and before the sale and leaseback agreements were signed. It was signed at the time of the issue of the Business Plan, but after Future had signed an offer to Pathé to arrange a sale and leaseback for The Queen. At the time Samarkand had not secured the film, and the Business Plan referred to Future's expected actions. The partnership was reliant on Future to deliver the film.

418. On balance we conclude that even though there was a close connection at the time of the agreement between the partners and Future, the purpose of the expenditure on the fees was to get the film and leaseback, and thus was for the purpose of the partnership's business.

Proteus: A&C fees

419. The listing in the Business Plan of Future's duties and the description there of the fee of approximately 9% of the capital raised suggest that the fee was paid for the purposes of the trade. But three matters gave us doubts as to whether the intention of the managing partner in agreeing to pay Future's fee was for the purposes of its business.

420. First, in the case of Proteus it seems that, at least on a literal construction of that agreement, the fee paid was twice the amount due: the words "approximately 9%" do not extend in our view to "over 20%". It is only if bank borrowing is treated as partnership capital (on the basis that new subscriptions would be made or the loans converted)) that the fee paid is that due. There was no evidence that Proteus gave this any consideration.

421. Second, immediately before the execution of the second agency agreement Proteus' obligation was only to pay a fee "negotiated in good faith". By executing the new agreement it became obliged to pay a very substantial fee ostensibly for services it had already received: at that time the sale and leaseback had been signed and Future's negotiating power was limited. There was no evidence as to whether the fee had been negotiated in good faith. We think it likely given our conclusion from Mr Levy's evidence that Future treated the partnerships as shelf companies, that Future's decision as to what should be paid was accepted by the partnership both at the time of the Business Plan and at the time of the agreement which reflected it.

422. Third, Mr Levy's evidence was that Future got a greater fee because of the special 3 year structure it brought to the deal. That structure required (1) partnership loss allocation provisions (including account policies which amortised the cost of the Rights over 3 years – accounting policies which Mr Cannon doubted) to ensure that each year's tranche of partners were allocated tax relief commensurate with their capital investment and (2) Future to obtain or to get the banks to commit to further capital contribution in later years. These arrangements had been put in hand before the agency agreement was signed. There was no need to pay for them. Nor was it something within the ambit of the earlier agency agreement.

423. All this suggests that in agreeing to pay and thus in making payment under the new agreement Proteus, through its managing partner had purposes other than of the business. Those could have been a gratuitous purpose of benefitting Future or a commercial purpose in the minds of those controlling the managing partner not to disturb, or to promote, their relationship with Future; or it could have been the making of an ex gratia payment to Future to recognise its structuring of the partnership.

424. These factors sufficiently disturb the conclusion which would otherwise arise from a simple reading of the second agency agreement to cause us not to be able to find on balance that the whole of the payments under that agreement were for the purposes of the business.

425. We conclude that that part of the fee paid for structuring was not paid for the purposes of the trade; given that Samarkand paid about 7% we conclude that of the fee of 9% , 2/9ths was paid in connection with the structuring and was not paid for the trade, of the remaining 7/9ths Gavin Harrison's calculations show that a large part of it was expended on paying legal and banking fees: it

seems likely that in a good faith negotiation Proteus would accept that the fee should be large enough to cover these amounts, and as result this amount was probably exigible from Proteus under the earlier agreement and was paid for the purposes of its business.

The Administrative fees: Samarkand and Proteus

426. The conclusions we reach above, however, cast no cloud on the nature of the payment for the administrative services obtained from Future. They were what the partnerships needed for their businesses. An expense incurred to obtain them must have been intended for the purpose of the business.

Conclusion: purpose

427. We conclude for Samarkand that all the fee was incurred for the purpose of its business.

428. But for Proteus we conclude that no more than 7/9ths of the fee was paid for sourcing and negotiating the sale and leaseback and administration services, and the remainder was incurred for a non trade purpose. The first part was incurred for a trade purpose.

(d) To which accounting period were the fees attributable?

429. Mr Cannon's expert evidence was that because he did not know when the partnerships received services under the agency agreements he was unable to conclude whether the fees paid were correctly expensed in the period of payment.

430. The basis for his conclusion is that payments should be accounted for in accordance with the accruals concept and expensed in the period to which they relate i.e. when the services were received.

