

SUCCESS FOR FILM INVESTORS BEFORE THE SPECIALS

The DLA Piper Tax Team is pleased to announce that it has successfully represented the Appellant in two appeals that were brought before the Special Commissioners in February 2007.

The two appeals concerned the provisions of the tax legislation that were in force during the tax years 2003/2004, 2004/2005 and 2005/2006 (“the relevant tax years”) which provided enhanced tax relief to those that incurred revenue expenditure on the production and / or acquisition of “British Qualifying Films”. The appeals also raised a number of issues of general interest as to the quantum and timing of tax relief. Notwithstanding the fact that the purpose of the film tax relief legislation was to boost investment in the British Film industry, by providing taxpayers that were involved in the British Film Industry with enhanced rights of deduction, HM Revenue & Customs (“HMRC”) are challenging a number of the structures that were put in place to increase such investment.

Simply stated, the tax relief entitled taxpayers to deduct against income the costs of production and / or acquisition of a film where the costs were of a revenue nature and were incurred in the “relevant period”. The film also had to be completed in that “relevant period”.

In terms of timing, Section 42 Finance (No.2) Act 1992 (“Section 42 relief”) entitled the taxpayer to deduct one third of the eligible costs in the “relevant period”, the remaining two thirds could then be claimed in each of the following two years. Section 48 Finance (No.2) Act 1997 (“Section 48 relief”) entitled relief for the total costs to be claimed in the “relevant period” but only where the costs of production were less than £15 million.

Set out below is a brief summary of the issues that arose in each appeal, together with the findings that were made by the Special Commissioners. However, of particular note in each decision is the emphasis that the Special Commissioners placed on the accounting evidence put before it and the real need for detailed witness evidence to be provided to assist the Special Commissioners in exercising its fact finding jurisdiction. The hard work and preparation for both of these appeals, which Halcyon Films LLP (“Halcyon”) and Micro-Fusion 2004-1 LLP (“MF”) should be commended for, resulted in all relevant material being put before the Special Commissioners in a manner that rebutted most of the factual contentions advanced by HMRC.

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MICRO FUSION APPEAL

The first appeal heard before the Special Commissioners was an appeal by a film production partnership, MF. During the tax year 2004/2005, MF entered into a number of complex agreements in relation to the production of a film, Mrs Henderson Presents. The main agreements entered into by MF were a One Picture Licence Agreement with Pathé Productions Limited (“Pathé”), pursuant to which MF acquired the right to produce the film Mrs Henderson Presents, and a Distribution Agreement, entered into with effect from 1 October 2004, which was amended by further agreement on 25 January 2005.

Under the terms of the Distribution Agreement, MF undertook to sell the master negative of the produced film to Pathé and to licence to Pathé, for a period of 21 years, the right to exploit the intellectual property rights in the film. MF was entitled to minimum guaranteed payments during the life of the 21 year licence and to a share of gross receipts. Individual investors became partners in MF and MF used the capital raised to meet the costs of production of the film.

The key issues in the MF appeal were as follows.

Exploitation Argument (this related to entitlement to claim relief)

HMRC advanced the argument that MF was not carrying on a trade or business which consisted of or included the “exploitation” of films as, after the production of the film, it sold the master negative (this being the physical record of the film) to Pathé. The Special Commissioners reviewed the transaction documents and the relevant evidence presented to it and held the following:

- MF incurred the production expenditure of the film;
- following the production, MF held all (or substantially all) of the rights in the film (both the ownership of the film and the intellectual property rights);
- MF at all times retained the reversionary rights to the intellectual property rights, subject to the exercise of a buy-out option conferred on Pathé;
- on the basis of the above, the Special Commissioners found that MF did not part with its rights to exploit the film but was turning the film to account for the income which could be derived from it and, thus, was “exploiting” the film.

