[2016] UKFTT 0521 (TC)

TC05270

Appeal numbers: TC/2012/6581; 2013/118; 2013/122

Income Tax – LLPs engaging in the making of films and video games – whether trading; whether trading with a view to profit; what amount was incurred on the acquisition of rights in respect of films and games, and what amount was incurred wholly and exclusively for the purposes of any trade; whether profits had been computed in accordance with GAAP.

FIRST-TIER TRIBUNAL
TAX CHAMBER

INGENIOUS GAMES LLP **Appellants**
INSIDE TRACK PRODUCTIONS LLP
INGENIOUS FILM PARTNERS 2 LLP
- and -

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

TRIBUNAL: JUDGE CHARLES HELLIER
JULIAN STAFFORD

Sitting in public in London on 3-6, 10-14, 19-21, 24-28 November, 1-5, 8-12, 15 December 2014, 18-20, 23,24 February, 17 March, 20-22, 26,27 May, 18-20, 23,24 26, 27, 30 November and 1 December 2015

David Milne QC, Richard Vallat, Roderick Banks, James Rivett and Edward Waldegrave instructed by Weil, Gotshal & Manges for the Appellants

Malcolm Gammie QC, Catherine Addy, Jonathan Davey, Michael Jones, Ruth Hughes, Imran Afzal, Sam Chandler, Nicholas Macklam and Oscar Schonfeld, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

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CHAPTER I: INTRODUCTION

1. Background

1. This is a decision on appeals made by the Appellant LLPs, Inside Track Productions LLP ("ITP"), Ingenious Film Partners 2 LLP ("IFP2") and Ingenious Games LLP ("IG"), against closure notices issued to them by HMRC which amend their partnership tax returns to deny their claims for trading losses.

2. The Appellants are members of a family of LLPs, investment in which was promoted by members of the Ingenious group[1] to individuals. The activities of the Ingenious Media Group in the period 2002 to 2010 included media consultancy and corporate finance, film and TV investment, private equity media investment, and asset management. We refer to the companies in the Ingenious Media group collectively as "Ingenious". The appeals are lead cases in relation to a further five appeals by other Ingenious LLPs.

3. If certain conditions are satisfied the LLPs are treated as partnerships for income tax purposes, and their investors as partners, taxable on their share of the profits and losses of the LLPs.

4. Between them the LLPs were involved in the production of a large number of films and video or computer games. Many £100m were expended in these activities. The LLPs argue that, in the early years, these activities resulted in trading losses which their investors could in appropriate circumstances set against their other taxable income.

5. We are told that the losses claimed by the family of LLPs amount in total to some £1,620m, that the tax reclaimed by their investors amounts to £620m, and that, with interest and penalties (if applicable), the total amount at stake is some £1bn. The Appellants say that some of that tax was, and all of that tax could be, recovered by the Exchequer as and when the LLPs made taxable profits.

6. It was common ground that the issues in the appeal are these:

(a) were the LLPs carrying on a trade?

(b) were they doing so "with a view to profit"?

(c) did they incur expenditure equal to 100% of the budget of the film or game?

(d) was their expenditure incurred wholly and exclusively for the purposes of their trade?

(e) were their losses computed correctly as a matter of generally accepted accounting practice ("GAAP")?

[1] By Ingenious Ventures Limited, in the case of ITP, and by Ingenious Media Investments Limited (formerly known as Ingenious Films Limited) in the case of the other LLPs.

7. In addition we consider in Chapter XI whether the arrangements for the films and games consisted of separate partnerships between each LLP and the distributor of the film or game.

8. In more detail the contested amendments in the three appeals of the LLPs are these:

(a) for ITP the amendment to its 2002/03 partnership return disallowing in their entirety trading losses of £64,671,573;

(b) for IFP2 the amendments to its 2005/6, 2006/7, 2007/8 and 2009/10 partnership returns disallowing in their entirety losses of £748,183,712, £76,393,501, £45,850,405, and £444,855 respectively; and

(c) for IG the amendments to its 2005/6 and 2006/7 partnership returns disallowing in their entirety losses of £25,614,984 and £74,068.

(d) In the rest of this decision we round amounts to the nearest £m, unless greater accuracy is required for the argument.

9. Individuals' subscription to the LLPs:

(a) ITP was launched in 2002 and by 5 April 2003 some 140 individuals had invested capital contributions of £26m.

(b) IFP2 was launched in 2005. It was the largest LLP and by 5 April 2006, the end of its first accounting period, 1,382 individual investors had made capital contributions totalling £778m.

(c) IG was launched in 2005 and by 5 April 2006 individual investors had made capital contributions of £27m.

(d) During the course of this decision we may also refer to another LLP, Ingenious Film Partners LLP ("IFP"), a precursor to IFP2, which was launched in 2004.

10. The LLPs were promoted by Ingenious to investors with the aid of Information Memoranda. Generally investors' subscriptions to an LLP were taken in one year only – the fiscal year of launch – although IFP2 raised additional capital from individuals in its second year of operation[2].

11. Overall the LLPs were involved in some 65 films, 64 of which were distributed in cinemas and many of which had a high profile and received critical acclaim. Most readers will recognise at least some of the following: *Avatar*, *Life of Pi*, *The Best Exotic Marigold Hotel*, *Night at the Museum*, *Shaun of the Dead*, *Hot Fuzz* and *Girl with a Pearl Earring*.

12. ITP contracted for 7 films all of which were shown in cinemas, IFP2 contracted for 22 films in its first period and since then for a further 5, and IG contracted for 12 games of which 4 were eventually published.

[2] and in later years from an Ingenious entity.

2. Summary of the Structure

13. What follows relates generally to IFP2. The same principles apply to IG except that it was involved in computer games. ITP was broadly the same as IFP2.

14. Each LLP had a number of individual members and a single corporate member (the "CM"). The individual members made subscriptions (capital contributions) to the LLP for their membership. The IFP2 LLP Members' Agreement provided that the CM could, and, in specified circumstances which never arose, would be required to, make a capital contribution of 50 for each 50 made by the individual members. The ITP Members' Agreement made no express provision requiring capital contribution by the CM; in practice it was treated as making a contribution of 65 for each 35 subscribed by the individual members.

15. The CMs of the IFP2 and IG LLPs were UK resident companies which were members of the Ingenious group. The CM of ITP was Sherwood Films Ltd, a company owned by a charity and which had no connection with the Ingenious group.

16. Each LLP had an Operator, another company in the Ingenious group, which, under an Operator's Agreement, managed its activities (for which it charged a fee).

17. The arrangements into which the LLPs entered for the production of the films and games all had broadly the same complex structure. This was known as the Commissioning Distributor Model.

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

(a) 30 (35 in the case of ITP) of the budgeted cost was sourced from the subscriptions of individual members of the LLP;

(b) and 70 (65 in the case of ITP) was sourced from a Commissioning Distributor (the "CD"), which was a Hollywood studio (a "Studio") or a vehicle formed by independent producers and other financiers;

(c) the combined 100 was provided to a Production Services Company (a "PSC"), a special purpose vehicle which made the film or game in accordance with an agreed specification. The PSC appeared to have been an associate of the CD: the same lawyers acted for the CD and the PSC;

(d) when the film or game had been made it was distributed by the CD and the proceeds of distribution divided in accordance with the terms of a "waterfall" which specified who should receive what and in what order, and under which amounts were to be paid to the LLP and paid to, or retained by, the CD.

19. There follows a summary of some of the four main agreements which were part of the suite of agreements for each film. The summary is of the written terms of the agreements rather than their legal effect (which we shall discuss later):

(a) by a loan agreement the CD agreed to lend 70 to the CM. The loan was expressed to be repayable only from part (or all, in the case of ITP) of the CM's drawings from the LLP. The loan was to be made by the payment of 70 (65) directly to the PSC;

(b) by a Production Services Agreement (the "PSA") the LLP agreed with the PSC for the making of the film on an Approved Budget of 100 in accordance with a detailed specification, and for payments to the PSC in accordance with an Approved Cash Flow;

(c) by a Commissioning and Distribution Agreement (the "CDA") the CD agreed with the LLP that the LLP would make the film in accordance with the same detailed specification and Approved Budget, and deliver it to the CD. It provided that receipts from the film would be applied in accordance with the waterfall which appeared in schedule 7 of that agreement;

(d) by a Deed of Acknowledgement the payments expressed to be payable under these three agreements were varied.

20. The combined cash effect of these documents was broadly that after they had been signed:

(a) the CD would pay 70 (65) to the PSC, and the LLP would pay 30 (35) to the PSC;

(b) 30% (35%) of the income arising from the film after the deduction of certain costs and fees would be paid to the LLP.

The detail of the provisions which resulted in this cash flow is explained in section 1 of Chapter III.

3. The Parties' Contentions

21. *The Trade Issue.* The LLPs each say that in connection with, and in pursuance of, these agreements they conducted a trade which incorporated the production and sale of films or games. HMRC say that it was not a trade.

22. *The View of Profit Issue.* The LLPs say that this trade was conducted with a view to profit. HMRC say that the object of the LLPs was to make a tax loss which could be allocated to the individual investing members, that the terms of business were such that profits could not realistically have been expected, and that the directing minds of the LLPs were, at best, indifferent to profit.

23. *The Amount Incurred Issue.* The LLPs say that in that trade they expended 100 on the film. 30 (35) came from the individual members and 70 (65) as a result of the payment of 70 (65) by the CD to the PSC under the loan agreement. HMRC say that the LLPs did not incur 100 of expense and that at least part of what they did incur was not incurred wholly and exclusively for the purposes of trade.

24. *The GAAP Issue.* The LLPs say:

(a) that in computing the accounting profits of the trade, 100 was expended by them on trading stock, namely the film, and that in accordance with GAAP they were required to carry that stock in their accounts at the lower of cost and net realisable value ("NRV").

(b) that NRV was equivalent to the virtually certain income which would be derived from the film, and that films were notoriously unpredictable. As a result generally the films, on which they had expended 100, were properly written down to about 20. That write-down gave rise to an accounting loss of about 80 in the accounting period in which the contract for each film was entered into.

(c) That accounting loss was a loss in the trade for income tax purposes.

These are the losses which the LLPs claim, and HMRC dispute.

25. HMRC say that the LLPs did not expend 100, that the estimation of NRV was overly prudent, and that GAAP, properly understood, would not give rise to a loss of 80.

4. The Effects for Individual Members and the CM

(i) Individual Members

26. The determination of the tax position of any individual member is not within the compass of this appeal. However, HMRC say that the expected tax position of the members is relevant to the issues in this appeal.

27. Most of the reported losses arose in the first accounting period of each LLP. The majority of the films were contracted for at or before the end of that period and the LLPs accounted for the cost of those films and the subsequent write down to NRV in that period. The relevant period ended on 5 April each year.

28. The LLPs allocated substantially all the losses arising in that first year to the individual members. If the LLPs are properly treated as partnerships, if they were carrying on a trade on a commercial basis with a view to profit, and if the losses were correctly computed, the members could offset their respective shares of the trading losses against other income. For an individual member who was paying tax at 40% this enabled him or her to recover 40% of the allocated loss.

29. In subsequent years the LLPs allocated to the individual members 99% of profits (ITP) or profits up to the amount of losses previously allocated (IFP2). Once losses had been recovered, profits were to be shared between the CM and the individual members. Drawings were not paid in tandem with the allocation of profits. Instead part of the amounts the LLPs treated as receipts under the waterfall were allocated as drawings as they arose (whether or not this mismatch affected the legal nature of the allocation or payment was not an issue which fell to be determined by us and our description is on the basis of the LLPs' description of the relevant amounts). The drawings paid to each individual member in any subsequent year were 50% of the amounts the LLP regarded itself as receiving under the schedule 7 waterfalls. Thus for example if in the case of ITP a film was written down to 80%:

(a) in year 1 the member subscribed 35 and had allocated to her a loss of 80. She made a tax claim for the loss and received 40% x 80 = 32 from HMRC;

(b) in year 2, if the LLP recognised film receipts of 50 and reported a profit of 50 (as might be the case where after the receipt the NRV of the remaining film remained at 20), the 50 would be allocated to the members and drawings of half that amount, 25 would be paid to them. The members would pay tax on that profit of 40% x 50 = 20, and retain 5.

30. Thus the Appellants say that the initial tax saving was recouped by HMRC as revenues flowed from the films. If an LLP's portfolio of films was sufficiently successful the whole of the initial tax reclaim would be reversed in later years.

31. From an investor's tax perspective this result could be attractive. In year 1 she would make a return of £32 for each £35 invested[3], and in year 2 a net return of £5 and so on. HMRC say that this profile, and its advertisement in the marketing material for the LLPs, meant that Ingenious managed the LLPs so as to secure the benefits of the first-year loss and to secure some level of continuing further payments to the investors, but that they were not concerned with obtaining such receipts as would mean that the LLPs recovered more than the aggregate cost of the films.

(ii) The effects for the CM

32. In ITP the CM was allocated only 1% of profits and losses until the LLP had broken even, but was treated as being allocated drawings of 50% of the LLP's schedule 7 income which were applied in reduction in of the CM loan.

33. In IFP2 a percentage of the LLP's schedule 7 entitlement was retained by the CD in reduction of the CM loan. That was treated as satisfying the drawings to which the CM was entitled. The effect of the various provisions was, as we explain in Chapter III section 1, that the CM, a member of the Ingenious group, retained after tax at least 5% of the net income of the film after costs, expenses and certain fees.

5. The Difference Between ITP and IFP: Non-production Activities

34. In the ITP structure the individual members contributed 35 to the LLP, which was applied in film contracts together with the 65 sourced from the CD. On a write down of NRV to 20, the losses allocated to the individual members would be 80. In 2004 changes were made to the provisions in the Taxes Acts relating to the trading losses of an LLP which non-active partners could set against their other income. The amount of such losses was restricted to the capital subscribed by the member.

35. The changes were heralded by a press release on Tuesday, 10 February 2004 called by some "Black Tuesday". After the changes the first-year loss which the structure of ITP delivered for use by an investor would be limited to 35, her capital subscription. Rather than loss relief of 80, worth 32 to a 40% taxpayer, the investor

[3] If the film were written down to 15% of budgeted cost then the tax relief would match the investor's investment in the LLP.

would be limited to loss relief of 35, worth only 14. The economics of the structure changed adversely.

36. IFP, whose first year-end was 5 April 2005, and IFP2 (5 April 2006) had an amended structure. There was little doubt in our minds that the changes made were as a result of the restriction on the availability of loss relief and, at least in a major part, were intended to restore the previous economic position for new investors in IFP.

37. For IFP and IFP2 individual members were offered loans to increase the amount of their subscription. For a total subscription of 100 the individual would provide approximately 36 from his or her own resources, borrow 3 under a "Tranche A" loan, and 61 under a "Tranche B" loan. The CM was permitted to subscribe an amount equal to the total subscription of the ordinary members. In parallel the Information Memoranda indicated an increased scope for the activities of IFP and IFP2: only about 56% of the funds raised were to be used in film production, and the remaining 44% in what have been called "non-production activities".

38. The structure of the financing of the film production was broadly the same as that for ITP. The Commissioning Distributor Model applied as before to the contracts for films, but the CD would (usually) provide 70% of the funds for a film (through the normal mechanism) and 30% would come from the individual members' subscriptions (as compared with 65:35 for ITP).

39. Thus if

(a) no profit was made from non-production activities in Year 1;

(b) the individual members contributed 100 and the CM 100;

(c) 56% x (100+100) = 112 was contracted for film production; and

(d) the films were written down to 20% of cost,

then a loss of 80% x 112 = 89.6 would arise. 99% of this (it had been 90% in the case of ITP) was allocated to the individual members. They could thus claim loss relief of 99% x 89.6. That was less than their capital subscription and so was not restricted. Thus in the first year they could make a tax reclaim for repayment of 40% x 99% x 89.6 = 35.5, giving, as was intended to be the case for ITP, a positive return for the individual investor in a matter of months.

40. The IFP2 and IFP Information Memoranda described the new business model of the LLP as being an integrated film business. Mr McKenna, the CEO of Ingenious, described it as a "virtual studio". In addition to film production the Information Memoranda indicated that each LLP would be involved in film development (1% of the funds), co-production (producing films with other producers and funding presales), sales and distribution (initially in conjunction with other sales agents and distributors) and rights acquisition (16% of funds raised on a film library).

41. Before us Mr Milne made it clear that IFP and IFP2 did not rely on the non-production activities as supporting their assertions that they were trading with a view to profit.

42. The non-production transactions which were undertaken were structured to be low risk because Ingenious recognised that losses on those transactions would expose individual investors to the risk that they would have to find funds to repay the Tranche A and Tranche B loans from their own pockets if losses were made (income tax loss relief being limited to their 100 subscription, which would be almost all used up on the expected Year 1 film losses). As a result the non-production transactions undertaken were low risk, low reward transactions.