431. Mr Back reached at first sight what appeared to be a different conclusion. He dealt separately with (1) the part of the fee paid for "A&C" (getting the film and leaseback), (2) the administrative services, and (3) the para 1.9(b) Sch 1 bank facility services. He concluded that the partnerships had an option under GAAP to expense or capitalise the A&C services, that they should have expensed any Administrative services unless the unexpired portion was material, and that they should have expensed para 1.9(b) services (procuring the Facility Banks).

432. But in relation to the para 1.9(b) services there was no difference: both agree that any payment for what was received in the first period should be expensed.

433. In relation to Administrative Services, Mr Cannon says they should be expensed in the period in which they were received; Mr Back says they should be expensed in the period of payment unless the partnerships considered that the unexpired (unreceived) portion was material. We believe that Mr Cannon would have agreed on the materiality point, and find they should be expensed in the period of payment unless there were material portions relating to later years, in which case those portion should have been expensed in later years.

434. In relation to the A&C services Mr Back says that the partnerships had the option of expensing or capitalising the expense and that their decision to expense them was reasonable. The effect of taking that reasonable step was to expense the costs in the period of receipt of the services – with which practice Mr Cannon was content. We find that the expensing of the A&C service expense in the period of receipt was in accordance with UK GAAP.

435. To summarise: we find:

(i) expensing A&C service costs in the period of receipt of the A&C services was in accordance with UK GAAP, and accordingly that a deduction for such expenses was permissible for tax purposes in that period unless otherwise prohibited.;

(ii) expensing Administrative service costs in the period of payment was in accordance with GAAP unless material services were to be received in later periods in which case they should be expensed in later periods;

(iii) the bank facility (para 1.9(b)) services should be expensed in the year of payment.

(e) Fees: Summary,

(1) The fees were to be treated as revenue in nature to the extent of 35% of the fee in Proteus' case and 45% in Samarkand's case.

(2) The fees paid by Samarkand were incurred wholly and exclusively, for the purpose of its business;

(3) Only 7/9ths of the fees paid by Proteus were shown to have been incurred wholly and exclusively for the purposes of its business.

(4) To the extent that these expenses were deductible, they were deducted in the correct periods

(5) As a result 35% of the fees paid by Proteus were deductible in its first year, and 45% of the fees paid by Samarkand.

XII <u>The Partnership Loss provisions (s.118ZEff and the 2005 Regulation)</u>

436. In this section we assume that the partnerships were carrying on trades.

437. Section 118ZE restricts the amount which may be given under section 380 or 381 in respect of a loss sustained in a trade in a year of assessment by a non-active partner – that is to say a partner who did not devote at least 10 hours per week on average in the activities of the trade. There was no doubt that the investing partners were non-active partners. The relevant parts of section 118ZE provide:

> "(2) The amount [of the loss] may be given otherwise than against income consisting of profits arising from the trade only to the extent that –
>
> (a) the amount given, …

does not exceed the individual's contribution to the trade as at the end of that year of assessment.

(3) A qualifying year of assessment means a year of assessment –

(a) at any time during which the individual carried on the trade as a general partner or a member of a limited liability partnership …"

438. Section 118ZG provides:

"(1) For the purposes of section 118ZE(2), the individual's contribution to the trade at any time ("the relevant time") is the sum of –

(a) the amount subscribed by him

(b) the amount of any profits of the trade to which he is entitled but which he has not received in money or money's worth, and …

(2) For the purposes of subsection (1)(a) the "amount subscribed" by an individual is the sum of –

(a) the total amount (if any) contributed by him to the trade as capital on or after 10 February 2004, reduced (but not below nil) by his withdrawn capital and …

(4) The individual's "withdrawn capital" is so much, if any, of the amount he has contributed to the trade as capital as –

(a) he has previously, directly or indirectly, drawn out or received back,

(b) he so draws out or receives back during the period of five years beginning with the relevant time,

(c) he is or may be entitled so to draw out or receive back at any time when he carries on the trade as a member of the partnership, or

(d) he is or may be entitled to require another person to reimburse him.

(5) An amount drawn out or received back that would otherwise fall within subsection (4)(a) or (b), or an entitlement that would otherwise fall within subsection (4)(c), shall be treated as not so falling if the amount drawn out or received back is chargeable to income tax as profit of the trade.

(6) In relation to a Limited Liability Partnership …

(7) This section is subject to provision made by regulations made under section 118ZN (partners: meaning of "contribution to the trade").

