Substantive appeal

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Cassim Atcha and *Prathab Jagajeevanram* review the Upper Tribunal's decision in the cases of *Samarkand* and *Proteus*

Key Points

What is the issue?

When should the question of ‘trading’ be assessed? How do we assess whether a trade is conducted on a ‘commercial basis’? What is ‘with a view to a profit’?

What does it mean for me?

‘Trade’, ‘commercial basis’ and ‘view to a profit’ are fundamental to the question of whether many tax reliefs can be claimed

What can I take away?

Subject to any appeal, a careful analysis of this decision will assist in seeing how the courts are now addressing these fundamental points, and how this might affect the availability of some tax reliefs

Trade is defined by ICTA 1988 s 832 in broad and circular terms as including ‘every trade, manufacture, adventure or concern in the nature of trade’. This has resulted in a number of cases being referred to the courts, by taxpayers or by HMRC, where the judges are required to decide whether a particular transaction or transactions amount to a trade. In this article, we consider the key issues in the Upper Tribunal (UT) dismissal of an appeal against a First-tier Tribunal decision (FTT) against two film partnerships, Samarkand Film Partnership No.3 (*Samarkand*) and Proteus Film Partnership No.1 (*Proteus*) – together the ‘Partnerships’ which undertook film sale and leaseback (S&L) transactions, were not carrying on a trade, and even if they were trading, not doing so on a commercial basis.

The FTT’s conclusion that the Partnerships had a ‘view to the realisation of profits’ was not challenged.

The consequence of the UT’s decision, subject to a further appeal by the Partnerships, is that the statutory film reliefs (ITTOIA 2005 ss 138 and 140) accessed at partnership level and interest relief claims made by the partners personally on loans taken out to subscribe to the Partnerships are denied in full.

It should be noted that, based on a legitimate expectation founded on HMRC’s Business Income Manual, the Partnerships also lost a judicial review claim against HMRC’s decision to deny statutory film relief. Aspects of the decision may be applied more broadly to all taxpayers and will be considered in next month’s issue of *Tax Adviser*.

Background

Statutory film reliefs for production and acquisition of films were introduced to encourage investment in the British film industry. S&L partnerships were set up to enable acquisition relief to be accessed by third parties looking to shelter their taxable income while allowing producers to raise additional funds. The immediate cash-flow benefit as a result of the tax reliefs available to partners was, in part, passed back to the producer by way of a cash net-benefit.

The life of a typical S&L structure is as follows:

1. The promoter creates a new partnership with one or more founding members.
2. The partnership signs a consultancy agreement with the promoter, who then identifies a qualifying film and negotiates the full terms of an S&L transaction.
3. The arrangement is promoted to potential subscribers.
4. Participating individuals become partners in the partnership in exchange for a contribution of capital, the majority of which is financed by way of a bank loan repayable over the lease term.
5. The partnership purchases the film, immediately leasing it back to the seller in return for a defined income stream (lease rentals) spread over the lease term (normally 15 years) that covers the annual repayments (capital and interest) on the loans taken out by the partners. A further income stream, contingent on film performance, might also be agreed.
6. The seller deposits a sum with a bank as guarantee for payment of the defined lease rentals.
7. The partnership claims an accelerated deduction (the statutory film reliefs) for the acquisition expenditure.
8. The partners immediately relieve the resulting partnership loss against their other income (sideways loss relief) and claim relief for the annual interest payments on their loans.
9. The benefit of the initial loss reliefs is then eroded and reversed by the tax payable on the income over the lease period.

Facts of the case

Proteus carried out an S&L transaction on the Roman Polanski-directed film Oliver Twist and claimed an accelerated deduction for the film acquisition costs pursuant to ITTOIA 2005 s 138 (spreading the deduction equally over three years).

Samarkand carried out S&L transactions on *The Queen* (Helen Mirren won the Oscar for best actress) and another minor film, and claimed an accelerated deduction for the film acquisition costs pursuant to ITTOIA 2005 s 140 – which allows a first-year deduction if the production cost is less than £15 million.

The individual partners claimed sideways loss relief for the losses incurred by the Partnerships and relief for the interest paid on the loans they took out to fund their capital contributions to the Partnerships on the basis that the Partnerships were trading on a commercial basis with a view to a profit.

Were the Partnerships trading?

Given that the UT decided that the FTT was reasonable in concluding that the Partnerships were not trading, we examine the principles applied by the FTT to the facts of the case used to arrive at their conclusion.