43. Further, not only was the LLP limited to low risk/low reward transactions but a large proportion of the funds which had been subscribed by the individual members had been lent to Ingenious which had used the monies to procure the loans to the investors. As a result the LLP did not have access to free cash to make any further investment (other than activities which required no real cash flow): it would have had to borrow and make a return on a low risk transaction which exceeded the interest rate on the borrowing.

44. We regarded the non-production transactions undertaken by the LLPs as odd and contrived. The evidence before us did not suggest that they were obviously trading transactions or would contribute materially to any profit. We therefore accepted Mr Milne's invitation to leave them out of account in considering whether the LLPs were trading with a view to profit. As a result we need say nothing about them in this decision other than in relation to the arguments HMRC deployed about the tax purposes and motivations of the LLPs.

6. The Evidence

45. There was a very large amount of documentary evidence.

46. We heard oral evidence from the following factual witnesses:

(a) Patrick McKenna, the founder and CEO of Ingenious. He is an accountant who was a partner in Deloitte before he left to join Andrew Lloyd Webber at the Really Useful Group in 1990. He has business interests in, and extensive experience of, the business of the film and entertainment industry and understood tax. He was an able witness. He saw difficulties coming and headed them off; he kept what he had said under review to correct any impression he did not want to deliver.

(b) Duncan Reid, the Commercial Director of Ingenious. Mr Reid joined Ingenious in 1998, and until 2001 had been Finance director. He was the one witness who could give a more detailed account of the activities of IG. Mr Reid was a robust witness who had a tendency to try to be helpful by making up explanations on the hoof rather than to give evidence of what he recalled had happened.

(c) James Clayton, who until 2014 had been CEO of the Investments division of Ingenious. Mr Clayton had joined Ingenious in April 2003, and had played a pivotal role in Ingenious' relationship with Fox for IFP and IFP2. Mr Clayton

was very careful in what he said and well prepared for what he wanted to recall but with a sketchy memory of matters for which he had not prepared.

(d) Nicholas Bower, who until 2014 had been a director of Ingenious' Investments division. Mr Bower joined Ingenious in 2005 and gave evidence of the activities of Ingenious and the LLPs after that date.

(e) Neil Forster, the Chief Financial and Chief Operating Officer of Ingenious. Mr Forster joined Ingenious in 2008 and gave evidence of the accounting records of the LLPs, including information as to the performance of the films and games to date, their projected future performance and the accounts of the LLPs.

47. We also heard from Reno Antoniades, a lawyer specialising in the legal aspects of film and television production, who gave us evidence of Ingenious' combative approach to negotiations – having been on the other side.

48. We heard expert evidence from the following experts in the film world:

(a) Eric Briggs of FTI Consulting Inc, which had acquired the respected Salter Group of which he had been the co-founder. Mr Briggs was an expert in forecasting the future income of films. He provided forecasts of the potential results of a number of films. This included developing a financial model for the "Lifetime Ultimate" for certain films, that is to say the total net income which might arise from the film from all sources over all time.

(In 2010 Ingenious prepared for HMRC their own forecasts of the results of the accounting profit or loss they estimated would arise from each of the films undertaken by the LLPs over the lifetime of the films. These were called the "2010 Ultimates", and were evaluated by Mr Briggs.)

(b) Jonathan Olsberg, a management consultant specialising in the film industry, who gave his opinion in relation to three films as to whether those three films would be profitable for their respective LLPs. Mr Olsberg had experience of working as a sales agent.

(c) Angus Finney, a writer, lecturer and specialist in the film industry who had been a Managing Director of Renaissance Films, a UK film production company between 1999 and 2005.

(d) Steven Sills of Green Hasson Janks LLP who had extensive experience in the auditing of profit participations from films.

49. We heard expert evidence from the following experts in the games world:

(a) Jesse Divnich, who until 2014 had been at EEDAR, a large speciality video games research firm. When he appeared before us he was at Tilting Point Media.

(b) Vincent Scheurer, of Sarassin LLP, an expert in the commercial practices of the video games industry.

50. We set out details of the evidence of the film and game experts in Appendices 2, 3, 6 and 8 to this Decision. We should note that some witnesses' evidence contained

passages in which they expressed views on the legal effects of some of the film documentation which we regarded as trespassing on our prerogative; we have taken only our own counsel in those matters.

51. We heard expert accounting evidence from:

(a) Peter Holgate, a chartered accountant who had until 2013 been senior accounting technical partner at PwC;

(b) Luke Steadman, a chartered accountant, head of the forensic investigations team at Alvarez & Marsal Global Forensic Dispute Services LLP;

(c) Richard Cannon, a chartered accountant employed by HMRC.

52. We address the accounting experts' evidence in Chapter X: GAAP. We should note that Mr Steadman and Mr Holgate were both instructed by the Appellants and that there was some duplication in their evidence. We have ignored Mr Steadman's evidence where there was duplication, or not treated it as adding weight to that of Mr Holgate.

7. Background: Making a Film

53. This summary is intended to make understandable some of what follows. It is perhaps a crude summary of the evidence before us in relation to the making of films but we hope it is sufficient for this purpose. The distinctions we suggest are not always observed and there are exceptions to most rules.

54. It is generally accepted that the making of a film is a complex and financially risky business.

55. There is a division between films, ("Studio films") which emanate from one of the six major Hollywood Studios (Warner Brothers, Disney, Fox, Columbia, Paramount and Universal), and "Independent films" which are made by other companies. There are two major differences: first the Studios have deep pockets and may resource the development and making of a film from their own funds; second the Studios have their own distribution networks and are not reliant on independent distributors to distribute their films to the public.

56. In the case of both Studio films and Independent films the film will start its way to adulthood with an idea written up as a screenplay. If it is not to die then, a producer has to be found to develop the screenplay and to find a director, cinematographer, actors, and crew.

57. In the case of an Independent film the producer will at the same time have to find sources of finance to make the film: some finance will be required for the development, more may be needed if the services of the cast are to be secured. The producer will have to start finding providers of finance to make the film. There will need to be a production schedule, a budget, and a cash flow projection. The development of the screenplay, the securing of talent, the refinement of the production schedule and the budget will have to take place hand in hand with the seeking of

finance to make the film. Getting everyone and everything in place at one time may be quite an act.

58. When a Studio is developing a film the process of securing finance will be an internal competition for the Studio's resources, although Studios may take on films already partially developed by others.

59. Films earn income from: (i) their showing in cinemas: the majority of this income will arise in the few weeks or months following their "theatrical release", and 98% of it within 6 months; (ii) video and DVD hire and sale and TV on demand sales: this income arises later and generally over a longer period than cinema income; and (iii) television display: this arises over a longer period still, sometime many decades (the Sound of Music was on our televisions again this Christmas). Generally the vast majority of such income arises in the first 5 years after release. There are other sources of income too: music rights and franchised goods and toys.

60. Each source of income has an associated cost. A cinema will generally retain about 50% of the box office receipts. For cinematic showings, copies of the film have to be made and distributed (although, now, digital distribution may change the form of such copies); DVDs have to be made and supplied to shops and other sellers; the film has to be advertised and promoted; licences have to be negotiated with television companies. The cost of copies of the film, and of promotion and advertising is known as P&A expense. There will also be costs of the production and distribution of DVDs etc.

61. For an Independent film these costs of exploitation of the film are generally taken from the film income before the balance, if any, is passed to the Collection Account for distribution to the maker, financiers and others; for a film made by a Studio, they will be borne by its own distribution network in countries where it has one.

62. In every territory there are distributors who arrange the exploitation of a film by all or some of the methods outlined. These may be arms of the Studios or independent distributors. In the case of independent distribution, rights to exploit the film in that territory for a period will be granted by the owner of the intellectual property rights in the film to a distributor generally in return for the reimbursement of P&A and a commission payable to the distributor, each out of the income from the film. The commission will be a percentage of the income.

63. A distributor may also agree to make an advance payment (a "sales advance"). If such a payment is made the distributor will be entitled to retain the net income of the film (after its P&A reimbursement and commission) until the advance is repaid. Unless there is fierce competition for a film an advance would be made only if a distributor took a higher commission.

64. If a distributor makes a sales advance before the film is produced it forms part of the financing for the production of the film. Generally, however, such a payment will be made on the delivery of the film. In such a case it is known as a presale. When a

presale is made the maker of the film may obtain debt finance secured on the security of the presale; alternatively the presale may form part of early returns to the film's financiers.

65. The maker of an Independent film may engage a sales agent to engage distributors. The agent will market the film to potential distributors and negotiate, or participate in the negotiation of, the terms of the sale of the rights in the relevant territory to a chosen distributor. An agent may provide the maker with estimates of sales in territories worldwide. Such estimates may provide a range, and suggest low and high (or "take" and "ask") figures which may form the basis for agreeing presales advances.

66. Others may take a share of the income produced by the film: actors, composers or directors may agree to receive part of their remuneration as an income share. As with the share of the income taken by cinemas, and distributors etc. the value of this remuneration will depend on the point in the "waterfall" of income at which the share is taken – whether it is calculated or paid before or after the cinema's 50% share, the recoupment of P&A expenditure, the commission taken by the distributors and so on. A right to a share taken at an early stage in that waterfall is more likely to result in some payment since, if calculated by reference to what remains at a later stage, there may be little left unless the film is successful.

8. Other People and Definitions

67. From time to time we refer to members of Ingenious staff who did not give evidence. They were:

(a) Paula Jalfon who joined as Head of Production in August 2002. She had considerable production experience. She left in April 2007; Mr Bower took over from her.

(b) Nick Crossley, business development manager. Mr Crossley's role included financial modelling.

(c) Kevin Mead, formerly CEO of Ingenious.

(d) Alison Brister, a legal advisor at Ingenious.

(e) Mark Fielding, a senior financial analyst at Ingenious.

(f) James (or Jimmy) Mulville, a member of the Executive Committee of IFP2 and chief executive of Hat Trick Productions.

(g) David Heyman, a member of the executive committee of IFP2 and the producer of the Harry Potter Films.

68. Definitions:

(a) WWBO: worldwide box office receipts: the gross amount received from tickets sold in cinemas. "Theatrical Receipts" is generally used to mean WWBO less the commission taken by the cinemas.

(b) Domestic BO (or NABO): the gross box office receipts in *North America*; (it seems that in the film industry North America is domestic).

(c) International BO: gross box receipts other than in North America.

(d) P&A: see section 7 above.

(e) The waterfall: the terms under which income from the film reaches those with an interest in it: some being entitled to income or reimbursement before others.

(f) GDI: Gross Distributable Income. This is a term used in the waterfalls to describe the income remaining for distribution after the deduction of certain fees and expenses (including P&A). Its calculation is described in Chapter III section 1.

(g) BR: 50% of the LLP's share of GDI under the schedule 7 provisions: see Chapter II section 3.

(h) BDR: a percentage of BR see Chapter II section 3.

(i) Ultimate: an estimate of the income from a film which will accrue to the holder of a right in it over the lifetime of the film. (Mr Sills regarded it as relating to the period of 10-15 years after release).

(j) 2010 Ultimates: Ultimate calculations prepared by Ingenious for HMRC in 2010 in relation to many of the LLPs' films.

(k) "Sideways loss relief": the ability of an individual to set trading losses arising in a fiscal year against other taxable income of the year.

(l) The"Ingenious basis" is the basis on which the LLP's computed their profits and losses. It assumed that the LLP (i) would incur the full budgeted cost of the film (100 rather than 30), and (ii) would earn income, which included amounts which were retained by the CD in reduction of the indebtedness of the CM, and was no more than 54.45% of GDI (rather than 30% of GDI).

69. Other terms are defined in the text.

9. The Structure of the Remainder of the Decision

70. In the remainder of this decision we address first the nature of the rights and obligations which arose under the contractual documents, and then, in separate sections, each of the issues which arise for determination. We address the contractual issues first because they are relevant to each of the latter issues.

71. In the sections on the particular issues, we set out our understanding of the relevant law and the nature of the evidence before us and our factual findings. Some of the factual findings in earlier sections may also be relevant in later sections, but we do not always repeat earlier findings.

72. There was a vast amount of documentary evidence available to us. Generally, however, we have not taken account of documents which were not brought to our attention by the parties. We understand that among the available documents were

some thousands of spreadsheets. The manipulation of the content of some of these spreadsheets was a significant feature of the cross-examination of some of the witnesses. In only one place in this decision have we relied upon the result of our own manipulation of a spreadsheet. That is referred to in Chapter VIII section 6.

CHAPTER II. THE CONTRACTUAL RIGHTS AND OBLIGATIONS

73. In this Chapter: we (i) explain the particular relevance of these matters to the issues in the appeal, (ii) set out our approach to the determination of these matters, (iii) set out the relevant provisions and our conclusions as to their legal effects (the rights and obligations which arise under them), and (iv) explain the effects of the provisions of the agreements which relate to creative control over the making of a film.

1. The Relevance of the Contractual Rights and Obligations to the Five Issues

74. The nature of the contractual rights and obligations of the LLPs under the contractual documents is relevant to:

(a) whether the LLPs were trading. Here questions arise as to whether the LLPs owned an asset, the film, which they sold, or whether they laid out monies in return for an income stream; and whether in some way they provided a service or merely invested;

(b) whether the LLPs' activities were undertaken with a view of profit. The LLPs computed their profits on a basis which assumed that they had incurred 100% of the cost of the film, and were entitled to the portion of the distributable income described in the schedule 7 waterfall (without reference to other documents). We call that the "Ingenious basis". Questions arise as to (a) whether on that basis a profit could realistically be expected or hoped for, and (b) whether in fact the LLPs' profit or loss should be computed by reference to expenditure of 30 (35)% of the budgeted cost and a different income entitlement, and, if that was the case, whether that affected whether the LLPs had a view of profit;

(c) whether the LLPs incurred 100% of the cost of the films or a lesser amount;

(d) the legal matrix to which GAAP should be applied to compute the profits or losses of the LLPs; and

(e) finally, whether the nature of the arrangement between the CD and the LLP was a partnership.

2.The Approach to be Taken to Determining the Rights and Obligations and Their Nature

75. As the following discussion of the authorities indicates, the tribunal must undertake a two stage process: it is first necessary to determine what rights and obligations arise under an agreement or suite of agreements, and then necessary to characterise them. In conducting the second step the labels the parties attach are not conclusive.

Ensign Tankers (leasing) Ltd v Stokes [1989] STC 705, [1991] STC 136, [1992] STC 226.

76. The judgements of the High Court, the Court of Appeal and the House of Lords in *Ensign* played a large role in the arguments on a number of the issues in this appeal and we shall return to them later. At this stage it is sufficient to give some of the background, from which it will be seen that there are certain parallels with the LLPs' appeals.

77. This case concerned a film, Escape to Victory, being made by Lorimar[4]. We shall return to the details of the case later but for present purposes the following bare summary is sufficient:

> (a) Ensign became a partner in Victory Partnership, a limited partnership, and together with other partners contributed capital equal to 25% of the budget for the film;
>
> (b) on the same day 16 further documents were entered into involving eight further parties. The most important of these were:
>
> > (a) a loan agreement between Lorimar and Victory Partnership under which Lorimar agreed to lend Victory Partnership 75% of the cost of the film;
> >
> > (b) a production services agreement between Lorimar and Victory Partnership under which Lorimar agreed to complete the making of the film and Victory Partnership agreed to pay Lorimar 25% of the budget immediately and the remaining 75% in stage payments;
> >
> > (c) a distribution agreement between Victory Partnership and two distributors under which the Victory Partnership granted the distributors exclusive distribution rights over the film in return for the gross receipts after deducting distribution fees and expenses.

78. The agreements provided that the loan was to be provided to Victory Partnership in tranches as Victory required the funds to meet the budgeted cost of the film but that those sums be paid into a special restricted bank account of Victory Partnership and on the same day repaid to Lorimar. The payments into the account were described as the making of the loan, and the payments out as the funding of expenditure on the film. The loan was expressed to be repayable only from 75% of the net proceeds of distribution (termed a non-recourse loan). By a letter the distributors were irrevocably directed to pay 75% of the net receipts to Lorimar. Those payments were documented as repayments of the non-recourse loan.

79. (The structure of the LLPs' contracts differs in particular in the fact that in their case the non-recourse loans were made to the CM, not to the LLP).

80. In the House of Lords, Lord Templeman (at page 232D) said:

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[4] (There was another film, Utu, but for present purposes that is not material.)