439. Before we move on to the regulations we should note various features which may affect the interpretation of the regulations of this section. First that, because it applies for the purposes of the loss limitation in s.118ZE, its

provisions apply to general partnerships and to Limited Liability Partnerships. Second, that the wording of subsection (5) appears less than perfect: it deals first with amounts drawn out or received back within (4)(a) and (b), and in its final 16 words says that if an amount "drawn out or received back is" chargeable to tax, it is not to be treated as withdrawn. That is all well and good, but the subsection also applies to amounts within (4)(c) – entitlements to have amounts drawn out or received back – and clearly the exculpation is intended to apply to them if they are chargeable to tax. But the words are "if the amount drawn out or received back <u>is</u> chargeable". An entitlement is not and may never be actually drawn or received yet these words are intended – expressly – to provide relief. There seem to us to be two possible readings:-

(i) that if the accrual of the amount of the entitlement is chargeable, then that accrual is not a withdrawal, or

(ii) if the exercise of the entitlement would be chargeable then the amount of the entitlement is not a withdrawal.

440. Of these we prefer the former. That is because:-

(i) we note that ss. (5) refers to the "amount" being chargeable rather than the withdrawal itself;

(ii) this is consistent with the scheme for the taxation of partnership income in which the income is taxed on the partners as it arises rather than on its withdrawal from the partnership;

(iii) that suggests that the question to be asked in relation to the interaction of (4)(c) and (5) is the same as that to be asked in relation to paras (a) and (b) and subsection (5) namely: is the amount taxable, not is the exercise of the entitlement taxable;

(iv) were subsection (5) to look to a future event, the fact that accumulated profits of a partnership may generally be withdrawn by partners would mean that the operation of subsection (1)(b) which permits such undrawn profits to be treated as subscribed capital would be uncertain in its operation in any year until the later exercise of the entitlement.

441. Thus we regard the words in sub s (5) "is chargeable to income tax" as meaning that relief is available under that subsection if the amount when it accrued was liable to income tax as profits of the trade.

442. We now turn to the 2005 Regulations. Regulation 3 says that they apply for the purposes of section 118ZN in computing an individual's contribution to a trade. Regulation 4, applies where an individual takes out a loan, Regulation 5 where the financial cost of a contribution is or may be reimbursed by someone else. Regulation 6 appears under the same heading in the regulations as Regulation 5 but appears to apply both to Regulation 4 and 5 (and possibly more generally) because it refers to financial cost being both borne and reimbursed by another.

443. The relevant provisions are these:-

"2. In those Regulations –

"any other person", in relation to an individual, includes a partnership of which the individual is a member; …

"4(1) This regulation applies where –

(a) an individual takes out a loan in connection with his financing of the whole or part of his contribution to the relevant trade, and

(b) at least one of the following condition is satisfied.

"<u>Condition 1</u>

There is, at any time, an agreement or arrangement, under which all or any of the financial cost of repaying the loan is, will or may be borne, or ultimately borne, by any other person.

<u>"Condition 2</u>

All or any of the financial cost of repaying the loan is at any time borne, or ultimately borne, by any other person …

<u>"Condition 3</u>

The liability to repay the loan is at any time assumed or released by any other person.

"<u>Condition 4</u>

[The actual financial cost of repaying the loan is substantially less than it would be on arm's length terms.]

"(2) When any of Conditions 1 to 3 are satisfied, there shall be excluded when computing the amount of the individual's contribution to the trade at the time in question the financial cost of repaying the loan, which <u>is, will or may</u> be borne or ultimately borne by the other person, or the liability to repay which is assumed or released by the other person, as the case may be …

"5(1) Where there is, at any time, an agreement or arrangement, under which all or any of the financial cost of making a contribution to the relevant trade <u>will or may be</u> directly or indirectly reimbursed to the individual by any other person paragraph (3) shall apply.

"(2) When at any time all or any of the financial cost of making a contribution … <u>is</u> reimbursed by any other person … paragraph (3) shall apply.

"(3) There shall be excluded in computing the amount of the individual's contribution … the financial cost … which is, will or may be [so reimbursed].

"6. No amount shall be excluded from the computations more than once, and the following shall not be excluded when computing the amount of an individual's contribution to the relevant trade –

(a) any financial cost which is borne or reimbursed by another individual in the normal course of domestic, family or personal relationships;

(b) any loan repayments not made by an individual due to his financial inability to pay, arising as a result of events outside his control which occur after the loan was taken out; and

(c) any amount on which the individual <u>is</u> chargeable to income tax as profits of the trade." [Our underlining.]

444. HMRC contend that Condition 1 of Regulation 4 is satisfied. In their statement of case for sample Partner E they also assert that Condition 4 was satisfied although this was not referred to in their skeleton argument. They say that Condition 1 is satisfied in the case of both Proteus and Samarkand for three reasons.