Trading Stock (this related to the entitlement to claim relief)

HMRC also argued that the film constituted “trading stock” in the hands of MF and thus was not eligible for Section 48 / Section 42 relief. On the basis of the findings of fact made in relation to the exploitation argument, the Special Commissioners held that it could not in substance hold that the Distribution Agreement was a sale of the film as MF retained reversionary rights.

Commencement of Trade (this related to the timing and quantum of the relief)

In the alternative to the exploitation and the trading stock arguments, HMRC argued that if MF was entitled to the relief claimed, it was not entitled to it in the tax year 2004/2005. An issue arose as to what was the “relevant period” for the purposes of MF’s claim. In addressing this issue, the Special Commissioners had regard to the date on which MF commenced its trade and also to the completion date of Mrs Henderson Presents. Following an analysis of the legislation, the Special Commissioners held that the “relevant period” for the purpose of Section 42 relief and Section 48 relief is the period from “commencement of

trade” to the end of the relevant tax year (and not the end of the accounting period as contended by MF). As the film was not completed in the tax year, the relief claimed was attributable to the tax year 2005/2006.

Due to the interpretation of “relevant period”, MF’s commencement of trade argument fell away. However, the Special Commissioners held that for a trade to be regarded as commenced in advance of any sales or equivalent earning of income, any activities must in fact be “operational” in the sense of undertaken and actively and single-mindedly pursued in a way which is intended to result in a profit earned. There was insufficient evidence before the Special Commissioners to convince it that MF had engaged in “operational” activities in relation to rights it had acquired in a screenplay under the terms of an Exclusive Acquisition and Financing Agreement. On the basis of the facts, it was held that the commencement of trade was 20 September 2004, this being the date on which principal photography of the film began.

The Applicability of Section 60 Finance Act 2005

After the appeal in the MF case was lodged against the relevant closure notice, HMRC sought to raise an additional argument on the basis of s.60, Finance Act 2005 (“s.60”). Interesting procedural issues were raised, however, the Special Commissioners did not make a determination on these as the substantive issue was decided in favour of MF. The basis of the s.60 argument advanced by HMRC was based on the facts of the case; HMRC contended that the Distribution Agreement between MF and Pathé (which was entered into with effect from 1 October 2004) did not become binding until after 2 December 2004; the Distribution Amending Agreement, dated 25 January 2005, was the relevant agreement between the parties; and the Distribution Amending Agreement was a “deferred income agreement” for the purposes of s.60.

The broad effect of s.60 (and the following provisions), if it were to apply to the MF Distribution Agreement, was that it would accelerate the income from the exploitation of the film as though it arose over a 15 year period rather than the 21 year period (which was the term under the MF Distribution Agreement). The consequence would be that the amount receivable in the period over 15 years, “the excess relief”, would be treated as received in the tax year in which the Section 48 relief was being claimed.

The Special Commissioners reviewed the agreements between the parties and the circumstances in which they were entered into and held, after an analysis of the facts, that the Distribution Agreement and the Distribution Amending Agreement were one agreement. Further, as that agreement fell within the scope of the grandfathering provisions relevant to the s.60 regime, it was not a “deferred income agreement” and so s.60 did not apply.

Deductibility of fees (related to quantum)

The final argument raised by HMRC related to the deductibility against income of the film consultancy fees paid by MF to Future Films Limited under the terms of a Film Consultancy Agreement. HMRC contended that certain of the expenditure paid to the Film Consultant was capital in nature as it related to the provision to MF of specialised know-how, contacts, experience and personnel. The Special Commissioners were of the view that this suffered from two deficiencies; it ignored accountancy evidence that the payments were revenue in nature and also that payments for such services were revenue in nature in any event. The Special Commissioners were of the view that there was nothing in the relevant Consultancy Agreement to suggest that the Film Consultant was MF’s agent in providing the services relating to the structure of MF’s business. Therefore, the entire amount of the consultancy fee was deductible for income tax purposes.