> "The parties agree that the 17 documents dated 14 July 1980 were interdependent, and constituted one single composite agreement or transaction, which was a tax avoidance scheme and must be read as a whole.
>
> "If the documents constituting the scheme are read as a whole, the rights of Victory Partnership under the scheme are the rights which were and remain vested in Victory Partnership after all documents had been signed. Similarly the obligations of Victory Partnership under the scheme are the obligations which were and remain enforceable against Victory Partnership after all documents had been signed. The financial consequences to Victory Partnership of the scheme are the consequences which flowed from the rights conferred and the obligations imposed on Victory Partnership. The taxation allowances and taxation liabilities of Victory Partnership are the allowances and liabilities which, pursuant to the taxing statutes are applicable to the final financial consequences.
>
> "When all the documents had been entered into, Victory Partnership was subject to an obligation to pay [25% of the budget] to [Lorimar] and subject to an obligation whereby any money paid by Lorimar into the scheme current account was immediately transferred back to [Lorimar]…When all the documents had been entered into, Victory Partnership had a right to 25% of the net receipts from the exploitation of the film."

81. Thus the tax results followed the financial consequences, and the financial consequences followed from the rights and obligations created by the documents and those were to be determined by considering the position under the composite agreement after all the documents had been signed.

82. In the first stage of that process, Lord Templeman describes the obligation of Victory Partnership as being to pay 25%, not 100% of the budget of the film, and its right as being to receive 25% of the net receipts. He thus regarded the legal effect of the agreement as being to remove from Victory Partnership the right to the 75% of the receipts directed to be paid to Lorimar.

83. At a later stage in his judgement he recognises the obligation to pay out of the current account but characterises it as merely an obligation to repay what Lorimar paid in.

84. In *Agnew v Commissioner of Inland Revenue* [2001] UKPC 28, [2001] 2 AC 710, Lord Millett said in relation to whether a charge was fixed or floating:

> "The question is not merely one of construction. In deciding whether a charge is a fixed or a floating charge the court is engaged in a two-stage process. At the first stage it must construe the instrument of charge and seek to gather the intentions of the parties from the language they have used. But the object of this stage is not to discover whether the parties intended to create a fixed or floating charge it. It is to ascertain the nature of the rights and obligations which the parties intended to grant each other in respect of the charged assets. Once these have been ascertained, the court can then embark on the second stage of the

process, which is one of categorisation. This is a matter of law. It does not depend on the intention of the parties."

85. In *Street v Mountford* [1985] AC 809, where the question was whether an agreement gave rise to a tenancy or a licence, Lord Templeman said (819C - G):

> "But the consequences in the law of the agreement, once concluded, can only be determined by consideration of the effect of the agreement. If the agreement satisfied all the requirements of a tenancy, then the agreement produced a tenancy, and the parties cannot alter the effect of the agreement by insisting that they only created a licence."

86. In *Antoniades v Villiers* [1988] 3 WLR 139, Bingham LJ said that the effects of the House of Lords' decision in *Street v Mountford* was that "the true legal nature of the transaction is not to be altered by the description the parties choose to give to it". Likewise in *Re Spectrum Plus* [2005] UKHL 41, where the question was whether a charge was fixed or floating, Lord Scott said at [80]:

> "Nor is there any doubt that the question as to how a particular charge be characterised depends upon the nature of the rights over the charged assets that have been granted to the chargee or reserved to the chargor. The label that the parties have attributed to the charge may have some indication of the rights the parties were intended to have but is not conclusive".
>
> and later: [119] "The nature of the charge depends on the rights of the chargor or chargee respectively over the assets subject to the charge ... and the label placed on the charge by the debenture cannot, in my opinion be prayed in aid to detract from that right."

87. The first stage is therefore to determine what rights and obligations arise under the agreements.

3. The Agreements and the Rights and Obligations Arising

(a) The Agreements in More Detail

88. Each LLP had a Members' Agreement. These were in similar terms for IFP2 and IG; that for ITP was somewhat different. These agreements were made between the founding members of the LLP, who included the CM. They provided for the accession to membership of individual members, capital contributions, and rights in relation to profits and drawing. These agreements were in place before the signing of the suite of agreements for any film undertaken by the LLP.

89. Shortly after the formation of each LLP it entered into an Operators Agreement with an Ingenious group company (the Operator) under which the Operator was appointed to manage and administer the LLP. The Operator agreed to provide promotional, operational, and administrative functions and to find and evaluate films to recommend to the Executive Committee. It was to negotiate the terms of the agreements and to represent the LLP in negotiations and execute agreements on its behalf.

90. In consideration of these services IFP2 agreed to pay 2.81% of aggregate capital contributions, and ITP agreed to pay 4% of each film budget and a success fee when receipts exceeded 105% of a film's budget.

91. The suite of agreements for any particular film or game was entered into at the same time as a single package. They included (clause numbers refer to the *Hot Fuzz* agreements):

(a) A licence of the screenplay by the CD to the LLP.

(b) The CDA. This recited that the CD had commissioned the LLP to make the film or game. It included provisions relating to the specification of the film and its delivery to the CD. It dealt with the relationship between the CD and the LLP in relation to decisions about the film or game. In schedule 7 (the waterfall) the gross receipts from the film were divided up. After the payment of certain expenses and distribution fees the balance, termed (in the IFP2 agreements) the Gross Distributable Income ("GDI"), was divided between the LLP and the CD in proportions which varied with the level of GDI.

(c) The PSA. By this agreement the LLP delegated to the PSC as principal the making of the film in accordance with the specification (mirroring the provisions in the CDA). Payment was to be made to a Production Account in the PSC's name in accordance with an Agreed Budget and an Approved Cash Flow (which phased the receipts of money over the period of the making of the film). The agreement dealt with the delivery of the film and with rights in the film. It included provisions relating to creative control.

(d) A Loan Agreement between the CD and the CM. Under this agreement the CD agreed to make a facility available to the CM "to enable it to make [a] capital contribution to the LLP". By clause 4.1 the loan was to be drawn down in accordance with the Approved Cash Flow, which phased the CD's contributions over several months (11 in the case of *Hot Fuzz*), and was directed to be paid directly to the Production Account (or otherwise as the PSC required).

The amount of the facility was 70% (65%) of the Budget for the film. The loan bore no interest.

In the case of ITP the loan was repayable only from Borrower's Receipts ("BR") which were defined as 50% of the amount which was stated to accrue to the LLP under schedule 7 of the CDA.

In the case of IFP2 the loan was repayable only from "Borrower's Distributable Receipts" ("BDR"). This was defined as a percentage of Borrower's Receipts. That percentage varied, in tandem with the variation of the one of the elements of the CD's share of GDI (the Studio Participation) under schedule 7 of the CDA.

Clause 5.4 provided that the CM could prepay the loan.

(e) A Guarantee Agreement (not present in the case of IG). For a fee a Completion Guarantor (in the case of Studio films a member of the Studio

group) agreed to complete the film if it ran over budget (or to abandon it and return monies to the parties).

(f) A Deed of Acknowledgement, which incorporated a Notice of Assignment and Irrevocable Payment Instruction (the "Deed of Acknowledgment etc."). Each of the Operator, the guarantor, the PSC, the CD and the LLP were parties to the Deed and the CM was the maker of the assignment and payment instruction. Under this combined document monies equal to BDR (BR) which were allocated to the LLP under schedule 7 of the CDA were agreed to be directed to be retained by the CD. It also gave details of the Production Account to which the CD should make payment under the Loan Agreement.

(g) A Pledgeholder agreement in which the film laboratory which held the master negative of the film undertook to hold it for the CD and the guarantor.

(h) Security Agreements under which rights in the film were assigned by way of security.

92. All the agreements for a particular film were entered into on the same day. They cross-refer and are not intended to take effect sequentially. We regard them as a single package to be construed as one composite agreement.

93. The suite of agreements for an Independent film differed somewhat. The documents for *Blackball* were provided to us as an example. Finance for that film came from a number of sources including the Isle of Man DTI, Mel Smith Enterprises ("MSE"), and a sale and leaseback organised by Ingenious. The Isle of Man DTI and MSE lent to the CD, which in turn entered into a loan agreement with the CM. A sales agent was involved as was an independent completion guarantor, Film Finance. Each of the agreements listed above formed part of the suite of agreements for that film but the schedule 7 waterfall provision in the CDA was replaced by a Collection Account Management Agreement. Under that agreement (and others) monies arising from the distribution of the film were to be paid into a collection account whose manager would pay them out – to the LLP and others – in accordance with the waterfall in that agreement (as affected by the terms of the Deed of Acknowledgement etc.).

94. The Appellants contend that the effect of these agreements was that the following monetary obligations and rights were created and satisfied:

(a) Under the CDA the LLP was obliged to fund the production of the film, and under the PSA the LLP had to "advance or cause to be advanced" 100 to the Production Account of the PSC;

(b) The CD was obliged to lend money (70) to the CM;

(c) The CM was obliged to make a capital contribution of 70 to the LLP;

(d) The payment of 70 by the Lender to the Production Account satisfied the Lender's obligation to lend, the CM's obligation to contribute capital of 70, and part of the LLP's obligation to pay 100;

(e) The LLP, having 30 cash from the contributions of ordinary members was obliged to satisfy the remainder of its obligation by paying that cash to the Production Account;

(f) When the CD began to receive monies from the exploitation of the film, the LLP had the right to receive the amounts set out in schedule 7 of the CDA;

(g) When that right arose the CM had a related right to drawings; and

(h) The Lender had a right against the CM for part of those drawings, namely BDR or BR to be retained by it, and the LLP consented to that retention.

95. The Appellants say it would have been inefficient and uncommercial for the parties to insist on these rights being replicated in actual cash flows because there would be banking, exchange and credit costs and risks at each stage They say that such inefficient and uncommercial cash flows were therefore "short-circuited" by the Deed of Acknowledgement etc., which provided that the funds advanced to the CM under the loan (70) should be paid to the Production Account at the same time as the LLP paid the balance (30) to the same account, and that the CD should retain BDR (BR). These short-circuit payments they say fulfil obligations and crystallise rights for all parties. They say that:

(a) for the Lender, its payment of 70 to the Production Account satisfies its obligation to advance funds under the loan agreement and that as a result the Lender becomes entitled to retain Borrower's Distributable Receipts (BR);

(b) for the CM, the Lender's payment of 70 into the Production Account "satisfies the CMs obligation to contribute capital to the LLP" and as a result the CM becomes entitled to (i) repayment of its capital contribution on a winding up and (ii) distributions or drawings out of the LLP representing the agreed share of gross receipts[5] ;

(c) for the LLP, the payment of 70 by the Lender to the Production Account: (i) causes the LLP's obligation to contribute 100% to the PSC to become unconditional because it amounts to the advance of the CM loan on which its obligation to pay the PSC was contingent; (ii) discharges its obligation as to 70 and crystallises its obligation to pay the remaining 30; and (iii) crystallises lasting obligations up the chain from the PSC to the LLP to produce the film, from the LLP to the CM and from the CM to the Lender; and (iv) leaves the LLP entitled to its payments under the schedule 7 waterfall;

(d) for the PSC, the payments (of 70 and 30) satisfy the LLP's obligation to advance production funding and therefore crystallise its obligations to make and deliver the film.

96. Overall therefore they say the Deed of Acknowledgement etc. fulfils, rather than removes, the LLP's obligation under the PSA to pay the full price of 100 to the PSC and crystallises the rights of the LLP under the PSA which were contingent on that payment. Each document has the legal effect it is intended to have just as it would

[5] But as we note later it does not seem to us to be the case that the CM's rights to drawings or on a winding up are affected by or related to whether or not it has made a capital contribution.

have had had the payment obligations under each contract been discharged in sequence rather than through the payment instructions.

97. For the reasons which follow in more detail below in paragraphs 101- 232 we do not accept this analysis. In our judgement the legal effects of the agreements are as follows.

(b) Capital Contributions and Membership Rights under the LLP Members' Agreement

98. The questions of whether the CM had a liability to contribute capital, and whether the payment of 70 (65) by the Lender to the LLP constituted the contribution of capital for the purposes of the Members' Agreements are particularly relevant in relation to our discussion of Expenditure in Chapter IX and GAAP in Chapter X. Mr Gammie says that as a matter of general principle a capital contribution must be something that serves to increase the asset base of the LLP.

99. The LLP Members' Agreements were amended and re-stated at various times. Those referred to below are those we understood to be in effect by the end of the relevant LLP's first year.

100. The CM was a party to, and acquired membership rights in, and obligations to, the LLP on the making of the LLP agreement. An individual member acquired membership rights under the LLP agreement on subscribing to the LLP and being accepted.

101. Each *individual* member's capital contributions affect his or her share of the profits and drawings allocated to him or her and rights on a winding up. The CM's capital contribution has no effect on such matters (other than in relation to capital gains and the quantum of allocation of losses): neither the amount nor the existence of such capital affects the CM's right to drawings under the Members' Agreement (see below). Nor does the amount of any CM's "contribution" which may be treated as made as a result of the relevant agreements affect its rights on the winding up of the LLP (see below).

102. The provisions in relation to contributions by the CM differ between the ITP agreement and those for IFP2 and IG.

(i) The ITP Members' Agreement

103. "Ordinary Members" are defined to mean individual members and the CM. The agreement defines a member's "Contribution" as "any money paid into the account of or transferred to the ownership of the LLP by an Ordinary Member". It provides that it is to be credited to his capital account. Thus, prima facie, Contributions are limited to monies paid or transferred directly to the LLP.

104. There is no express requirement in the agreement for the CM to make a contribution, but clause 2.3 provides that no investment shall be made in any film unless the Operator is satisfied:

"that the [CM] has entered into contractually binding commitments such that the [CM] will finance its agreed Contribution in respect of that film" in accordance with the agreed cash flow and budget.

105. One construction of this is that the CM's "Contribution" means a contribution to the cost of the film, not a contribution to the capital of the LLP, and accordingly that the CM's contribution to the film, however made, is not a contribution to the LLP. That would be consistent with the definition of "Contribution" in the LLP agreement as limited to money "paid or transferred to the ownership" of the LLP, and would be supported by clause 11.10(f) of the Members' Agreement, which requires a supermajority of individual members to alter any provision of the agreement.

106. The alternative argument it is that the capitalised "Contribution" in clause 2.3 of the Members Agreement indicates that its contribution to the budget of the film would be treated as a capital contribution to the LLP.

107. On the second construction the Loan Agreement between the CD and the CM (of which the Operator plainly had knowledge) may be regarded as evidence that, in relation to a particular film, the Operator could be satisfied as required in clause 2.3 of the Members' Agreement. That is because it recites that the CM "has agreed" to make a contribution to be utilised for the film, and therefore is evidence of an "agreed" contribution, and it is a contractually binding agreement which could be regarded as being "such that" the contribution would be financed.

108. However, whichever construction is adopted, there is no provision in the ITP Members' Agreement requiring the CM to make a contribution. Any agreement by the CM to make and for the LLP to accept a contribution could only have arisen on signing the suite of agreements for the film and therefore cannot be regarded as a pre-existing obligation of the CM which was changed or satisfied by those agreements. And there is no provision by virtue of which any sum due to be paid pursuant to the loan agreement becomes a capital contribution before it is actually paid.

(ii) The IFP2 and IG Members' Agreements

109. "Capital Contributions" are defined in the Agreement as "money contributed" to the LLP as capital by Ordinary Members. Ordinary Members in these agreements are defined to *exclude* the CM. Ordinary Members become such on application and paying their capital contribution; the CM became a member on the making of the agreement.

110. Having defined Capital Contributions by reference only to Ordinary (individual) Members only, the Agreement then provides in clauses 8.3 and 8.4 that:

(a) The CM is entitled to make Capital Contributions at its discretion, but they may not exceed the aggregate of the Ordinary Members' capital contributions (Cl 8.3).

(b) If at any time the Operator issues a written demand or if a winding up order is made, the CM becomes obliged to "pay" by way of Additional

Corporate Member's Contribution[6] an amount equal to the excess of the aggregate of the ordinary members' capital contributions over the CM's Capital Contributions at that time (Cl 8.4).

111. We asked the Appellants if the Operator had made such a demand. Mr Milne told us that they did not believe that one had. We conclude that none was made. A winding up order had not been made at any relevant time. As a result we find that no liability to contribute arose under clause 8.3 or 8.4. As a result any contribution to capital was purely voluntary. The CM had no obligation to contribute.

112. We also note that the definition of "contribution" as "money contributed" by individual members, which, although applicable only to individual members, suggests that a contribution otherwise than in cash to the LLP was not intended to be a contribution. If that is right then a variation of the Agreement would have been required to permit it to have been so made.