(1) <u>The terms of the charge on the Cash Account</u>

445. In the case of all three major films, The Queen, Irina Palm, and Oliver Twist HMRC say that clauses 2.2 to 2.4 of the Charge over Cash Deposit and Account (under which Haiku charges a cash account with the Facility Bank (sic) as security for the payment of rentals under the Leases and the Loans to the partners) has the effect that the partners obligations to repay their loans may be met by payment from the cash deposited by Haiku, and that is an arrangement under which the financial cost of repaying the loan may be borne by another person within Condition 1.

446. Clause 2.2 of the Charge provides that Haiku has no right to operate the account and that it authorises the Facility Bank to apply the monies in the account to meet:

"(a) the payment obligations of the Lessee to the Lessor with respect to the Rentals under the Film Lease (which Rentals have been assigned to the Bank) and/or

(b) the payment obligations of the Borrowers under the Facility Letters."

447. Mr Yates argued that if payment was made under 2.2(b) it did not diminish the right of the partnership to receive payments from Haiku under the lease.

448. Clause 2.4 gives the Facility bank a wider power to apply the Deposit towards the satisfaction of the partner loans. Mr Yates makes the same point about the operation of this clause.

449. Mr Peacock says that: (a) in the case of Proteus only, clauses 4.2 to 4.4 of the Notice of Assignment of Rental Payments from Proteus to the Facility Bank provide that the Facility Bank will not make payment under clause 2.2(b) of the charge; (b) if payment were made under clause 2.2(b) in discharge of the borrowers' obligations the payment would be taxable; and (c) that such

taxability brings into operation the exception in Regulation 6(c) for any amount which is chargeable to tax.

450. We should outline clauses 4.2 to 4.4 of the Notice of assignment for Proteus. Clause 4.2 provides that if, after a security review, the deposit balance is paid to haiku's account with the Facility bank-

> "payments from [that account] shall only be made to the account [of Proteus at the Facility Bank] in payment of [Lease Rentals]".

451. Mr Yates says that this clause is not saying that the only permissible destination of monies is to the Proteus account in payment of lease rentals because that is inconsistent with clauses 2.2(b) and 2.4 of the Charge.

452. Under Clause 4.3 of the Notice, Proteus confirms that no claim would be made under the Lease if payments are made in accordance with cl 4.2. On Mr Yates' interpretation of cl 4.2 this confirmation would not extend to other payments under cl 2.2 or 2.4 of the Charge and in respect of those amounts the rentals would remain payable by Haiku.

453. Under Clause 4 of the Notice of Assignment the Facility Bank as assignee of the Lease agrees not to claim against Haiku if payments are made under the Charge of Deposit. But Mr Yates says that says nothing about Haiku's obligation to Proteus which (as in cl 2.6 of the Charge Haiku confirms to the Bank) "remain in full force and effect notwithstanding anything in this" Charge.

454. In any event, Mr Yates says there is no equivalent to these extra clauses in the Samarkand documentation. It must be caught.

<u>Discussion</u>

455. We note first that the provisions of the Charge come into substantial effect only if at some time more than three years after the security documents are executed, the Facility Bank conducts a 'security review' finding itself unhappy with the conduct of the guarantor bank.

456. In that event the guarantor pays the amount of the deposit to an account of Haiku at the Facility Bank and the Charge affects that account. This is a "may be" situation, not an "is" one within the Conditions of Regulation 4.

457. The first question is whether, if the Facility Bank takes advantage of cl.2.2(b) or 2.4 and uses Haiku's cash to pay off the Partner Loans, it may still demand the payment of rentals from Haiku (which are due to it as assignee of the lease agreement). Mr Peacock says that no court would enforce that payment: it would say "you all agreed that the debts would be settled from rental payments, one of you, the partners, have had the benefit of those debts being settled, you can in those circumstances maintain no claim to the rents." We agree. Although these are complex professionally drafted documents in which one would expect to see every eventuality catered for and spelled out, it cannot have been the case that the parties intended the guarantor to be able to secure a windfall by claiming a second amount from Haiku and must have intended that the use of the monies to pay off the loan would pro tanto

extinguish the liability to pay rentals. Nor does this conclusion fly in the face of clause 2.6 (which provides in favour of the Facility Bank that Haiku’s obligations under the lease remain in force notwithstanding anything in that deed): that clause presumes the obligation to make payment notwithstanding anything in the Charge, but the exercise by the Facility Bank of an option given by the Charge is not something “in this deed”: rather it is something done pursuant to the deed.