- The accelerated deduction for film acquisition costs pursuant to ITTOIA 2005 ss 138 and 140 is available if 'the *person* carrying on the trade has incurred acquisition expenditure'.
- The FTT stated that a partnership, defined as 'the relation which subsists between persons carrying on a business in common with a view of profit' (PA 1890 s 1), changes when the 'persons' change. The UT agreed, further noting that the admission of a new partner, in law, creates a new partnership. This led both tribunals to identify the 'person' that has incurred acquisition expenditure as being the partnership as constituted when that outlay was incurred.
- It was acknowledged by the FTT that the leasing of a single asset could be a trade, as it was in *Bennett v Rowse* 38 TC 476, where the buyer of an aeroplane hired it out to the seller. They further accepted the view of Millet J in the High Court in *Ensign Tankers (Leasing) Ltd v Stokes* [1989] STC 705 (Ensign) that the purchase of a completed film with a view to its distribution and exploitation for profit (though highly speculative) was a commercial transaction in the nature of trade. However, the FTT sought to differentiate both cases on the basis that the Partnerships' acquisition and leasing formed a 'single composite transaction'.
- The FTT concluded (which the UT held as justified and factual) that the acquisition and leasing formed a single composite transaction due to their pre-ordained nature since there could be no acquisition without a lease and vice versa. This was crucial to the judgment because the FTT acknowledged that, if it had not viewed the acquisition and the lease as being a single composite

transaction, it might have decided that a trade was being carried on.

- The ‘single composite transaction’ conclusion stemmed from the application of one of the nine principles expounded in Millet J’s judgment in Ensign as being relevant to the determination of whether a particular transaction associated with the procurement of a tax advantage is a trading transaction. That principle is that, when considering the purpose of a transaction, its component parts must not be regarded separately and the transaction must be viewed as a whole.
- Another of the nine principles considered by the FTT was that a transaction must, in addition to exhibiting some of the badges of trade, have a genuine commercial purpose. In viewing the acquisition and lease as a composite transaction, the FTT viewed the commercial reality in this case to be the payment of a lump sum in return for a fixed income stream. The UT again upheld this to be a justified factual conclusion.
- Although the FTT did go on to consider the ‘badges of trade’ noted in *Marson v Morton* [1986] STC 463, they were considered in light of this view of a composite transaction, and all but one badge failed to evidence trade.

For the above reasons the UT saw no error in law in the FTT having concluded that the Partnerships were not trading.

‘On a commercial basis’

The sideways loss relief claimed by the individuals under ICTA 1988 ss 380 and 381 require the trade to be carried out ‘on a commercial basis’.

The FTT concluded the following:

- A serious interest in profit is at the root of commerciality.
- That serious interest must not be in a profit that is simply an arithmetic excess of income over expenditure, but in a real commercial profit. In other words, there has to be a serious interest in profit in net present value terms.

This conclusion – correct in the UT’s view – may not have been fatal if the tax reliefs claimed by the partners could have been taken into account in the calculation of ‘profit’ in the context of a partner’s real commercial profit. Given that the question is whether the Partnerships’ activities were carried out on a commercial basis, both tribunals took the view that the activities to be considered are those carried on by

the partners collectively (excluding personal tax benefits) rather than those carried out individually (including the personal tax benefits). The tax reliefs claimed by each partner were deemed not to be actions taken collectively as members of the Partnerships, and thus disregarded when considering whether the commerciality test is met. This view was indeed fatal because this analysis led the UT to conclude that the activities carried on in common by the partners did not give rise to a profit in net present value terms, hence it could be regarded as uncommercial.

View of profit

Sideways loss relief under ICTA 1988 s 380 requires the trade to be carried out with a ‘view to the realisation of profits’, and sideways loss relief under ICTA 1988 s 381 requires that ‘profits of the trade could reasonably be expected to be realised within a reasonable time thereafter’.

The plain definition of profit as an excess of income over expenditure was applied here by the FTT to conclude that the Partnerships did, on that basis, have a view of profit. This part of the FTT’s decision was not challenged by HMRC.

Conclusion

Partners in S&L partnerships where the resulting tax positions remain undetermined will rightly be concerned about the potential exposure that they might now face in light of this decision, but we believe that there remain prospects for settlement, particularly given that there are other means to access relief for acquisition expenditure and loan interest costs.

The readiness of the tribunals to treat the acquisition of an asset and its lease as a composite transaction and that transaction as not being on a ‘commercial’ basis where its net present value does not produce a positive result is a potentially unhelpful development for the unsettled statutory relief film S&L cases. Moreover, it is also of wider application to the whole S&L industry, although the question of trade will ultimately turn on the specific facts of each case. If the FTT’s decision, upheld by the UT, is not overturned, it remains to be seen whether HMRC would seek to contain the decision to *Proteus* and *Samarkand* based on their own facts or would seek to argue for a wider application.