113. There is nothing in the *Members' Agreements* which provides that a payment to the PSC by the Lender is to be treated as a (voluntary) contribution of capital by the CM or as satisfying an obligation created by an Operator's notice, had one been given, for the CM to contribute capital or make payment. However, as was the case for ITP:

(a) in the Loan Agreement (between the Lender and the CM) the recitals contain a statement that the loan is made to enable the CM to make a capital contribution to the LLP (and clause 4.1 provides that "The [CM] hereby irrevocably directs the Lender that all sums drawn down by the Borrower shall be paid to the Production Account for the film)", and

(b) recital (B) to the CDA (between the LLP and the CD) is a statement that the CD has agreed to make the loan to enable the CM capital contribution.

114. We conclude that the parties to those agreements intended that a payment by the Lender to the Production Account would be treated as a (voluntary) capital contribution by the CM, but did not make any express provision in the agreements to that effect. Further, whether or not that payment would be so treated by the LLP was governed by the pre-existing provisions of the Members' Agreements, which as we have noted may have required amendment to have that effect. Although it was possible for the CM to agree with the LLP to renounce rights under the Members' Agreement (as we conclude it did in relation to drawings) it was not possible for an agreement between the LLP and the CM to amend the Members' Agreement so as to create rights in the LLP in the CM's favour. We proceed on the basis that the LLP agreed to recognise some form of capital contribution from the CM as a result of the CD's payment. We shall investigate the legal rights and obligations which arose as a result of such recognition later in this section.

[6] The ITP Members agreement restricts the concept of Capital Contribution to that of an ordinary member.

(iii) ITP: Rights Arising as a Result of Making a Capital Contribution

115. Clause 8.1 of the Members' Agreement requires the amount of any member's capital contribution to be credited to his capital account. That of itself imposes no economic obligation on the LLP.

116. The making of a capital contribution by the CM does not affect its rights on a winding up. That is because clause 19.4 of the ITP Members' Agreement provides that any surplus on a winding up shall be "payable to the Individual Members pro rata to their respective Contributions". Nothing is due to the CM.

117. In heading *(f)* below we discuss the CM's entitlement to drawings. The provisions set out there make clear that the CM's entitlement to drawings under the ITP Members' Agreement is unaffected by whether or not it has made a capital contribution or the amount of such a contribution.

118. Thus even if by virtue of the relevant agreements the CM is to be treated as having made some form of "capital contribution" to the LLP, that had no effect on its rights under the ITP LLP agreement (other than the administrative crediting of any contribution to the CM's capital account).

(iv) IFP2 and IG: Rights Arising as a Result of Making a Capital Contribution

119. Clause 8.3 of the Members' Agreement requires the amount of the CM's capital contribution to be credited to its capital account. On its own that imposes no economic right on the CM or obligation on the LLP unless the agreement specifies an effect of such a balance being so credited. For the following reasons it seems that it does not.

120. Clause 22 of the IFP2 Members' Agreement deals with rights on a winding up. Clause 22.1 provides for the application of any surplus first to individual members in respect of and up to part of their capital contributions, then to the CM in respect of its "Additional Corporate Member's Contribution", then for interest on part of the individual members' capital contribution, then to the CM up to part of the balance of its "Capital Contributions", then for interest on part of the CM's Capital Contribution and then as to any balance equally between the individual members and the CM.

121. But clause 22.2 provides that for the purposes of clause 22:

> "Capital Contributions shall be treated as made only when the amount of such Capital Contribution is actually received in freely transferable funds by the [LLP]."

It is clear to us that the LLPs never received any monies in from the CM "in freely transferable funds". Thus the monies paid by the CD to the PSC did not give rise to a Capital Contribution for the purposes of clause 22.

122. As noted earlier, "Additional Corporate Member's Contribution" is defined in clause 8.4 of the agreement to mean the sums the CM undertakes to pay on 14 days'

notice from the Operator (which notice was not given) or on the winding up of the LLP by way of:

> "capital contribution…equal to any difference between the aggregate Capital Contributions made by the [CM] (including for the avoidance of doubt any payment made under this clause 8.4) and the aggregate Capital Contributions made and committed by the [individual] members".

123. Not only does the drafting of this clause and clause 22 suggest that an Additional Corporate Member's Contribution must be a Capital Contribution and so not relevant for the purposes of clause 22.1 unless received in freely transferrable funds, but no notice was given by the Operator requiring any contribution and there was no winding up in prospect.

124. Thus any capital contribution treated as made as a result of the agreements would not be an Additional Corporate Member's Contribution or a Capital Contribution, and, as a result, would have no effect of the CM's *rights* on a winding up.

125. We note that if the CM was properly to be treated as having made a capital contribution by virtue of the relevant agreements together with the CD's payment, then IFP2 lost *pro tanto* the right to call for an Additional Corporate Member's Contribution. But an Additional Corporate Member's Contribution made in freely transferable funds carried with it the right to a distribution on the winding up of the LLP, whereas a capital contribution treated as made pursuant to the relevant agreement did not because it was not so made. Thus any loss of the right to call for an Additional Corporate Member's Contribution by virtue of the recognition of a capital contribution by the CM carried with it the loss to the extent of that contribution of the LLP's contingent liability to the CM on winding up.

126. In heading *(e)* below we discuss the CM's entitlement to drawings. The provisions set out there make clear that the CM's entitlement to drawings under the IFP2 or IG Members' Agreement was unaffected by whether or not it has made a capital contribution or the amount of such a contribution.

127. In the IFP2 Members' Agreement losses may to be allocated to the CM up to the amount of 90% of its Capital Contribution. Thus the amount of any Capital Contribution it has made will affect the amount of losses which can be allocated to it. But the making or amount of any capital contribution does not thereby confer any right on the CM. (Any right to the allocation of profit flowing only from a previous allocation of losses or the 50:50 provision after losses have been compensated.)

128. Thus, as is the case for ITP, even if the effect of the relevant agreement was that the CM was to be treated as having made something called a "capital contribution" that had no effect on its rights under the IFP2 or IG Members' Agreements (other than the right to have an accounting entry made in its capital account).

(c) Obligation of the LLP to Pay the PSC

129. In this discussion we refer to the terms of the *Hot Fuzz* suite of agreements. We understood that the agreements for other films had materially similar terms. In particular the suite of agreements for Independent films was somewhat different and some of the differences are noted in the discussion which follows; but those we saw contained terms with the same import as those described below.

130. The PSA has three clauses which relate to payment to the PSC:

(a) clause 3.1 provides that, subject to:

(a) other provisions of the agreement,

(b) the receipt by the CM of funding under the Loan Agreement, and

(c) the opening of the Production Account,

the LLP shall "advance or cause to be advanced the Production Funds to the Production Account"[7]. It will be recalled that the Loan Agreement requires the Lender to pay 70 to the Production Account;

(b) clause 3.2 provides that the LLP shall "pay or cause to be paid the Production Funds" (the 100) to the Production Account or such other account notified by the Guarantor, and that an LLP nominee shall be a signatory to that account;

(c) Clause 3.5, is headed "Initial Funding".

(a) In the ITP agreements (*Wimbledon*) it provides that the LLP "will pay a sum equal to [35] ("the Initial Funding") into the Production Account", (and to the extent not immediately used interest on the unused portion of the Initial Funding will be paid to the LLP).

(b) In the IFP2 agreement it provides that so long as the PSC has delivered to the LLP:

"…evidence that the [Lender] has advanced a sum equal to …70%... of the Production Funds to the Production Account[8]…",

the LLP will pay a sum equal to 30% of the Production Funds ("the Initial Funding") to the Production Account in accordance with the Agreed Cash Flow.

In this context paragraph E of the Deed of Acknowledgment etc. provides that if the Guarantor abandons the Film the Abandonment amount (the unused funding) must be paid to the LLP up to the Initial Funding, and the balance to the Lender.

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[7] The Independent film Wimbledon's PSA did not have condition (c) and condition (b) was phrased "subject to the receipt of funding under the Loan Agreement". The Wimbledon Loan Agreement is between the CM and the CD and the LLP is not a party; it directs payment by the CD directly to the PSC. It seems clear to us that the "receipt of funding" referred to in the Wimbledon condition (b) must have the same meaning as condition (b) in the Hot Fuzz Agreement.

[8] [for which purpose the Lender shall be deemed to have advanced the amount shown in the budget as overhead]

131. Clause 4.1 of the Loan Agreement deals with the drawing down of the loan. It includes the following provisions:

> "The Facility shall be drawn down in accordance with the Approved Cash Flow upon satisfaction of the conditions precedent."
>
> "The [CM]… directs the Lender that all sums drawn down …shall be paid to the Production Account."

132. And, for good measure, by the payment instructions in the Deed of Acknowledgment etc., the Lender is instructed to pay the proceeds of the loan "in accordance with the… Approved Cash Flow" to the Production Account of the PSC.

133. On its own clause 3.1 might appear to create a contingent obligation for the LLP to pay or procure the payment of the full amount of the Production Funds (100) to the PSC. But the contingency is the receipt of funding by the CM under the Loan Agreement and that agreement expressly provides for such funding to be advanced by payment to the Production Account. Thus the obligation in clause 3.1 arises only if 70 (65) has been paid to the Production Account by the Lender. As a result this clause cannot oblige the LLP to pay more than 30 (35).[9]

134. Furthermore, in the case of IFP2 clause 3.5 makes plain that the LLP's obligation to pay (rather than to procure payment) is dependent on the Lender having paid 70 (65), and is to pay only 30 (35). Reading 3.1 and 3.5 together the obligation undertaken by the LLP is to pay (as opposed to procure payment of) only 30. And in the case of ITP imposes an obligation to pay 35 only.

135. It does not seem to us that clause 3.2 of the PSA creates a free-standing and absolute obligation on the LLP to pay, or procure the payment of, the full amount of the Production Funds to the LLP. That clause must be read in context. It deals with the administration of the account or its substitution by another: its purpose is administrative. It falls after clause 3.1 which makes any obligation to pay or cause payment contingent. In our judgement that contingency is applicable to the obligations under clause 3.2.

136. This of course leaves the question as to whether the LLP has an obligation to procure the payment of the 70 (65). If there is such an obligation it must flow from 3.1 or 3.2 (because 3.5 deals only with the obligation to pay 30 (35)). But clause 3.1 makes any such obligation contingent on the receipt of funding by the CM. The PSA acknowledges in the definitions clause the provisions of the loan agreement and the Deed of Acknowledgement etc. Clause 3.1 (and 3.2) must be seen, in the light of the provisions of those agreements, to mean that any receipt of funding under the loan agreement could and would only be by payment by the Lender to the Production Account. Thus any obligation to procure payment of the 70 (65) could arise only after

[9] Clause 3.2 makes it a condition to drawdown that the LLP is not *in breach* of its obligation to pay the Initial Funding. But that obligation arises only once the loan has been made. Thus clause 3.2 does not affect the conclusions above.

that 70 had actually been paid by the Lender to the PSC because it is only then that funding would have been received by the CM under the loan agreement. Such an obligation does not seem to us to be capable of being described as an obligation of the LLP to procure payment of 70 (65).

137. These propositions may be tested thus: suppose the Lender did not pay the 70 and the LLP did nothing to try to procure the receipt of 70 by the PSC. What action could be taken against the LLP? The answer is none because it is not required to do anything under clause 3.1 until the Lender has made payment.

138. That conclusion is reinforced by the rights created to repayment in the case of the abandonment of the film. The LLP is entitled to receive only the Initial Funding – the 30% (35%).

139. Finally we should say that whilst we accept that under clause 4.1 of the CDA the LLP agrees to procure the making and delivery of the film, we note that under clause 16 of that agreement the LLP is absolved from all liability which arises as a result of a failure to comply with the agreement as the result of a failure of the CD to comply with the provisions of the loan agreement. Thus the CDA does not provide a back door obligation on the LLP to pay 100.

140. Mr Milne's criticism of this analysis in his cross-examination of Mr Cannon relied on the proposition that the LLP was obliged to transfer the full 100 to the PSC and that its obligation was satisfied by the procurement, through the Irrevocable Payment and Assignment, of the payment of 70 directly to the PSC, and that that payment resulted in a cost to the LLP by reason of the corresponding reduction in the amount of the debtor representing the CM's unpaid capital.

141. We reject that analysis for four reasons. First, there never was an obligation to transfer 100. There was never an obligation which was later satisfied: it all happened at the same time. The rights and obligations which arise under the relevant agreements lie in the difference between the legal position of the parties immediately before and immediately after the agreements were executed, not on what is expressed in the agreement to make up those obligations or how they are described by the parties.

142. Second, as we have concluded above, the CM did not have an obligation to make a capital contribution. In the case of ITP there was not even any express discretion conferred on the CM to make such a contribution. Thus the CM never became a debtor, and so it cannot be said that a cost to the LLP arose as a result of the reduction of the debt.

143. Third, even if the CM is to be treated as contributing capital of 70, the capital would be subscribed only when the CD pays 70 to the PSC.

144. Fourth, even if GAAP required the recognition of a debtor from the CM the question of whether any reduction of that debtor gave rise to a cost or an expense relates to the financial consequences of, and the accounting for, the transaction, not the determination of the rights and liabilities which arose under the documents. That

accounting will depend in part on the legal rights and obligations. They are the starting point. We address the accounting effects later.

145. Finally we note that the provisions of clause 4.1 of the Loan Agreement (see [129] above) do not sit well alongside clause 3.5 of the IFP2 PSA. That clause subjects the LLP to an obligation to pay 30 only when the full 70 has been received by the PSC from the Lender. i.e. only when the PSC has delivered:

> " (d) evidence that the [Lender] has advanced a sum equal to seventy per cent (70%) of the Production Funds into the Production Account",

but under the Loan Agreement the Lender is required to make payments only as required by the Approved Cash Flow. That phases payment over many months. If the loan was drawn down in this manner it would not be until the film had incurred at least 70% of its costs that the LLP would be obliged by clause 3.5 to make the Initial Funding payment of 30.

(d) Rights in Relation to Receipts from the Films or Games

146. The relevant provisions are the following:

147. Clause 11 of the CDA provides that the CD shall pay the LLP the entitlement to Gross Receipts set out in schedule 7. The CDA provides for the CD to pay the amount of the Gross Receipts determined by schedule 7 "to or at the direction of" the LLP.

148. The allocations in schedule 7 make reference to the Loan Agreement, in particular paragraph I(I) provides:

> "Until repayment in full of the [CM loan] from the sums directed to the Studio by the CM pursuant to the payment instruction agreed between the [CM, the LLP and the CD], the [CD] shall pay…100% of the remaining Gross Receipts to or at the direction of [the LLP]."

149. The "Irrevocable Payment Instructions" referred to in that paragraph of schedule 7 to the CDA are annexed to the IFP2 Deed of Acknowledgement and provide that "Partnership Receipts (defined as amounts to which the LLP is entitled under the CDA) shall, until the loan… has been repaid in full …be paid…as to an amount equal to Borrower's Distributable Receipts… at the direction of the CM and as to the balance to the [LLP's bank account]". The ITP instructions refer to BR but are otherwise the same.

150. The "Irrevocable" Payment Instructions are given effect in the Notice of Assignment in which the CM gives notice to the LLP (copying the CD) that the CM has assigned "its right title and interest in the Borrower's Distributable Receipts" to the Lender "by way of security", and gives "irrevocable" authority to the LLP to "pay the Borrower's Distributable Receipts in accordance with the Payment Instruction".

151. The Deed of Acknowledgement is from the LLP and the Operator to, *inter alia*, the Lender, the CD and the PSC. In it the LLP:

(a) acknowledges the notice of assignment and undertakes to comply with it,

(b) consents to the assignment of the right to receive BDR (BR in the case of ITP) to the Lender and agrees that the Lender is "now entitled to receive" BDR "*in place of the corporate member*",

(c) "irrevocably" instructs the CD to make all distribution payments under clause 11 of the CDA in accordance with the payment instructions,

(d) makes provision for the repayment of the Initial Funding if the Guarantor abandons the film.

The Deed includes the agreement of the Lender and PSC to this arrangement.

152. A cursory reader of the relevant agreements might conclude that the LLP is first given an entitlement to 100% of the remaining Gross Receipts and that it then directs that part of its entitlement is to be paid to the Lender: indeed the documents themselves encourage that conclusion.

153. But such a reading is dependent on an assumption that the agreements be read as taking effect sequentially with a pause between each, so that rights might accrue and then be alienated. That assumption, however, is not justified: the agreements were made as part of a package, they were executed on the same day, they refer to each other as agreements which have been made – thus for example, clause I(I) of schedule 7 of the CDA expressly acknowledges the existence of the payment instructions and therefore evidences that they were contemporaneous with, or preceded, the CDA.

154. The documents must be read as coming into force together and must be read together. Reading the documents together, the effect of their payment provisions is that, from the time of execution of the documents, the Lender and not the LLP is entitled, together with any other entitlement under the CDA, to retain that portion of the receipts equal to BDR (BR) and the LLP entitled to receive the balance, and that there was never a time when the LLP was entitled to receive more.