458. In the case of Proteus, in our view the effect of cl4.2 of the Notice is, contrary to Mr Yates' view, to limit the width of the power given by clause 2.2 and 2.4 of the Charge so that payments were permitted to be made only to Proteus’ account at the Facility Bank. We can see no other meaning to that provision. As a result in our view the contractual documents do not permit the direct discharge of the partner loans. On this basis our conclusion in the preceding paragraph is relevant only to Samarkand.

459. The second question is whether, if such payment were made to repay the partners’ loans, it would be taxable as trading profits so that Regulation 6(c) might apply. This is on the assumption of course that the relevant partnership was trading.

460. It seems clear to us that if a sum which arises from the partnership business is paid to or for the benefit of a partner in circumstances where that payment has the effect of depriving the partnership accounts of the receipt of an equivalent sum, then that sum is properly to be regarded as a receipt of the business in computing its liability to tax. The benefit derived by the partner is received by him in his capacity as a partner in the business and properly forms part of the taxable profits of the business.

461. A payment of a lease rental received by the partnership directly would, it was common ground, have been taxable income in the hands of the partnership. The benefit of a payment to reduce a partner’s loan which took the place of such a rental payment would in our view have been similarly fully taxable income.

462. Next, does the conclusion that the payment would have been chargeable to income tax mean that Regulation 6(c) applied? Condition 1 is potentially applicable because the charge is an arrangement whereunder the financial cost <u>may</u> be borne by another person. Regulation 6(c) presents exclusion where the amount “is” chargeable to income tax.

463. Mr Peacock says that in a case where Condition 1 applies – where the financial cost is, will or may be borne by another you have to read 6(c) as providing exemption if the amount ‘would be’ chargeable to tax. It was plainly intended to deal with each condition and should be read sensibly.

464. Mr Yates says that 6(c) gives relief only if at the end of the year of assessment at which s.118ZN applies the amount “is” chargeable to income tax. He says Regulation 6(c) is intentionally narrow intended probably to catch excepted circumstances arising from the “is” Condition in Condition 2. He contrasts the “is” language of section 118ZG(5) with its express reference to section 118ZG(4)(c) with the narrower language of Reg 6(c) which makes no specific reference to Condition 1: if the draftsman had intended a Condition 1

"is, will or may be" to fall within Reg 6(c) he would have incorporated an express reference to Condition 1, The Regulation says "is" and means "is". The potential payment under the Charge was not actually chargeable in any relevant year. Reg 6(c) does not apply.

465. As we have explained above it seems to us that the exception provided for in s.118ZG(5) encompasses accrued profits which were taxable and which the partner is entitled to withdraw in the future but which he has not withdrawn. The "is or may be" in s.118ZG(4)(c) refers to the existence of the entitlement; the "amount" is what s.118ZG(5) operates upon. Seen in this way the reference in s 118ZG(5) to subs (4) is part of a restriction on the operation of the provision rather than an extension: that is because it specifically omits the subs (4)(d) circumstances. On that basis the lack of express reference to Condition 1 does not imply that the draftsman did not intend to include that Condition in the ambit of subs (5). We therefore find nothing in s.118ZG which suggests that a narrower or broader meaning be given to the similar provisions in Regulation 6.

466. In the context of Condition 1 Regulation 6 requires one to ask the question whether any of the relevant financial cost is an <u>amount</u> which is chargeable to income tax. One may say "a trading profit is taxable" meaning that if a profit is made it will be taxable: thus "is" does not always carry the certainty of tax. We note also "chargeable" rather than "charged". Chargeable suggests "capable of being charged" rather than "is actually charged". The question as to whether an amount is chargeable may relate to whether it is capable of being charged, rather than simply to whether it is charged in the relevant period. We note also that no time is specified for the operation of Regulation 6: it does not specify the period in which the charge to tax must arise.

467. For those reasons it seems to us that the language of Regulation 6(c) is capable of bearing the meaning Mr Peacock attributes to it, although we recognise that it is also capable of bearing the meaning Mr Yates advocates. In these circumstances we ask whether there is anything in the wider context of the Regulation which suggests one meaning rather than the other.

468. Mr Peacock says that the purpose of the exemption in Regulation 6 is that it reflects the principal that you will not have offended if you bear the cost of the debt from income liable to tax because that is the best proof that you are really on the hook for the finance in the first place. We agree: the sense is that if you're taxable on it then you bear the cost. In that context we agree that Regulation 6(c) should be read widely so that any amount of a financial cost which may be borne by another is not to be excluded if it would be chargeable to tax as income.

