

Film partnerships - a recent tax case

Synopsis: A tax avoidance case in which a film partnership was found not to be trading, as it had no view to making a profit.

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Film tax relief has been around longer than any other creative relief in the UK. The original film tax relief was introduced in 1992 (Section 42 of the Finance (No. 2) Act 1992). And much has changed, even since the introduction of the current iteration of film tax relief, introduced in 2007.

The crucial points at issue in the case of Gala Film Partners (TC08891) were...

- whether a limited liability partnership (LLP) was carrying on a trade with a view to realising a profit; and
- whether expenditure was laid out wholly and exclusively for the purposes of such a trade.

Gala Film Partners LLP was set up in May 2003 by Invicta Capital Limited (Invicta) “as a vehicle to be used for high-net-worth individuals (HNWIs) to invest in arrangements which Invicta devised”. These arrangements related to the distribution of films produced by Sony and related entities. It was operated and marketed to potential new investors by WJB Chiltern Wealth Management Services Limited (Chiltern).

Gala Film Partners, LLP appealed against amendments made by HMRC to its partnership tax return for the 2003/04 tax year. In a closure notice dated 28 August 2015, HMRC concluded that Gala did not, as it had claimed, incur a loss in that tax year of £110,755,060.68 in the course of carrying on a trade of film distribution and that it had taxable profits of £552,570.52.

A was referral made by HMRC and the individual members of Gala (under s 28ZA Taxes Management Act 1970) for the First-tier Tribunal to determine whether they were, as they had claimed, entitled to relief (under the tax rules applicable at that time) by set-off against their other income for (a) their allocated share of the loss and (b) the interest paid on the bank loans made to them to finance their contributions to Gala.

(The hearing took place in public from 8 November to 6 December 2021, and the judgment date was 4 August 2023.)

Gala’s information memorandum (IM) summarised the consequences of a potential new member’s investment of £10m into the partnership (of which only £2.246m would be a direct cash contribution and the remaining £7.754m borrowed by the investor on a full recourse basis)...

1. The LLP borrows a further £1.35m for each £10m invested.

2. The LLP acquires distribution, sequel and remake rights for a portfolio of films from Sony for 21 years for £1.35m. It spends £10m on advertising the films and other trading expenses.
3. The LLP enters into an eight-year distribution agreement with a Sony affiliate, which will pay an annual minimum royalty payment (MRP) during the term of the agreement. This MRP essentially services the interest on the two loans, while in year eight the MRP increases to ensure repayment of both loans.
4. Sony is granted a call option enabling it, in year three or any subsequent year, to buy the LLP's business for the greater of a) the market value of Gala's interest in the films or b) the net present value (NPV) of the unpaid MRP at the date the option is exercised.

The IM then described the taxation consequences for such a member...

1. If Sony does not take up the option, the LLP will receive income from the distribution of the films for a total of 21 years and will have the right to exploit all sequel and remake rights to the films. In this event, Gala "anticipated" that taxable trading income above MRP would be received by the LLP and shared by its members.
2. If Sony exercises the option in year three, the NPV of the unpaid MRP would approximate to £9.19m enabling both the member's and Gala's loans to be repaid.
3. Sony's purchase of the LLP's business during year three would result in a capital gain of about £7.98m, with a capital gains tax (CGT) liability at a tapered 10% rate of £798,000, although members with brought-forward losses could reduce or extinguish this.
4. The member would claim a trading loss of £10m in year one, which they would relive against other income.
5. On the basis that Sony exercises the option, "the net outcome for the Partner is a positive cashflow of approximately 10.2% of his original capital contribution."

Sony did exercise the call option in 2006, and the LLP did not receive any income under the distribution agreement apart from the MRP paid before its exercise. A member subscribing £10m as illustrated in the IM would achieve the following...

- Initial cash contribution - (£2,246,000).
- Tax relief on "trading loss" - £4,000,000.
- CGT liability (ignoring losses b/f) - (£798,000).
- Net return - £956,000.

The Judge considered how it would have panned out Sony had not exercised its option and the arrangements had continued for the eight-year term of the distribution agreement and Gala had received only the “minimum royalties” saying: *“Gala would have made a small profit but, in cash terms, the members would have made a significant loss. In that case, the income tax which the members would have had to pay on the “minimum royalties” (in particular, that due on the final “minimum amount”) would, in effect, cancel out in full the benefit of the tax relief.”*

A key part of HMRC’s case was their argument that, under the terms of the distribution agreement, there was no realistic prospect of Gala receiving income in excess of the “minimum royalties”.

HMRC said: *“..it was expected and inevitable from the outset that the call option would be exercised at the first opportunity (as it was) so that the members would suffer only a CGT charge on the option price and thereby obtain the tax benefit. In their view, that was the only realistic way of the members making a return from their investment in Gala.”*

Gala contended that it believed that it and the members had a reasonable prospect of making a profit through receiving a share of “gross receipts” from the films, and that there was genuine uncertainty as to whether the call option would be exercised.

Whether an enterprise is a trade depends on an evaluation of all the facts relating to it against the background of the applicable legal principles.

The question of a view to profit is derived from case law (Ingenious Games LLP): a wholly subjective test which, as regards an LLP, is to be assessed by reference to the subjective views of its “controlling mind”.

An issue here was that “the parties took different views on who the controlling mind was”. Gala believed it was Invicta (the entity engaging with Sony), while HMRC believed it was Chiltern (the entity engaging with potential new members). So, there was a fundamental difference of opinion as to the driving motivation for the LLP’s activity.

Another problem was that the deal with Sony proved to be insubstantial: *“Gala did not provide goods or services to Sony or anyone else, or make any material contribution, in respect of the distribution process.”*

The Judge took extensive evidence and produced 744 detailed paragraphs of analysis. Her judgment can be summarised as follows...

“...a reasonably sophisticated potential investor, of the kind ... the Gala proposal was aimed at..., on reading the IM, would conclude from its overall tenor and the scenarios, that the arrangements described in it provide an investor with...

1. *the opportunity to make a return from an investment in selected films due to tax relief alone ... on the basis that the Call Option would be exercised...*
2. *the speculative possibility of making a larger return by the time the Call Option was exercised, depending on the success of the films chosen..."*

There were only two ways a member would make an overall positive cash return from investment in Gala...

- if the call option were to be exercised, and/or
- were Gala to receive very substantial amounts as gross receipts.

"The IM provided a prospective investor with no means of assessing whether Gala had any realistic prospect of receiving a share of gross receipts and of the likely level of any such share." The selling point, as far as any potential investor was concerned, would be the tax relief.

Gala was not trading with a view to a profit, and any monies it expended were not wholly and exclusively for the purposes of the trade.

Accordingly, loss relief was not due and no tax relief was due for interest on borrowings. *"In our view, it is plain ... that, during the 2003/04 tax year, Gala's activities were not carried on "on a commercial basis" and/or "so as to afford a reasonable expectation of profit" and/or "in such a way that profits in the trade could reasonably be expected to be realised in that period or within a reasonable time thereafter" as those tests has been interpreted in the caselaw set out above."*

The appeal was dismissed.