155. In this context the provision in the Deed of Acknowledgement etc. that the Lender is "now" entitled to receive BDR "in place of" the CM is properly seen as describing the only entitlement which arises or arose under the agreements rather than as being the record of a change in existing entitlements.

156. The CD and the LLP are parties to the Deed and the CD expresses agreement to it. It is clear that it varies the rights and obligations which the parties would otherwise have had under the CDA alone. It does not do this *after* those rights have arisen, but as part of the composite agreement *by which they arise*.

157. In our judgement the effect of the Deed of Acknowledgement etc. and the CDA is that the only payment right the LLP acquires under the suite of documents is the right to the payment of the balance of GDI after deducting the amount of BDR (BR). Together these documents confer no right on the LLP to receive the amounts in schedule 7 without deducting the amount of BDR (BR). The LLP could not, after the coming into effect of these documents, compel the payment to it of schedule 7

amounts without the deduction of BDR (BR); and the Lender could resist any action to prevent it retaining BDR (BR).

158. The assignment by the CM of BDR (BR) is expressed to be "by way of security". That does not in our view alter the effect of the agreements. That is for the following reasons:

(a) For reasons we discuss below it was not clear that the CM has a pre-existing right to drawings to assign in whole or part, or that if it had a right to drawings that right would be to an amount which equals or exceeds BDR (BR). The purported assignment was, to that extent at least, not an assignment of a right of the CD by way of security or at all, and can only have been an assent by the LLP to the method of computation of its right to receipt from the CD;

(b) The assent and agreement of all the other parties to the Deed indicate that they are agreeing to an alteration in what would otherwise be the rights to the receipt or retention of monies had schedule 7 not been part of the composite agreement, and, if the CM does not have any right to drawings which it can assign, that agreement of itself gives effect to the alteration, not the purported assignment;

(c) The Loan Agreement provides that the CM has to repay "to the extent it becomes entitled to BDR", and that the CM's entitlement be "assigned by way of security…to be applied in repayment of the loan". The application in repayment of the loan is not 'security' for payment, it is payment. Even taking the assignment to be a security to pay the very amounts which arise under it, when a calculation is done and an amount notionally due to the LLP is arrived at, unless the security has been terminated, the amount thereof representing BDR belongs (or continues to belong) thenceforth to the CD/Lender.

(d) Even if the CM did have a right to an identifiable portion of the LLP's income from a film as drawings, and even if that portion would always be more than BDR (BR), there is simply no way in which the right of the CD/Lender to retain an amount equal to BDR (BR) can be unwound at the election of the CM. The notice of assignment provides that the instructions cannot be revoked without the consent of the CD. In the Deed the LLP undertakes to the CD/Lender, the guarantor and the PSC to comply with the "irrevocable" instruction and gives its "irrevocable" authority for payment to be made according to Appendix 1. It provides that the CD/Lender "is now entitled to receive" BDR. Appendix 1 says in paragraph 1 that BDR is to be paid at the direction of the CM but in paragraph 3 says that such amounts "shall be retained" by the CD. The Deed of Acknowledgement etc. affects, not just the position of the CM, but the rights and obligations of the LLP and the CD.

(e) In *Ensign* the loan from Lorimar was expressed to be repayable from 75% of the proceeds of distribution of the film. Victory directed the distributor to pay that 75% directly to Lorimar and required the distributor to grant security over the rights granted to Victory under the distribution agreement. Lord Templeman described Victory as being entitled to 25% of the distribution proceeds.

159. Mr Milne says that it is wrong to regard the rights of the LLPs as limited to the receipt of 30% (35%) of GDI and their obligations as limited to being obliged to pay 30% (35%) of budget. He advances a number of reasons.

160. *First* he suggests that in *Ensign* Lord Templeman was applying a *Ramsay* analysis: that in effect he was applying a special tax world description of rights and liabilities. So that when he spoke of Victory's right to 25% of the net receipts he did not refer to a contractual right enforceable in the courts.

161. We do not agree. Lord Templeman reads the agreements as a composite, but that is not the application of a special regime. Not only do later decisions emphasise that the *Ramsay* doctrine is one of general effect (and prevents tax lying on an island of its own) but cases such as *Anthoniades v Villiers* where Lord Templeman said "the two agreements were interdependent. Both would have been signed or neither. The two agreements must therefore be read together" show that analysing a set of agreements to determine the rights and obligations which arise from them as a composite is a general and proper approach.

162. *Second*, Mr Milne says that if an agreement provides for A to pay B £10 and for B to pay A £7 and for settlement to be a net £3, there is nothing objectionable in regarding the agreement as creating only an obligation on A to pay £3 and a right of B to receive £3. But if there are more than two parties and if the effects are not just ephemeral then such a simple approach is not possible. As a matter of general law one does not collapse and integrate contracts if there are a number of parties. Here the CM became liable under the loan. The loan was recognised in the accounts of the CM. It was not ephemeral. The making of the loan triggered the LLP's obligation to pay, and the making of the loan had permanent consequences for the CM. Here the arrangements went round four sides of a square and the obligations at each stage were permanent obligations reflected, in particular, in the accounts of the CM.

163. In the same vein he says that in *Ensign* Lord Templeman was dealing with an arrangement between two parties, Victory and Lorimar, and that the same analysis is not appropriate for an agreement which involves more than two.

164. We do not find this convincing. The question is: what rights and obligations were created by the agreements? When the dust had settled who was obliged to do what and who had what rights? When there are more than two parties involved each may be left with some right or obligation and that right or obligation may have permanent effects, but until the remaining rights and obligations have been isolated those effects cannot be determined. The permanent effects do not determine the rights and obligations, they are their consequences.

165. Nor is Lord Templeman's analysis in *Ensign* restricted to that between two parties. When he said: "When all the documents had been entered into, Victory Partnership had a right to 25% of the net receipts from the exploitation of the film", that related to the position of the distributor, Lorimar and Victory Partnership. Mr Milne says that that might be possible if you had an ephemeral situation but here we

have the loan and the CM's subscription to the LLP and those elements do not disappear.

166. The effect of the relevant agreements was that if the CD paid the 70% (65%) to the PSC the CM became liable to the CD under the terms of the loan agreement (in so far as that can be called a liability). Whether that was a loan to the CM is a question of categorisation; the first step is to determine liability. Whether that liability is to be called a loan, and whether or not it has permanent effects on the CM does not affect the determination (not characterisation) of other rights and obligations under the agreements.

167. *Third*, Mr Milne says that in relation to receipts under the waterfall, the legal obligation of the CD is to pay 100% to the LLP and part of that is applied by the partnership for the benefit of the CM to repay its loan.

168. This to our minds is to try to determine the rights and obligations by reference to a narrative rather than to look at the obligations and rights created by the terms of the agreements. By the Deed of Acknowledgement etc. the LLP did not give away something it had, but agreed that it would *ab initio* be entitled to less. Treating the LLP as renouncing a right to the CM requires the prior conclusion that it had that right. That would be the case only if the right to 100% existed before the making of the Deed. But it did not. The LLP never had the right to receive 100% because the agreements read together did not give it that right.

169. The LLP may have had the right to enforce payment of BDR to the Lender. That would have been possible where the Lender was not the CD, although in all the Studio cases they were the same person. Logically, where the Lender and the CD were the same person, there can have been no right to enforce payment to the Lender. It may also be that the LLP had the right to require the Lender to treat the CM loan as reduced by the portion of GDI to be paid to or retained by the Lender. But neither of such rights are a right to receive payment or value.

170. *Fourth* he says that the irrevocable payment instruction did not affect the right of the LLP to 100%. It is common for lenders to direct that funds are transferred directly to where they are ultimately to be deployed. Such payment instructions do not replace the contractual steps which they fulfil. He relies on Lord Millett in *Peterson v CIR* [2005] STC 448.

171. In *Peterson* the taxpayers had paid $*x+y* under a production contract to make a film. $*x* was funded by the taxpayers out of their own resources and $*y* from a non-recourse loan made by a lender connected with the production company. Unbeknown to the investors on receipt of $*x+y* the production company immediately recycled $*y* to the lender and used only $*x* to make the film. The only issue before the Privy Council was whether the deduction of $*x+y* claimed by the taxpayers could be disallowed under the provisions of an anti-avoidance section of the New Zealand law.

172. Lord Millett, who gave the opinion of the majority, said that the taxpayers were induced to enter into the arrangement by tax advantages which arose from two

features of the arrangement which were not uncommon in commercial financing, one was obtaining depreciation allowances and the other was to fund the investment with non-recourse loans which increased the amount of the tax allowances. He described a non-recourse loan as a "loan made on terms that the borrower has no personal liability to repay it." ([14]). He continued:

> "[15] Borrowed money belongs to the borrower not lender, and this is so whether the borrower incurs a personal liability to make repayment or not. Depreciation allowances depend upon the taxpayer having incurred the cost of acquiring an asset, not his liability to repay the lender. It does not matter how he came by the money to acquire the asset ..."

173. And later:

> "[44] The leverage obtained by the use of a non-recourse loan meant that the investors did not sustain an economic loss after the tax deduction is taken into account [this was a potentially objectionable feature of the scheme] ... the fact that the investment was funded by a non-recourse loan did not alter the fact that the investors had suffered the economic burden of paying the full amount of $\$x+y$. It was not and could not be suggested that either loan was on terms which meant that it was unlikely ever to be repaid. The investors have repaid one of the loans in whole or in part, albeit out of the film receipts ...
>
> [45] The circular movement of money sometimes conceals the fact that there is no underlying activity at all. But each of the payments in the circle must be examined in turn to see whether it discharged a genuine liability of the party making the payment. It does not matter whether external funds were introduced into the circle or whether cheques were handed over and duly honoured. If the money movements did not discharge a genuine liability the introduction of external funds will not save it; if they did, their absence will not affect it. ... subsequent payments in a circle in which the investors were unaware and which they could not control did not alter the fact that they had borrowed y dollars and used it towards the discharge of their liability to the production company, thereby suffering the loss or incurring the relevant expenditure."

174. He then noted that the New Zealand Board had conceded that the $\$x+y$ was paid as consideration for the making of the film.

175. Lord Bingham and Lord Scott delivered a trenchant dissenting opinion in the course of which they disputed that the $\$y$ represented the discharge of "genuine liability".

176. Mr Milne relied upon [45] in particular as confirming that cash flow was irrelevant. What mattered was whether there was a genuine liability. In the present case he says that the loan to the CM was a real loan which created a real obligation to repay.

177. We found little help in *Peterson*. In relation to the question whether the LLP had a liability to pay 100, Lord Millett says that cash flow is not determinative and what matters is whether or not there is a genuine liability. Our conclusion is that there

was not a genuine liability of 100 because the LLP, under the terms of the agreements was never obliged to pay any more than 30, and never became obliged to suffer the cost of paying more than 30.

178. *Fifth*, Mr Milne says that if, for example, he had agreed a fee of £1,000 with HMRC for his professional services and he directed HMRC to pay £700 of that fee to, say, Mr Cannon in satisfaction of a debt he owed Mr Cannon, no one would say that Mr Milne's professional income should not include £700 of that £1,000.

179. But that example addresses a different question, namely, what is the extent of Mr Milne's income. The first question is what right does Mr Milne have to compel HMRC to pay him the £700? And the answer is none (assuming the assignment was properly executed). In the later computation of his income he might well regard the extinguishment of his debt to Mr Cannon as income.

180. *Sixth*, he gave the example of a house-buying transaction where a bank advances a loan to a purchaser and short circuits payment to the buyer followed by his payment to his solicitor followed by payment to the seller, by making payment directly to the buyer's solicitor or perhaps even directly to the seller. He says that there is no doubt that the buyer has a liability for the purchase price of the house and after the advance of the funds a liability to the bank. But to our minds: (i) the agreements in this appeal are different: the LLP is obliged to pay only when the CD has paid the PSC; in an ordinary conveyancing transaction the buyer's obligation would not be so constrained; (ii) in the case of the house purchase, the agreement for the mortgage will create a debt due to the bank from the buyer when the money is paid; in the agreements in the appeals the only obligation which arises to the LLP is in some way to recognise a capital contribution from the CM. The issue is: what were the legal rights and obligations created by these particular agreements?

(e) Rights in Relation to a Film

181. The following provisions of the CDA (*Hot Fuzz*) are relevant:

(a) Clause 2.1 provides that from the Delivery Date (when the film is finished) the LLP assigns to the CD all its rights in the film. It says that, subject to the licence in clause 2.7, nothing in clause 2 shall vest rights in the film in the CD before the Delivery Date.

(b) By clause 2.4 an undated executed assignment is to be delivered by the LLP to the CD to have the delivery date inserted by the CD to give effect to 2.1.

(c) Clause 2.5 provides for a back up option for the CD to acquire the rights in the film if a court declares the assignment ineffective, (and the LLP acknowledges that specific performance would be an appropriate remedy if the option is not complied with).

(d) Clause 2.6 makes Clause 2 subject to the Reserved Copyright under the PSA and provides that the rights to that copyright transfer to the CD only when they move to the LLP from the PSC. (The Reserved Copyright is 5% of the copyright in the film, which under the PSA is reserved by the PSC from the

assignment of all present and future copyright in the film to the LLP until the completion of the film when it is "assigned to [the LLP] simultaneously with and included within [the LLP's] assignment of the copyright to the [CD]").

(e) By clause 2.7 the LLP grants to the CD an exclusive and irrevocable licence of the rights in the film in perpetuity or until the date of the assignment (subject to the LLP's right to produce, complete and deliver the film under the agreement). The carve out of the right to produce and deliver the film indicated that the licence was intended to exclude the LLP from using the film rights as well as prohibiting its granting such rights to others.

(f) Clause 6.3 gives the CD exclusive control over the distribution and marketing of the film; and clause 6.4 gives it the exclusive right to gross receipts, although it has to pay the LLP under the waterfall.

(g) In the warranties in clause 7 the LLP warrants that it will not authorise anyone else to exploit the film, create encumbrances over, or otherwise deal with rights to the film, and in clause 9.20 it agrees not to release the film to any third party.

182. In addition in the Deed of Guarantee, Security Assignment and Charge the LLP assigned by way of security such rights as it might have at any time in the film to the CD and, in another similarly entitled document, also assigned them by way of security to the Completion Guarantor. What rights the LLP had must have been limited to the equity of redemption under these deeds.

183. In the Pledgeholder Agreement to which the LLP, the PSC, the CD and the Guarantor are parties, the film laboratory associated with the production of the film agrees that it will "constructively hold" the film materials for the CD and Guarantor only, and will limit the LLP's access to (i) obtaining dailies, (ii) access for inspection and cutting, and (iii) work on the film or the soundtrack by another laboratory if approved by the CD and Guarantor until receipt of the notice of Delivery.

184. The effect of those clauses of the CDA is to deprive the LLP of any substantial right in relation to the film while it is being produced. Its rights are limited to those in relation to the making of the film and, if it can be said to be a right, a right to deliver what interest it has on the Delivery Date (a "right" to which the CD, not the LLP, gives effect by dating the assignment required by clause 2.4). Any attempt by the LLP to renege on the agreement would in our view be subject to a remedy of specific performance in favour of the CD. Moreover the interest the LLP has is subject to the terms of the exclusive licence to the CD and its obligations not to exploit the film.

185. Before the date of completion of the film the LLP is in a position analogous to that of a trustee of the film. It is the holder of 95% of the copyright in the film but, as a result of the licence, the benefit of that copyright is enjoyed exclusively by the CD. After the date of completion of the film the LLP has no different right to exploit the film and the CD's right to exploit the film is the same as it was beforehand.

186. The remaining 5% of the copyright is assigned to the LLP and by the LLP to the CD at the same time. The effect is that the LLP never has the right to that 5%.

187. The commercial effect of the provisions is that the LLP can do nothing with any part of the rights associated with the film at any time during its production. It is bound by iron fetters. The LLP cannot even get its hands on rights to exploit the film by defaulting on the agreement since the laboratory would not let it have the materials, the licence would remain in effect and specific performance would almost certainly be given.

188. Mr Gammie argues that the LLP is not just in a position analogous to a trustee but holds such rights as accrue to it under the PSA on constructive trusts for the CD. He says that a specifically enforceable agreement will give rise to an immediate constructive trust in favour of the purchaser. Where the whole of the consideration has been provided the vendor loses any beneficial interest and becomes a "bare trustee" of the property (*Lloyds Bank plc v Carrick* 4 All ER 633 at 637F. He relies on *Mountney v Treharne* [2002] EWCA Civ 1174 [203) CH 135 where Jonathan Parker LJ said that although the basis of the equitable jurisdiction was founded on an order *in personam*, equity treated as done that which ought to have been done. That was why under a specifically enforceable contract for the sale of land the purchaser was trustee in equity for the owner and a trust beneficiary was immediately entitled to his interest in the trust property; "the plaintiff's rights, although founded upon the ability of the courts to make an order *in personam* ... became an interest in the property itself. Once the decision is reached that an order for specific performance could have been made ... thereafter the legal owner holds the property shorn of all those rights ...which the courts of equity would hold belong to another".