469. As a result we conclude that the potential application of the provisions of clause 2.2 of the Charge do not result in the reduction in the contribution to the trade by the amount which could be so paid.

470. Finally, although not argued before us, we incline to the view that the payment of the loans using money provided by Haiku in circumstances where that payment diminished the rentals due by Haiku (and receivable by the Facility Bank) does not result in the financial cost of repaying the loan being borne by Haiku: Haiku bears the cost of the lease payments not of the loan. Nor

does the partnership bear that cost since it had already assigned the benefit of the lease payment to the Facility Bank.

(ii) Clauses 20.5 to 20.7 of the Partnership Deeds

471. These clauses provide that if a partner ceases to be UK resident then that partner "shall in consideration of the payment by the Managing Partner of a sum equal to the outstanding amount of the loan [from the Facility Bank] transfer and assign to the Managing Partner" his partnership share.

472. HMRC say that since the managing partner may thus assume the cost of repaying the loan, Condition 1 is satisfied. Mr Yates says that to the extent the value of the partnership interest acquired by the managing partner falls short of the amount of the loan at the time of sale, the managing partner bears part of the financial cost of the loan.

473. Mr Peacock's reply is that because the partnership share consists principally of a right to receive rentals, its value is no less than the value of the unpaid rentals. Those rentals are designed to be paid from the deposit and so have a value equal to the deposit, and the deposit has a value almost exactly the same as the outstanding loan. Thus the value of what the managing partner gets is at least equal to the amount he pays for the discharge of the loan. As a result he bears no financial cost of its repayment.

474. We had two concerns with Mr Peacock's response. First the partnership had assigned the lease rentals to the Facility Bank and charged the Haiku deposit from which they were to be paid to that bank. Para 10.5 of sch 2 to the Charge by Samarkand in favour of the Facility Bank provides that until the loans are repaid the only payments to be made out of the account into which the rentals financed from the deposit are paid are those to be paid in the scheduled repayments of the partner loans unless the Facility Bank agrees otherwise. (Our copy of the Proteus charge lacked schedule 2 although it was referred to in the document, but given the other similarities between the documents and their tables of contents we assumed that it was likely that the Proteus charge contained a similar provision.) Thus the managing partner, on its acquisition of the partnership interest acquires no immediate right to rental payments, but only to the value of them once all the loans had been repaid. Money receivable in the future may be less valuable than money receivable today.

475. Second the value of the right to the future rentals, even if they would as a result of the assignment and repayment of the loan become payable as they arose to the assignee of the partnership interest, would depend on interest rates current at the date of acquisition. Whilst when the transactions were set up the interest rates applied in the cashflow models (which we believe were at about market rates) meant that the value of the rental stream equalled the value of the deposit and therefore of the loan, if interest rates increased the market value of the future rental stream would be lower but the amount of the loan would remain constant. Thus the managing partner would bear a cost equal to the difference on assuming the partnership interest and repaying the loan.

476. Mr Peacock replied that it was the arrangement entered into at the outset to which the regulations had to be applied, and that envisaged almost

exact equivalence between the value of the future rentals and the amount of the debt.

477. Regulation 4(3) requires the exclusion in computing the contribution to the trade at the time in question of the cost of repaying the loan which may be borne by another. The 'time in question' is the time at which the provision of s.118ZE operates, namely at the end of each year of assessment. Thus it falls to be considered at the end of each year of assessment how much of the financial cost of repaying the loan may be borne by another. The only practical way we can see of giving these provisions effect in a case in which the cost which may be borne may vary is to make a determination of the amount by reference to conditions applicable at the end of the relevant year of assessment. Thus in this case there will be a cost borne by the managing partner if the present value (determined by using interest rates applicable at the end of the year for the period of the remaining rentals) of the future rental stream is less than the amount of the loan.

478. We do not agree with Mr Peacock that the amount of that cost should be determined at the outset by reference to the then prevailing circumstances. Condition 1 refers to an arrangement but Regulation 4(3) bites on the amount which may be borne pursuant to that arrangement. That looks to a potential future cost. We see no warrant in this language for assessing the amount of the future potential cost by reference only to the circumstances prevailing when the arrangements were set up.

479. We conclude that Regulation 4(3) may apply at the end of a particular year of assessment. We had no evidence of relevant interest rates and so were unable to determine whether it did and if so what amount should be excluded in relation to the year of assessment relevant to the appeal.