HALCYON APPEAL

The Halcyon appeal concerned three separate sale and leaseback transactions that the Appellant entered into during the tax year ending 5 April 2004. The Appellant was seeking to claim relief in respect of the acquisition costs incurred on the purchase of each film. At the time that the claim was made, s.101 Finance Act 2002 (“s.101”) had been introduced and this limited the relief that could be claimed under s.48, in respect of acquisition costs, to circumstances where the film was acquired by the producer or directly from the producer. As Halcyon was neither the producer, nor did it acquire the films from the producer, it was not entitled to claim relief under s.48 and instead claimed the relief under s.42.

The key issues in the Halcyon appeal were as follows:

The s.101 issue (this related to entitlement to claim)

The key argument advanced by HMRC in this appeal was that s.101 applies to s.42 and so Halcyon was not entitled to claim relief as it was not the producer and it did not acquire the film from the producer. The issue gave rise to a matter of statutory construction and, after a detailed analysis of the legislation, the Special Commissioners held that s.48 does not provide a self-standing relief, instead, it provides a special regime within the context of s.42. The construction of the legislation is such that where expenditure falls outside the scope of the special relief, it falls back into (or remains within) the basic s.42 regime. Accordingly, Halcyon was entitled to claim the relief sought under s.42.

Commencement of Trade (this related to timing and quantum)

In the alternative, HMRC contended that if s.42 relief was available to Halcyon, it was not entitled to the quantum of the relief that it sought as it did not commence its trade at the beginning of the relevant tax year, as it contended. As in the MF appeal, the issue of the “relevant period” arose. The Special Commissioners applied the same principles as in the MF appeal and had regard to when Halcyon entered into “operational” activities. The Special Commissioners determined that Halcyon’s trade commenced when Halcyon entered into the sale and leaseback transactions in relation to the master negatives concerned.

Deductibility of fees (this related to quantum)

As also argued in the MF appeal, HMRC contended that certain of the expenditure paid to the Film Consultant, LMI, by Halcyon was capital in nature as it related to the provision to Halcyon of specialised know-how, contacts, experience and personnel. The Special Commissioners reviewed the contractual documents between Halcyon and LMI and held that there was nothing to support a finding that LMI acted as an agent in relation to any of the business set-up services provided to it by third parties. Consequently, the amount of the consultancy fee was deductible for income tax purposes.

Acquisition Costs (this related to quantum)

The final argument raised by HMRC related to the amount of the acquisition costs that relief was being sought in respect of. This was on the basis that the acquisition costs included not only the costs of production but certain other costs incurred by the Distributor which were incorporated into the acquisition price. The Special Commissioners held that the evidence showed that the sales price for each film was

commercially negotiated at arm's length between the parties, with each party mindful of its own interests. Further, the sale agreement for each film provided that the price had to be justified by reference to "the fair value of the film in the books of the seller" as established according to UK accounting standards. The Special Commissioners had regard to the evidence of the accountants for each distributor who signed off on the cost of the film in the books of the seller and stated that they could see no basis to look beyond the price paid by Halcyon for the master negatives.

CONCLUSIONS

1. A number of issues were addressed in the above Decisions which will be of relevance to many film partnerships involved in film transactions concerning the production and /or acquisition of films. We are aware that this area of tax relief is one that HMRC are reviewing and that they are raising similar issues in a number of open enquiries into tax returns that seek to claim relief in respect of film production and / or acquisition costs. A detailed analysis of the facts relevant to affected partnerships is required to ascertain whether they are factually on all fours with the facts found in the MF and Halcyon appeals and whether these Decisions can be applied to them.
2. The Decisions emphasise the importance of good implementation and the need to substantiate every assertion made with sound documentary evidence. It is not known whether HMRC will seek to appeal the points of law decided by the Special Commissioners. However, in the absence of an appeal, taxpayers can be confident that challenges by HMRC will focus on the facts and the integrity of the implementing documents.

A copy of the Decisions can be obtained from [The Special Commissioners website](#).

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