189. For the purposes of the equitable principle he says that a formal transfer is irrelevant if there is nothing outstanding from the intended transferee. Here the contractual assignment of the rights was not dependent upon any further action by the CD – the CD had provided consideration in the form of its promise to make payments of receipts under the composite transaction. The principle extends to personal property and was not affected by the fact that the agreement is to be assigned a right which will be acquired (or blossom) in the future.

190. The Appellants say:

(a) that the obligation to assign is in the future. It seems to us that *Mountney v Treharne* shows that this does not prevent a constructive trust arising;

(b) that because clause 2.1 of the CDA requires the assignments to take place without further formality on that date there is little scope for a constructive trusteeship. We were not persuaded by this argument: the object of equity is to create an immediate interest in the property;

(c) that the LLP's obligation was to make a film and then transfer it. It was not an existing asset. We were not convinced by this. The rights in the film accrue as to 95 % to the LLP as they arise. As they arise they may be subject to the constructive trust;

(d) that in certain circumstances the agreements provide that the rights will be transferred to the Completion Guarantor: they say that makes HMRC's analysis impossible: the CD cannot be beneficial owner when its entitlement depends

upon the contingency, namely the completion of the film as opposed to its abandonment by, and transfer to, the Completion Guarantor.

191. The guarantee provides that the guarantor will ensure timely delivery of the film but that it may choose to abandon the film. In that case it provides that the guarantor must pay the LLP 30 and the LLP is required to transfer to the guarantor all the LLP's interest in the film. The LLP's obligations are secured by one of the Deeds of Security Assignment and Charge in which, as noted earlier, the LLP assigned to the Completion Guarantor by way of security "all of its rights, title and interest (if any) ... in relation to the Film".

192. The LLP's obligations under the completion guarantee must be read with clause 2.1 of the CDA, which provides that "with effect from the Effective Date (a date no later than a set date) and subject only to clause 4.8 (which deals with the LLP rescinding the agreement) the [LLP] irrevocably transfers and assigns to the [CD] all of its rights in the film free of any encumbrance other than pursuant [to the completion guarantee or the security for it]".

193. It seems to us that the agreement with the Completion Guarantor was an encumbrance to which the film was subject and that, since the CD has notice of that encumbrance, any interest it has in the film will be subject to the rights of the completion guarantor. Thus specific performance would vest the film in the CD subject to the rights of the guarantor. We therefore consider that the LLP is a constructive trustee of the rights it holds in the film for the benefit of the CD or, if the contingency arises, the guarantor notwithstanding clause 2.1 of the CDA. But whether or not that is the case it is clear to us that the LLP was always devoid of any of the benefits of ownership of the film.

(f) The CM's Entitlement to Drawings or to an Amount Equal to BDR/BR

194. The quantitative effect of the limitation in the LLP's right to payment from the CD depends on what is BDR (or in the case of ITP, BR). BDR is defined as a percentage (varying with GDI) of Borrower's Receipts ("BR"), which in turn is defined as 50% of the LLP's Receipts under schedule 7.

195. The Appellants say that BR represents the entitlement of the CM to drawings under the LLP Members' Agreements. As the following discussion shows, however, there may be a difference between BR (and BDR) which is an amount determined as a fraction of GDI, and the rights the CM may have had to drawings prior to the signing of the suite of agreements for a film. The ITP and IFP2 Members' Agreements differ in this regard.

(i) <u>ITP</u>

196. The Members' Agreement provides for profit and losses to be allocated 99:1 between the individual members and the CM until the LLP's aggregate receipts from the film equal its budget, and thereafter at the discretion of the Operator.

197. In relation to drawings, clause 9.6 provides that aggregate receipts for a year be distributed between the individual members and the CM in the Drawings Proportion. (see below). Clause 9.5 provides that the "Operator shall be entitled *but not obliged*" to make to the CM an advance distribution of the receipts in respect of any film. By clause 9.6(a):

> (a) "as soon as practicable after the end of each accounting year … an amount equal to the aggregate Receipts received in that year as shown on the Individual Film Accounts for each film shall be allocated for distribution, net of any deductions to be made in accordance with this agreement, by way of drawings between the [individual] members and the [CM] in the Drawings Proportion for that film".

198. By clause 9.6(b) if the amount of advance distributions to the CM exceeds the CM's entitlements under 9.6(a) the CM "shall use its reasonable endeavours" to repay the excess within 10 days and in any event before the year-end distribution is made.

199. The Drawings Proportion for a film is defined to be the proportion to be determined by the Operator under the Operator's agreement. The definition of Net Individual Members' Entitlement in the Members' Agreement indicates that individual members will get at least 40%, so that the maximum that could be allocated to the CM is 60%, but there is no further determination. There is thus no determination of Drawings Proportion in that agreement. The Drawings Proportion is not made dependent upon any capital contribution by the CM.

200. In response to the tribunal's questions the Appellant said that the Operator "determined to allocate 50% of the receipts as drawings to the CM" pursuant to its rights under the agreement. However we saw no evidence of any such determination other than that which might be drawn from the agreements for a film. Clause 12.2 of the Operator's agreement requires the Operator to endeavour to operate consistently with the Information Memorandum and the Information Memorandum says that drawings will be allocated typically no less favourably to the individual investors than 45:55 :: Individual:CM. Again that merely indicates that any determination would be unlikely to allocate more than 55% to the CM. We concluded that no determination of the Drawings Proportion for any film had been made before the signing of the relevant agreements.

201. Thus we concluded that, apart from anything which could be derived from the terms of the film agreements negotiated by the Operator, there was no express or implied entitlement for the CM to drawings under the Members' Agreement equal to 50% of the receipts of the LLPs from any film or otherwise. There was thus no pre-existing right of the CM to a particular amount or proportion of drawings which was capable of being assigned or alienated by the relevant agreements.

202. The effect of the relevant agreements is not wholly clear:

> (a) The advance allocation of drawings permitted to be made by clause 9.5 is not an entitlement to such drawings (as is shown by the recovery provisions of clause 9.6(b)). And yet it appears to be an entitlement that the CM purports to

assign because what is being assigned is not any right to end of year drawings but to receipts as they accrue;

(b) "Receipts" are defined as any income of the film "indefeasibly received" by the LLP. By virtue of the Deed of Acknowledgement etc., BR is not indefeasibly received (or receivable) by the LLP because the LLP has irrevocably agreed that its entitlement will be reduced by that amount. Thus under the Members' Agreement there would be a lesser pot of income to allocate for distribution. If the Operator set a 50:50 Drawings Proportion then the CM would receive half the net income as well as receiving the benefit of any indebtedness it might have to the CD being reduced by BR.

(c) In the Deed of Acknowledgement etc. the CM purports to assign its right to BR, and yet, absent any determination by the Operator, it appears to have no such entitlement.

203. The Operator's Agreement charges the Operator with negotiation of agreements on behalf of the LLP. It seems to us that by its negotiation of the agreements, and its accession to the Deed of Acknowledgement etc. in which the CM states that it has "assigned our right, title and interest in and to Borrower's Receipts" to the Lender and the LLP agrees that its income will be reduced accordingly, the Operator either:

(i) implicitly agreed that it would fix a 50:50 Drawings Proportion for the relevant film until the CM loan indebtedness was discharged, or

(ii) agreed, in the context of the LLP having agreed that an additional amount equal to BR would be retained by the Lender, that what would otherwise have been set as the Drawings Proportion of the CM would be reduced accordingly.

204. We prefer the second of these. The first gives difficulties with the definition of Receipts in the Members' Agreement. If all the Operator had done was to agree that the Drawings Proportion should 50:50, there would also have to have been some amendment to the definition of Receipts, since the part of the exploitation proceeds of the film which was BR would not indefeasibly be received by the LLP. The result would have been that the individual members would be allocated only half of what was left after deducting BR. The Operator is given power to determine the Drawings Proportion "on behalf of the Individual Members": so to reduce their share would seem to us to fall outside that power.

205. We conclude that by the agreements the LLP is agreeing to its right to income being the schedule 7 amount reduced by the amount of BR, and the Operator is agreeing to set the Drawings Proportion to such that no drawings are to be allocated to the CM in respect of the film and the CM is concurring.

(ii) IFP2 and IG

206. Clause 9.2 of the IFP2 Members' Agreement provides for losses to be allocated first to individual members up to 90% of their capital contribution and then to the CM up to the amount of 90% of its Capital Contribution and then 50:50 between the CM and the individual members. When profits arise they are to be allocated first to individual members to absorb the losses previously allocated to them, then to the CM

to absorb the loss allocated to it and then "subject to clause 9.8", 50:50 between the individual members and the CM.

207. Clause 9.8 provides that at the Operator's discretion it may elect to allocate 100% of particular profits to the Ordinary (individual) members but that such an election applies only in relation to profits in respect of which such an election is made.

208. Mr Reid told us that this discretion applied only to income from non-production activities. We cannot read that limitation into the words used; it may be that in practice such was the case, but in describing the CM's rights under the Members' Agreement they must be regarded as subject to the contingency that the Operator could make such an election.

209. In a Payment Deed in the Fox deals and for an IG deal with Codemasters, the Operator and the LLP agree that the CM's share of receipts will be 50% – so that effectively the Operator agrees not to exercise the clause 9.8 discretion while the CM loan is outstanding.

210. The drawings allocations are in clause 10 (it is to be noted that the CM's rights to drawings are independent of whether or not it has made a capital contribution of any sort):

> "10.1 The Ordinary Members (taken as a whole) and the corporate member shall each be entitled to draw 50% respectively of all Partnership Income (defined as the income received by the LLP *less operating expenses*) … Such drawings shall be paid … from time to time during the course of each accounting period at the direction of the Operator.
>
> 10.2 When the Operator has elected to allocate 100% of the profit [to the Ordinary Members] pursuant to clause 9.8, the drawings entitlement set out in clause 10.1 shall be altered such that the Ordinary Members shall be entitled to draw 100% of such Partnership Income …".

211. Thus, unless the Operator makes an election, the CM is entitled to be paid drawings equal to 50% of receipts after deducting expenses at such times as the Operator in its discretion shall decide. So, absent such an election, Borrower's Receipts will be the same amount as the CM's entitlement to drawings *before* its reduction by expenses. But if the Operator made such an election the CM's drawings entitlement would be to nothing.

212. There are a number of difficulties with the purported assignment of BDR by the CM because the CM does not have an entitlement under the LLP Members' Agreement to 50% of the receipts as drawings. Instead:

> (a) The right to drawings is to 50% of income received after deducting operating expenses. There is no such deduction in relation to payments of BDR;

(b) The drawings provision makes the time of payment of such drawings a matter for the Operator. The right to payment therefore may arise after the time of receipt by the LLP, but the right to BDR arises at the same time as the LLP would have acquired, were it not for the Deed, the right to payment;

(c) The LLP Members' Agreement envisages that the CM's right to drawings is defeasible at the election of the Operator, whereas the retentions by the CD are fixed;

(d) Further, the effect of the agreements is to deprive the LLP of any entitlement to the payments of BDR. Thus the amount of BDR cannot form part of the income of the LLP and cannot be part of the drawings.

213. Some of these difficulties are avoided in those cases where a Payment Deed was executed. That Deed purports to fix the CM's drawings entitlement at 50% of Receipts, thus preventing the deduction of expenses and any election under clause 9.8. It seems to us, however, that this works only in relation to the election under clause 9.8: there the fact that the Operator is party to a deed must prevent it from exercising the election in relation to the relevant film, but it does not seem to us to be capable of amending the rights of the members under the Members' Agreement so as to enhance the CM's right to drawings by removing the effect of the deduction of expenses. Nor does the Payment Deed deal with the timing of payments.

214. But whatever the difficulties with the mechanism of the assignment, the effect of the agreements must be that after they had been signed the CM has agreed that its right to drawings was different from what it was before. In the case of ITP it will have no rights to drawings from the film, in the case of IFP2, its rights will be to (i) what it would have been had the LLP's income been increased by BDR, less (ii) BDR.

(g) The Loan Agreement

215. Mr Gammie argues that the transaction which results from the Loan Agreement is not a loan. He says that, just as Lord Templeman did not regard the flow of Lorimar's money into Victory Partnership and back as giving rise to a loan, so too the flow of money from the CD to its associate company, the PSC, is not a loan to the CM even if the parties attempted to characterise it as such.

216. Mr Gammie refers us to *Chitty on Contracts* 32nd edition where at 39 – 258 it is said that a loan is a contract "whereby one person lends or agrees to lend a sum of money to another in consideration of a promise ... to repay that sum on demand or at a fixed or determinable future time, or conditionally ..., with or without interest [but that] where A pays money to B at the request of C on terms that he is to be repaid by C, it is sometimes a difficult question to say whether the transaction amounts to a loan by C". In this appeal the Appellants argue that there was a loan by the CD to the CM on precisely that (difficult) basis.

217. In *Potts Executors v IRC* [1951] NEC 443 the question arose as to whether a director's current account to which there were debited payments the company made to third parties at the director's request gave rise to "a sum paid by way of loan" to the

director for the purposes of section 40 FA 1938. The majority of the House of Lords held that on a fair meaning of the words in the statute the payments made were not "by way of loan". There was a division among their Lordships as to whether the "payment by A to B" example in the preceding paragraph could be regarded as a loan to C.

218. In *Re HPC Productions* Ltd [1962] CH 466 Plowman J considered whether sums of foreign currency paid by A (TV limited) to C, a third-party, at the request of B were the lending of foreign currency for the purposes of section 1 (1) of the Exchange Control Act 1947, which made such lending an offence. He held they were not: first he rejected the proposition that "to lend" means to grant "financial accommodation – the temporary use of money in return for a promise to repay an equivalent sum", secondly he held the nature of A's claim against B was generically and commercially different from money lent, and thirdly he relied on the majority in *Potts*.

219. In *Aspect Capital Ltd v HMRC* [2004] UK UT 81 (TCC) the UT was concerned with whether for the purposes of section 419 TA 88 a company had made a loan or advance to a participator. Section 419(2) provided that the company should be regarded as making such a loan in a case where the participator incurred a debt to the company. The UT held that whether there was a loan between A and C (using the *Chitty* appellation) depended on the circumstances, and that the circumstances of that case gave rise to a loan for the purposes of the Act.

220. These cases Mr Gammie says lead to the conclusion that there was no loan between the CM and the CD no matter how the Loan Agreement was entitled or how it described the transactions. A loan involves an obligation to repay: here there was in substance no such obligation. The label "loan" was a legal pretence. The characterisation of the CD's contribution to the Budget as a loan to the CM (and a capital contribution by the CM to the LLP) was the mischaracterisation of a transaction which was in reality an income sharing transaction between the CD and the LLP.

221. In this context Mr Gammie says that if the nature of the rights and obligations arising under the agreements was such that there was no loan and no capital contribution, then the expense of 70 cannot have been incurred by the LLP. The transaction was simply a means of facilitating an income sharing agreement between the LLP and the CD. As a matter of general principle a capital contribution must be something that serves to increase the asset base of the LLP: the CM contributed nothing to the LLP as a result of the Studio's payment and at best divested itself of part of what would have been its share of future receipts.

222. Mr Milne says that in *Potts* Lord Simmonds was concerned with the statutory question of whether monies were paid to the director by way of loan – for he had said that the question was not what the transactions were but whether they fell within the fair meaning of the section. Lord Oaksey had said that in the particular circumstances of the case the payments made in accordance with long-standing practice were not made by way of loan ([466]). Lord McDermott (dissenting) said that when bankers

accommodate a customer by allowing a payment to a third party which creates or enlarges an overdraft they are in effect lending to that customer.

223. Mr Milne relies upon the *Commissioner of Taxpayer Audit and Assessment v Cigarette Company of Jamaica* [2012] STC 1054 PC. There the Jamaican authorities challenged an undocumented, interest-free, inter-company loan. The Jamaican Court of Appeal had held the loans were genuine, the main reasons being (1) that the loans were in the audited accounts of the debtor, and (2) that they had been repaid. In the Privy Council Lord Walker noted that it was now accepted that the loans were real loans "their existence was acknowledged regularly by the directors of Carreras signing the balance sheet". The same, says Mr Milne, is true of the CM loans since they appear in the audited accounts of the CM and Mr Holgate's evidence had been that that was the correct treatment. And they had been repaid, at least in part.