(iii) <u>The Charge over the Partnership Assets</u>

480. Each partnership charged its assets to the Facility Bank as security for the repayment of the loan to the partners. Thus there was an arrangement under which the partnership might bear the financial cost of the loans.

481. However each partnership deed contained an indemnity by each partner to the partnership against liabilities and costs of the partnership arising from the partner's personal affairs.

482. HMRC say (1) that for the purposes of the 2005 Regulations the partnership is another person, (2) that even though the indemnity means that the partnership does not <u>ultimately</u> bear the cost of the loan, the partnership does <u>bear</u> the cost. In relation to the second point Mr Yates says that these are intended to be wide ranging regulations and should not be interpreted narrowly.

483. Mr Peacock says (i) the partnership would, in return for assuming the liability to the Facility Bank, acquire the indemnity from the partner: that was not bearing a cost: the partner remained on the hook for the cost of that loan: (ii) if the charge crystallised and the Facility Bank seized the partnership's assets, each partner would bear the cost of that seizure in proportion to his partnership share: the cost of the loans would thus be borne by the partners rateably: no one else bears the cost of a partner's loan; (ii) regulation 2 provides that "any other

person" includes a partnership of which the individual is a member. For those purposes a partner in a general partnership is not a 'member' of it: the concept of membership is reserved for membership of LLP. Thus the definition does not override the general requirement of s.848 ITT01A which provides that:

> "Unless otherwise indicated (whether expressly or by implications), a firm is not to be regarded for income tax purposes as an entity separate and distinct from the partners."

Discussion

484. We do not accept Mr Peacock's third argument. It seems to us that the words "a partnership of which the individual is a member" are as apt to describe a member of a partner in a general partnership as a member of an LLP. Indeed because one might shy from describing an LLP as a "partnership" they appear more suited to describing a general partnership than an LLP. We accept that in s.118ZE(3)(a) the language distinguishes between "a general partner [and] a member of a limited liability partnership" but that distinction indicates to us that a member of LLP cannot be called a partner, not that a partner cannot be called a member of his partnership. We conclude that for the purposes of the Regulations "any other person" includes a general partnership and may include Samarkand and Proteus.

485. We do not however regard the fact that someone may pay an amount as indicating that he bears the cost associated with that payment. To our minds a person bears a cost if his net assets are diminished as the result of the cost. By contrast a cost is ultimately borne if as the result of a series of transactions or the lapse of time a cost which was not initially borne by a person ultimately reduces his net assets. We do not regard the contrast between "borne" and "ultimately borne" as requiring that the mere payment or assumption of a liability comprises the bearing of a cost. "Borne" indicates the carrying of a burden without relief.

486. For that reason, to the extent that the indemnity given by the partner to the partnership has equivalent value to the liability assessed or discharged by the partnership for the partner we do not regard the cost as borne by the partnership. (We note that the test is whether the liability is borne by the partnership not whether the partner continues to carry a cost.)

487. If the value of the indemnity is less than the value given in discharge of the loan then we accept Mr Peacock's submission that the only circumstances in which that could happen would be where Haiku, the guaranteeing bank, or the deposit holding bank had failed and the partner had in consequence become unable to fund his indemnity. That circumstance would fall within Regulation 6(b).

488. We conclude that no reduction in the contribution to the partnership business falls to be made by reason of the charge over the partnership assets.

(iv) Condition 4

489. Condition 4 applies where the financial cost of repaying the loan was substantially less than it would have been on arm's length terms. Although this

Condition was raised in HMRC's statements of case, it was not discussed before us, nor was any evidence adduced which would have entitled us to make a clear determination of the issue.

XIII **Is Proteus' loss restricted by the Relevant Period provision?**

490. Section 138(6) ITTOIA requires the proportionate reduction of a deduction if the relevant period is less than 12 months.

491. HMRC says that Proteus had no trade until at the earliest 2 December 2005, when the investing partners came in, and therefore that even though accounts were prepared for the partnership for the 12 month period to 5 April 2006, the relevant period runs from the time the trade started to 5 April 2006 and so was less than 12 months. Thus they say any relief should be restricted.

492. Section 133 defines relevant period for the purposes of the relevant provisions:-

"In this chapter "relevant period" in relation to a trade, means –

(a) a period of account of the trade, or

(b) if no accounts of the trade are drawn up for a period, the basis period for a tax year."