224. We do not think that Lord Walker's remarks in that case are wholly persuasive. He was recounting what had been accepted rather than reaching a judgement, he recounts the signing of the balance sheet as the acknowledgement of, and therefore as evidence of, indebtedness, and he continues "Carreras was at all times in a position to repay the whole of the loan out of cash or readily realisable investments". The CM, by contrast, was not able to make repayments under the Loan Agreement: it had no substantial assets (and there was some doubt whether it even had a bank account), the presence of the loan in a signed balance sheet might acknowledge indebtedness but it does not determine whether or not that indebtedness is a loan, and the proper accounting must be based on a proper understanding of the rights and liabilities not the other way around.

225. It seems to us, however, that it does not matter in considering the tax position of the LLP whether the transaction between the CM and the Lender was or was not a loan. What matters is first what rights and obligations arose *to the LLP* from the composite transaction, and second what were the consequences of those rights and obligations for the LLP. It does not seem to us that the characterisation of the relationship between the CM and the Lender affects the rights and obligations of the LLP or their characterisation. The question is whether the LLP incurred an expense, not whether the CM incurred a loan obligation.

226. We note that the CM had a right under clause 5.4 of the Loan Agreement at any time to pay the CD the balance of the 70, and that the agreements do not specify what would happen if the CM did pay the CD the balance of the 70. The payment instructions in the Deed are irrevocable; the LLP consents to the retention of BDR by the CD. It would require a good deal of implication of terms to be able to conclude that if the CM did "repay" the balance of the 70 that thereafter (i) the LLP would be entitled to payments from the CD inflated by BDR (BR), or (ii) the CM would become entitled to additional drawings. We do not think that such terms could be implied. The absence of provision for such matters shows that such a happening was never realistically contemplated. We conclude that the rights of the LLP under the transaction would not be affected by any payment by the CD under clause 5.4.

(h) Summary: The Rights and Obligations Arising Under the Relevant Agreements

227. In summary we conclude:

(a) The Members Agreements did not in the circumstances confer an obligation on the CM to make any capital contribution. Further:

(a) the provisions of the LLP Members' Agreements were such that whether or not the CM made, or was obliged to make, a capital contribution to the LLP, the CM's rights to profits and drawings and on a winding up were unaffected; and

(b) we doubt whether the payment by the Lender of 70 to the PSC's Production Account constituted the making of a capital contribution to the LLP by the CM in accordance with the Members' Agreement;

(b) No obligation was conferred by the agreements on the LLP to pay or cause to be paid any more than 30 to the Production Account (and as we later conclude, no cost was incurred by the LLP by reason of the CD's payment of 70). Further, in any event that liability to pay 30 arose only once the whole of the 70 was paid, but the payment of the 70 was required to be made in accordance with the Approved Cash Flow and not all at once. Thus the liability to pay arose only at the end of production of the film;

(c) The agreements conferred on the LLP a right to receive from the CD only the schedule 7 amounts as reduced by BDR (or BR). In the next Chapter we show that the amount of this entitlement was 30% (35%) of GDI;

(d) The rights the agreements conferred on the LLP in relation to a film between signing and completion of the film were, or were in their incidents, those, or equivalent to those, of a mere trustee for the CD, and those (negligible) rights were the only rights transferred to the CD by the LLP on completion of the film; and

(e) Whilst the agreements confer on the CD the right to retain BDR (BR) in computing the amount payable to the LLP, it is not completely clear that the CM had a right to payments of that (or any) amount by way of drawings, but any such right was relinquished to the extent of BDR (BR).

228. As a result of those conclusions as to the rights and obligations of the parties we concluded that the commercial and financial consequences for the parties of the agreements were these:

(i) The LLP was obliged to pay 30, suffered no other cost, and became entitled to 30% of GDI;

(ii) The CD was obliged to pay 70 and became entitled to retain 70% of GDI;

(iii) The PSC was obliged to make the film; once made its ownership transferred to the CD; while it was being made the CD had (apart for 5% held by the PSC) rights in the film equivalent to those of a beneficial owner;

(iv) In ITP the CM had no right to drawings in relation to the film unless the Operator decreed; in IFP2 it had a right, defeasible at the election of the Operator, to drawings equal to half the net receipts from the film less BDR.

229. Mr Milne regarded an analysis of the type which gives rise to the preceding paragraphs as wrongly reliant on cash flow. He drew our attention to the decision of the FTT in *Eclipse 35* in which they said:

> "[367] Therefore whilst the cash flows … can be said to be fundamental to Eclipse 35's participation in the arrangements entered into … it does not follow that the arrangements do not have the commercial purpose of effect which on their face they purport to have."

230. Mr Milne says the cash shortcuts taken do not affect the financial consequences for the parties. That seems to us to ask us to determine those rights by reference to a deal other than the one the parties actually agreed to. It is abundantly clear that the Studio negotiated a deal in which the substantial sums it would invest in a film would never go through the LLP. The form of the agreements indicates to us that the Studio would never have allowed the funds to be freely available to the LLP. The deal which was negotiated was not one under which a shortcut was taken but one in which it was never intended that the LLP should have free access to the funds. If the LLP had had free access to the funds would it then have agreed to pay 100% of the cost for only at most 54.55% of GDI?

231. We must determine the rights and financial consequences of the parties from the deal they actually signed, not the one which they want to require the tribunal to think they signed.

4. Control Over Making the Film

232. In the following paragraphs references to clauses are to the *Hot Fuzz* agreements but these clauses were, we understood, common to all the film packages.

233. The PSA provides for the PSC to make the film as an independent contractor. The film is defined as the film conforming to a specified screenplay and a Specification which details, among other things, the producer, director, proposed artist(s), location, length, budget and delivery date.

234. Clause 2.3 of the PSA provides that creative control shall be exercised by the LLP (although day-to-day decisions are to be made by the PSC[10]) but that the LLP is prohibited from taking any decision which would impair the approval rights of the CD under the CDA (see below). The PSC acknowledges that certain matters are, under the CDA, subject to the approval or consent of the CD and agrees to obtain CD approvals on behalf of the LLP and keep the CD informed.

235. Clause 4.1 of the PSA sets out matters over which the LLP is initially expressed to have a right of approval but requires that the LLP and the PSC shall "consult meaningfully" with each other over them, and that if there is any dispute the Completion Guarantor's decision shall be final. The relevant matters include items such as producer, directors, cast, crew, composer, designer, screenplay and cash flow.

[10] For *Happy go Lucky* the LLP's rights were further made subject to the rights of Mike Leigh as the director and writer.

In relation to these matters, the effect of this clause is to give the LLP a chance of influencing the making of the film but only if its suggestions or ideas are acceptable to, or coincide with, those of the Completion Guarantor (a company associated with CD). It has the right to be heard.

236. The obligations placed by the PSA on the PSC to make the film are mirrored in obligations of the LLP under the CDA. The CDA provides that the LLP shall proceed with the production of the film (which is defined by reference to the same specification as in the PSA). It provides that the CD shall have an absolute right of approval over the list of all the matters which were in clause 4.1 of the PSA. It too provides for meaningful consultation between the CD and the LLP, but also provides that on any dispute the Completion Guarantor's decision shall be final.

237. The CDA provides that the film shall conform to the specified screenplay and, subject to the list of approvals, permits the LLP to exercise, in consultation with the CD, creative control over other matters, but also that the LLP shall comply with all lawful requests of the CD in relation to the film. Taken together with the equivalent terms of the PSA this gives the CD or an associate company effective control over the making of the film.

238. In their first Note of Evidence HMRC show in relation to the film *Australia* how each obligation of the PSC to the LLP under the PSA in relation to the making of the film is matched by corresponding obligation of the LLP to the CD although there are three obligations of the LLP to the CD under the CDA (to deliver a cost statement, copies of documents in relation to the film and rushes) which are not mirrored in the PSA. The summary is not disputed by the Appellants.

239. Thus, after the documents were signed all the LLP had to do under the agreements was to pay and sit back and wait. If asked it could consent to matters in the Approvals List, but it could always be overridden by the CD through the Completion Guarantor, and in any event it was likely that anything it was asked to approve had the approval of the CD (since the PSC was its associate). If it wanted it could make suggestions but it had no right to compel the execution of its ideas or at least any ideas of substance. But there was also a disincentive to interference: clause 16.2 of the CDA (*Hot Fuzz*; clause 17.2 in *Australia*) provided that the LLP would not be liable for any default which derived from a default of the Studio, the Completion Guarantor or the PSC unless the PSC's default derived from an autonomous act of the LLP. If the LLP interfered it did so at its own risk.

240. In summary: the CD had control over the creative content of the film. The LLP had a right to be heard but was incentivised not to interfere.

CHAPTER III. THE FINANCIAL EFFECTS OF THE AGREEMENTS, THE IFP2 "TAP" AND ELEMENTS OF THE APPROVED BUDGET

1. Cash Movements

241. In this Chapter we examine the combined effect of the terms of the waterfall, the Deed of Acknowledgement and the Members' Agreements on the cash that moves under those agreements to the LLP, the CM and the individual members. This is an analysis of the cash movements not of the rights and obligations under the agreements although, *inter alia*, it illustrates the conclusions we reached in the preceding chapter.

242. As we shall explain, the structure of the ITP and IFP2 waterfalls differ. In particular in the IFP2 waterfalls there are various steps or "Stages" at which the division of receipts changes in a complex fashion. These differences were instructive.

243. From the analysis which follows we reach the following conclusions:

(a) in the ITP structure, the CM, a non-UK-resident orphan company which was not part of the Ingenious group, received almost none of the cash which flowed to the LLP. It benefited only to the extent of the repayment of the CM loan (to the extent that may be called a benefit);

(b) in the IFP2 structure, where the CM was a UK-resident member of the Ingenious group, the CM received from the cash which flowed to the LLP sufficient to enable it to retain, after the payment of corporation tax, at least 5% of GDI whatever the level of GDI, and also benefitted from repayments of the CM loan;

(c) in the IFP2 structure, the cash received by the LLP was 30% of GDI and the cash retained by the CD was 70% of GDI, whatever the level of GDI. In the ITP structure the CD retained 65% until loan repayment and thereafter kept 79% (being a commission of 30% plus 70% of the balance).

244. We draw the following inferences:

(a) In the IFP2 structure the CD's concern was to ensure that it was entitled to retain 70% of GDI, and it was not concerned with the description attached to the retention: it was equally happy to be entitled to the cash as a part repayment of the CM loan as it was to be entitled to it as a "participation" or a commission.

(b) The 70:30 (65:35) ratio of cash retained by the CD to that received by the LLP reflected their respective cash contributions to the making of the film when there was no shortfall financing.

As we explain elsewhere, where there was shortfall financing under which the CD (or Shortfall Financier) provided additional finance over and above the 70% (65%) which flowed through the CM loan, the ratio of cash receipts by the LLP to receipts by the CD was the ratio of cash investment by the CD (and if

different the Shortfall Financier) to the cash investment deriving from the LLP's ordinary members; and thus would be less than 30:70 (35:65).

Thus the sharing of GDI represented the CD's proportionate investment in the film.

(c) Because the IFP2 CM was not obliged by the agreements to make any repayments (other than by the 'assignment' of BDR) of the CM loan, it would retain for its sole benefit any drawings paid or payable directly to it by the LLP. Thus, in the case of IFP2 the 5% (or more) of GDI retained after tax by the CM was in the nature of a real economic profit obtained by it.

(d) The additional complexity of the steps in the IFP2 waterfalls existed solely for the purpose of providing this after-tax economic benefit for a member of the Ingenious group.

(e) One of the objects of IFP2 in entering into this format for the agreements for films was therefore to secure a benefit for the CM.

245. In the course of his cross-examination Mr Reid, when asked about the absence of Studio participation step calculations in the model for the IFP2 Information Memorandum, said that he remembered "Mr McKenna being quite insistent that when it came to IFP2 we should go back into battle with the studios to not have the step ups." When asked whether this made sense given that it was understood that the step ups were there to deliver a net after-tax profit to the Ingenious CM, he said yes, it was there to make sure the CM did not go bankrupt. He then said that Mr McKenna had argued that they should simply reduce the loan payments to the Studio so that the Studio would get less than 70% of GDI. That did not make sense: reducing the Studio's take was one thing; changing the net profit retained by an Ingenious entity was quite different.

246. These answers, in our view, betrayed either a very defective memory or willingness to make statements which he did not know to be true. The step mechanism was not there to make sure the CM did not go bankrupt because of lack of cash to pay the tax; it was there to deliver to it a net after-tax economic profit: even before profit became allocable to the CM it received, net, 5% of GDI.

(a) ITP

247. The ITP Waterfall provided first for a definition of Gross Receipts, which comprised receipts from cinematic distribution, home video/DVD and TV. From Gross receipts there were to be deducted (assuming at each stage that there was sufficient left for the next stage):

(a) A Distribution **Fee** of 20% (kept by the CD)

(b) Distribution Costs (P&A and video/DVD costs etc.)

(c) Contingent participations of third parties such as actors, and

(d) The amounts payable to the Completion Guarantor to reimburse it for payments it made if the film went over budget.

248. The net amount left after these deductions was in other agreements called Gross Distributable Income or "GDI". We shall use the same term here. GDI was to be dealt with thus:

(a) The CD would retain a Distribution **Commission** of 30%,

(b) Then the CD "shall pay" ITP 100% of the balance until the CM Loan was repaid,

(c) After that the remaining amount if any was to be divided 70% to the CD and 30% to the LLP "which [the CD] shall pay to [the LLP]".

(There are other provisions in the waterfall which relate, for example, to unused contingency in the Budget, which are irrelevant for present purposes.)

249. The Deed of Acknowledgement etc. irrevocably directed the CD to retain 50% of the LLP's share of Gross Receipts under the CDA[11] until the loan was repaid.

250. The Members' Agreement provides for the receipts from a film as shown in the individual film account to be allocated between the CM and the individual members in the Drawings Proportion, which (as explained above) was taken as 50:50.

251. The financial result of the combined effect of these provisions at different levels of Gross Receipts is shown in the table below. It assumes a Budget of 100, and a payment under the loan agreement (a 'loan') of 65. The assumption made in the table for distribution expenses is fairly arbitrary.

[11] There is a slight discrepancy between the Notice of Assignment and the Deed of Acknowledgment: the former instructs the CD to pay Borrower's Receipts (which were defined as 50% of the share of gross receipts the LLP was entitled to receive under schedule 7) to the CD, the latter simply to retain 50% of receipts.

Gross Receipts	300	500	700
CD Fee (20%)	(40)	(100)	(140)
Dist Expenses	(210)	(300)	(360)
GDI	**50**	**100**	**200**
CD Commission	15	30	60
Schedule 7 LLP entitlement	35 (=50-15)	70	133*
Retained by CD as loan repayment	17.5 (=50%x35)	35	65
Balance of GDI once loan repaid	Nil	nil	10
Total actually to be paid to LLP	17.5	35	68
LLP receipt as % of GDI	**35%**	**35**	**34%**
Individual members drawings	17.5	35	>35

252. *In narrative form and looking at column 4: GDI is 200: the CD's commission is 30% or 60: that leaves 140. Of that 100% goes to the LLP until the loan is repaid. The loan was 65. Half of what the LLP was allocated until the loan was repaid went in repayment of the loan, thus until the LLP was allocated 130 the loan was not repaid. Thus only after 130 did the 30%:70% allocation kick in. Thus of the 140, the first 130 is allocated to the LLP then 30% of the balance of 10. So the LLP's allocation is 133. Of that 65 is retained by the CD (as repayment of the loan) and the LLP gets paid 68. The LLP treats itself as entitled to 133 and applies the Drawings Proportion to that. It has treated the first 130 as divided 50:50 between corporate and individual members; if it treats the next 3 as similarly divided the members will get 1.5; the Operator could change the proportion to allocate all the extra 3 to the individuals.

253. Thus it will be seen that the amount to which the LLP is entitled to enforce payment to itself is, until the film makes substantial returns, the same proportion of GDI as the proportion of the budget provided by the payment actually made by the LLP. If the film 'breaks out', the CD retains a 30% commission and takes 70% of the balance – thus 79% of GDI in all, leaving the LLP with 21%.

254. It will be seen that the CD retained a distribution fee of 20% from the Gross Receipts. In the IFP2 deals this was reduced to 15%.

(b) IFP2

255. The schedule 7 allocation of Gross Receipts is more complex for the IFP2 films. First, it includes an extra line allocating a further part of GDI to the CD as a variable "Studio Participation". The steps in the variation of that allocation are matched in the definition of Borrower's Distributable Receipts (the amount to be retained by the CD in repayment of the loan). The overall effect, as the table below shows is that the LLP retains the right to a payment of 30% of GDI and the CD retains 70%.