493. Section 832 TA 88 provides a definition of "period of account"

"(a) in relation to *a person*, means any period of which the person draws up accounts, and

(b) in relation to *a trade*,… or other business means any period for which accounts of the business are drawn up.

494. Mr Peacock says that Proteus drew up accounts for its trade for the 12 month period to 5 April 2006. That was a 12 month period and therefore its relevant period was a 12 month period. The date upon which Proteus commenced its trade within that period is irrelevant. He says that the words of section 133 taken with section 832 are clear. There is no need to read anything in and no reason why one should.

495. The Special Commissioners in *Micro Fusion* considered a similar provisions in relation to section 48 FA (No2) 1997 at [113] to [122]. They said they saw the force in Mr Peacock's argument that the provisions should be read in terms of their words, but [[121]) they found three objections to that course which were sufficient on balance to persuade them that the relevant period meant the basis period, the period determined by ss196-216 ITTOIA.

496. Mr Peacock attacked these objections before us persuasively, but there is no need to recount the battle here for we came to our conclusion on a different basis.

497. Section 832, in defining period of account distinguishes between the situation "in relation to a person" and that "in relation to a trade". The words of section 133(a) expressly direct attention to the second situation for they say "a

period of account of a trade". Thus of the two meanings of "period of account" in section 832 it is the second, and not the first which must be applied. That means that the period referred to in 133(a) is the

"period for which accounts of the trade are drawn up".

498. The distinction drawn in section 832 between (a) the situation in relation for a person (in which case the period of account is any period for which he draws up accounts) and (b) the situation in relation to a trade shows clearly to our minds that the period in (b) cannot encompass any time when the trade is not conducted: accounts of the trade can only reflect a period when the trade was being carried on.

499. Therefore we conclude that if the trade of Proteus started after 6 April 2005 (assuming it had a trade) any period of account of that trade had to start after that date. As a result the 12 month accounts of Proteus are not accounts of the trade and the relevant period for section 133 is not that 12 month period.

500. After 5 April 2006 Proteus' accounts would be accounts of any trade it was conducting, and their periods would be periods of account; but no accounts of the trade had been drawn up for the period from its commencement to 5 April 2006. As a result section 133(b) would apply for that period and the relevant year would be the basis period. That would be determined by section 199 ITTOIA and be less than 12 months.

501. So, on the assumption that Proteus' trade started after 5 April 2005 and before 5 April 2006, we find that there will be a proportionate reduction in the section 138 allowable deduction.

XIV Summary and Conclusions

(1) Summary

(a) The partnerships

502. We have found that the partnerships were not trading in the period in question. If we were wrong and trade was being carried on, we found that it was a trade which included or consisted of the exploitation films.

503. Samarkand incurred expenditure on Irina Palm equal to the price paid under the sale and purchase agreement. That expenditure was incurred wholly and exclusively for the purposes of its partnership business.

504. Samarkand did not incur expenditure of £8,162,791 on The Queen. At most some 1% of that sum was so incurred. But the whole of that sum was paid wholly and exclusively for the purposes of the partnership's business.

505. All but £1.1 million of the price paid by Proteus for Oliver twist was incurred on the film. The whole amount was expended wholly and exclusively for the purposes of the partnership business.

506. 35% of the fees paid by the Proteus to Future, and 45% of the fees paid by Samarkand to Future were, or are to be treated as, revenue in nature. The remainder of such fees were capital in nature and therefore not deductible.

507. Any loss arising to Proteus in its first period would be restricted by the application of section 138(6) because its relevant period was less than 12 months.

(b) The partners

508. The partners were not entitled to sideways loss relief because the businesses of the partnerships were not carried on on a commercial basis with a view of profit.

509. There were circumstances in which Reg 4(3) of the Partnership Loss Rules could apply to restrict the availability of relief for losses of the partnerships.

(2) Conclusions

510. We dismiss the Proteus appeal. We have concluded that Proteus did not trade in the period.

511. We dismiss the Samarkand appeal. We have concluded that Samarkand did not trade in the period.

512. We dismiss Sample partner E's appeal. Since Proteus had no trade it had no trading losses for which the partner could claim relief in the period to 5 April 2006.

513. The Samarkand and Proteus referrals:

(1) Regulation 4(3) may apply as a result of clause 20.5 to 20.7 of the Partnership deeds to restrict the availability of partnership losses;

(2) The businesses of the partnerships were not carried on on a commercial basis in the periods in question.

XV Rights of Appeal

514. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

CHARLES HELLIER

TRIBUNAL JUDGE
RELEASE DATE: 20 September 2011