256. The IFP2 waterfall also includes a "gross corridor" for the LLP, which takes effect before the level at which Gross Receipts are large enough to absorb the Distribution Fee and the Distribution Expenses. This corridor was negotiated by Ingenious after its experience with *Closer* and ITP in which, although the film was successful, the distribution expenses were so great that there was no GDI and no receipt of monies by ITP.

257. The "gross corridor" provision specifies that alongside and *pari passu* with the deduction from Gross Receipts of Distribution Expenses a proportion (16.67%) of the gross receipts should be siphoned off for the CD and the LLP as if it were GDI. Once the film makes enough so that Gross Receipts exceed the distribution commission and the distribution expenses the gross corridor makes no difference to the eventual right of the LLP to payment; but until the receipts reach that level, or if they never reach that level, it provides a source of receipts which the LLP would not otherwise have.

258. The table below is prepared on the assumption that Gross Receipts are high enough to give rise to GDI. As a result the allocations which arise as a result of the gross corridor are not shown.

259. The IFP2 Waterfall provided, like the ITP agreement, a definition of Gross Receipts, which comprised receipts from cinematic distribution, home video/DVD and TV. From Gross Receipts there were to be deducted (assuming at each stage that there was sufficient left for the next stage):

(a) a Distribution Fee of 15% of gross receipts to be kept by the CD,

(b) then, until Distribution Costs had been recouped, 16.67% of gross receipts to be applied as GDI (the "gross corridor"),

(c) then, Distribution Costs (P&A and video/DVD costs and contingent participations of third parties such as actors),

(d) and then, the amounts payable to the Completion Guarantor to reimburse it for payments it made if the film went over budget (in some agreements this was limited to the amount of the Sale and Leaseback Proceeds where a sale and leaseback of the film had also been arranged).

260. The net amount left after these deductions was GDI. GDI was to be dealt with thus:

(a) The CD would retain a Distribution Commission of 30%,

(b) The CD would also retain a "Studio Participation" of

"(i) 15.45% of GDI until GDI exceeds 165% of approved production budget,

(ii) 34.71% of GDI until GDI exceeds 204% of approved production budget, then

(iii) 27.14% of GDI thereafter"

(words taken from the *Hot Fuzz*/Universal agreements).

(c) Then until GDI was equal to the budget, the CD "shall pay" 100% of the balance to or at the direction of the LLP;

(d) After that the Completion Guarantor would recoup any unrecovered completion costs;

(e) Then the CD "shall pay" to or at the direction of the LLP 100% of the balance until the CM Loan shall have been repaid "from the sums directed to the Studio by the [CM] pursuant to the payment instructions agreed between the [LLP, CD and CM]";

(f) After that, the remaining amount, if any, was to be divided 70% to the CD and 30% to the LLP "which [the CD] shall pay to [the LLP]".

261. In their accounts the LLPs treated themselves as earning receipts equal to 54.55% of GDI when GDI was less than 165% of budget. That was 100% less 30% less 15.45% Studio Participation. Once GDI exceeded 165% their percentage interest in GDI fell. Thus they treated themselves as paying 100% of budget and receiving no more than 54.55% of GDI. References in this decision to receiving up to 54.55% reflect this effect.

262. The addition of the Studio Participation to the waterfall schedule was matched by a provision in the IFP2 loan agreements, which likewise does not appear in the ITP agreements. This is the definition of Borrower's Distributable Receipts (BDR) (the amounts which repay the loan) as "the following percentages of [BR i.e. 50% of the amount of Gross Receipts allocated to IFP2 in schedule 7]:

"(i) 90% … until GDI ... totals in aggregate 165% of the Approved Production Budget ...

(ii) 30% … until GDI totals in aggregate 204% of the Approved Production Budget, thereafter

(iii) 60% ..." until the loan is repaid [ex *Hot Fuzz*/Universal documents].

In other words, as shown in the table below, 45%, 15% and 30% of GDI remaining after the Distributor Commission and Studio Participation.

263. Taking together the provisions of the CDA, the loan agreement and the payment instructions, the overall monetary effect of these provisions is shown in the following table, which is adapted with gratitude (but without the same presentational skill) from

HMRC's Evidence Paper (itself adapted from a table prepared by Mr Cannon). It shows how these provisions affect the cash which is to be paid to IFP2 and that which the CD is entitled to retain. It will be seen that the cash retained by the CD is maintained at 70% of GDI, whatever the level of GDI, and that the right of the LLP to cash payment is retained at 30% of GDI.

264. One of the effects of the additional provisions, when coupled with the allocation to the CM in the IFP2 Members' Agreement of drawings of 50 % of net partnership income is that at stage (i) 10% of what is expressed to be otherwise part of the CM's drawings is not retained by the CD but is actually to be paid to the LLP, and thus remains receivable by the LLP and payable to the CM, and that at stages (ii) and (iii) there is a qualitatively similar 'free' retention. We have included in the table lines indicating the effect on the CM in relation to drawings which may be allocated to it in excess of the amounts retained as BDR by the CD. It assumes a budget of 100. The calculations in Appendix 4 show that when GDI is 4.174 x budget the CM loan will be repaid. Thus the table breaks stage (iii) into stages (iiia) and (iiib) being respectively before and after the loan is repaid.

Stage		(i)	(ii)	(iiia)	(iiib)	***ITP****
Aggregate GDI		Under 165	Over165, under 204	Over 204, under 417.4	Over 417.4	
CM Loan repaid		No	No	No	Yes	*No*
Incremental GDI		10	10	10	10	*10*
A: Distributor Commission	30%	(3)	(3)	(3)	(3)	*(3)*
B: Studio Participation	15.45%; 34.71%, 27.14%	(1.55)	(3.47)	(2.71)	(2.71)	
C: Remaining GDI		**5.45**	**3.53**	**4.29**	**4.29**	*7*
D: Borrower's Distributable Receipts (BDR)	45%, 15%, 30%, 30%	2.45	0.53	1.29	1.29	*50%x7 =(3.5)7*
E: Total cash to studio (A+B+D)		**7.00**	**7.00**	**7.00**	**7.00**	***6.5***
Total cash to LLP (GDI-E)		**3.00**	**3.00**	**3.00**	**3.00**	***3.5***
F: Profit allocation to corporate member**		Nil	1.76	2.15	1.5	*Nil*
G: Cash via LLP to corporate member		0.27	1.24	0.86	1.5	*Nil*
Corporation tax on CM profit**		Nil	0.53	0.65	0.45	*Nil*
Net CM retention**		0.27 =5% x C	0.18 =5% x C	0.2 =5% x C	1.05 =~24% x C	***Nil***

** The calculation of these figures is explained in Appendix 4, which also contains references to Mr Bower's evidence on the subject.

*** ***Comparison prior to loan repayment***

265. The Appendix also explains how the stages match the levels of revenues at which revenue is such that (i) the first year write down has been extinguished, (ii) the allocations to the LLP will approximate to budget, and (iii) the CM loan has been repaid.

266. Thus the effect of the step provisions is to channel into different pockets of the Studio different proportions of the GDI flow which accrues to the Studio. The aggregate flow to the Studio is 70% of GDI in all cases[12] but as the volume of the flow changes taps and sluice gates are opened and closed or raised and lowered so that the entitlement flows into (or remains within) different pools under the same ownership. The effect, among other things, is to alter the rate of repayment of the CM loan depending on the level of GDI.

267. No commercial reason for the Studio seeking such different rates of allocation was suggested to us, and for the reasons which follow it seems to us that these taps and sluice gates were added to the waterfall for the benefit of a member of Ingenious' group, the CM: for the provisions result in a cash and economic benefit to the CM. In the ITP waterfall the CM was an orphan and these provisions were not included. We conclude that they were included for the benefit of the Ingenious group in order to deliver a return of at least 5% after tax to the CM.

268. In the ITP structure the Operator's agreement provided for the Operator to receive a "success fee" which became payable when total individual members' receipts exceeded 105% of budget; by contrast the benefit to the CM shown in the table arose as soon as revenue started flowing from the films. This provided an incentive in the IFP2 structure for Ingenious to manage that LLP so as to receive revenues.

269. We should note that we found it odd that the IFP2 and IG Information Memoranda made no prominent mention of this benefit to the Ingenious group, although the allocation of 50% of drawings to the CM is clearly stated.

270. We should note that in this section we have set out the amount of cash the various parties would receive under the combined effect of the relevant documents. In the preceding section we have set out our understanding of the parties' legal entitlements under those documents. We should record that Mr Milne regarded the two as different, but that our analysis was that they were the same.

2. The Importance of GDI

271. One of the conclusions we draw from the quantitative illustrations above is that GDI was shared 70:30 (or 65:35) between the CD and the LLP. Mr Milne argues that this is to overstate the importance of GDI, and that this effect cannot be taken as an implicit admission that there was a 70:30 (65:35) economic deal between the LLP and

[12] See also para 23 of Appendix 2: Mr Sills' evidence. It is also noteworthy that under the Avatar waterfall there is a provision at the end in para 1H that if the foregoing terms did not deliver 70% of GDI to the CD, that there should be an adjustment to achieve that effect.

the CD. He says that the 70:30 analysis is inappropriate mathematically, legally and commercially, because GDI depends on the "off the tops" that come into the calculation before the setting of GDI. He says that the same overall commercial deal could have been reached by increasing the Studio's off the tops and reducing its share of GDI.

272. Mr Milne points to an analysis which Ingenious prepared for HMRC which used a leaked distribution statement for *Harry Potter and the Order of the Phoenix*. In that analysis it is shown that under the ITP model, with a Distribution Fee of 20% and a Distribution Commission of 35%, the same result was delivered as was delivered in the leaked statement in which there was charged a 35% Distribution Fee only.

273. Whilst we agree that if Distribution Expenses and talent etc. participations (together 'non-fee off-the-top expenses') are a constant percentage of Gross Receipts a change in the Distribution Fee can be compensated by a change in the Distribution Commission so that the LLP and the CD receive the same sums for any level of Gross Receipts, that is not the case where non-fee off-the-top expenses are not proportionate to Gross Receipts, and that will be a particular concern if Gross Receipts turn out to be small.

274. Thus for example if Gross Receipts are 100 and non-fee off-the-top expenses are 85 (because there was an unsuccessful expensive advertising campaign) a fee of 15% leaves GDI of nil, so that the total retention by the CD will be 15. But if the fee was 10% GDI would be 5 and only an increase in the Commission to 100% would leave the CD in the same position, which would mean that however successful the film (if the advertising had paid off) the LLP would receive nil. This effect was of course one reason for the gross corridor obtained by IFP2 but the presence of that corridor does not materially affect the example just given.

275. The reverse effect applies if a film is spectacularly successful and receipts become disproportionately large in comparison with non-fee off-the-top expenses (an effect to which Mr Briggs in some of his Ultimates gave voice by capping P&A expenditure); in such a case the value of a percentage point change in GDI is worth disproportionately more than the percentage change in the fee which would have balanced it had there been no slow down in the rate of P&A expenditure as a proportion of Gross Receipts.

276. Further the striking of GDI in our view represents the point at which the spoils are divided between the distribution activity and the activity of financing and making the film. For Independent films GDI is the equivalent of the amounts available for distribution from the collection account. For such films the balance on the collection account represents Gross Receipts less expenses less the distribution agents' fees and costs. Thus for *Happy Go Lucky* the Collection Account Management Agreement provided that the balance on the collection account was, after payment of the collection account manager's fees and sales agent's expenses, to be divided up between the LLP, the financiers and the CD. In the Studio agreements the Studio is both maker and distributor, and the division between fee and interests in GDI represents the division between those activities.

277. In that connection:

(a) Mr Olsberg indicated that for Independent films distribution fees would be in the order of 15-25 %.

(b) We were told that Ingenious had managed to negotiate lower fees for the IFP2 deals, normally at 15%, than for the ITP deals – normally 20%.

(c) Mr Clayton, when speaking of negotiation with Fox over the waterfall about the level of the distribution fee said that at that time "the market rate was more like 15%".

(d) Mr Reid said a 15% distribution fee was about a right arms-length fee and that the CD's distribution fee was "for the job of distributing" (although there was some profit in that).

(e) Mr McKenna described the Studios as having profit centres to each of which was ascribed part of the monies retained by the CD. A distribution fee of 15-20 was a reasonable fee for the distribution activity (or profit centre).

278. A consequence of our conclusion that GDI represents the return to the makers and financiers of a film is that the CD's "Distribution Commission" (rather than the distribution fee) is not compensation for distribution, despite its name, but a producer's profit allocation.

3. Items in the Budget

279. The CDA and the PSA and others of the suite of documents referred to an Approved Budget and an Approved Cash Flow.

280. In each case the Approved Budget consisted of the direct costs of actors and filming together with the addition of (i) Studio Overheads of 15% of the direct cost, (ii) a Completion Bond Fee of 2% of the direct cost, (iii) a Contingency of 10% of the direct cost and (iv) an Executive Producer Fee payable to an Ingenious entity of 5% of the direct cost.

281. The Approved Cash Flow showed the agreed weekly costs of production and the payments to be made by the CD and the LLP. Certain costs such as those relating to the writing of the script were (at least in *Hot Fuzz*) scheduled to be paid before the agreements had been signed. The Executive Producer Fee was scheduled to be payable in the week of signing as was the Completion Bond Fee. The *Hot Fuzz* Cash Flow suggested that the Studio Overhead was to be paid when the film was complete.

282. In what follows it is to be recalled that the PSCs appeared to have been subsidiaries or associates of the CD.

(a) The Studio Overhead

283. Mr Reid told us that he assumed that the CD invoiced the PSC for this. We saw no evidence of any agreement between the PSC and the CD for the payment of this

sum. We were uncertain whether it would in fact have been paid, since it would just be paying back to the CD what the CD had paid to the PSC.

(b) The Completion Bond Fee

284. The Completion Guarantee is between the LLP and the completion guarantor (an associate of the CD in Studio deals). It recites that it is given in consideration of a bond fee received by the guarantor. For *Hot Fuzz* this was £191,339. The agreement does not make express who paid the fee. In the cash flow and budget for *Hot Fuzz* this amount is shown as being payable as part of the budget of the film.

285. The Guarantor (for *Hot Fuzz*) was a subsidiary of the CD and its obligations were guaranteed by the CD.

286. If the film goes over budget and the Guarantor funds the deficit, its outlay is recouped in the schedule 7 waterfall after distribution fees and costs (and for IFP2 the gross corridor), but before the striking of GDI.

287. Independent films often had completion guarantors. Mr Finney noted that normally films made by Studios did not: the over-budget risk was borne by the Studio.

(c) The Contingency

288. Clause 7 of the IFP2 *Hot Fuzz* CDA provides that if the actual cost of the film is less than budget (including the contingency) then the surplus in the production account is to be paid to (retained by) the PSC.

289. In the ITP agreements unused contingency was to be repaid to the LLP and the CD in the ratio 70:30 through the waterfall.

(d) The Executive Producer Fee

290. As part of the suite of documents for a film, the PSC entered into an Executive Producer Agreement with an Ingenious company (the "EP") under which the EP agreed to render to the PSC:

> "services of a nature generally and usually rendered by Executive Producers as shall be mutually agreed and shall be rendered (to the extent mutually agreed) in the manner customary in the production of feature films including ... cooperating with and advising the [PSC] with respect to the finalisation of the production budget and the financing arrangements for the film (the "Services")";

a somewhat vague description of the services to be rendered, and encompassing activities – the financing of the film – which had already taken place.

291. The EP agreement provided for a payment of a fee of 5% of the budget for these services. The Deed of Acknowledgement provided for the LLP to withhold the EP fee from the first payment of Initial Funding, which would otherwise be paid by the LLP

to the PSC, and required it to be paid instead to the Operator (presumably for the account of the EP).

292. In his book *The International Film Business*, Mr Finney says that the term "Executive Producer" is often applied to "a producer who takes a specific role in co-financing a feature", although he says that the term has been much abused and has been applied to those involved in early development without active responsibility of the film-making process. Mr Finney told us that a typical Executive Producer Fee was 2 to 2.5% of Budget.

293. Mr Milne argued that it was typical of such agreements in the film world that they would be a little vague or flexible in their terms. He noted that in the Producer's agreement between Simon Channing Williams and the PSC for *Happy Go Lucky*, a similarly vague clause introduces the producer's obligations "to render all such services as are usually rendered by a first-class producer ... conscientiously and in a businesslike manner ...". But we note that the later clauses of that agreement include much more detail: to ensure the film is produced, to assist in cutting, editing and promotion, to engage artists and to control certain expenses.

294. Mr Clayton said that the agreement could perhaps have been more detailed but perhaps "by the time we came to sign it we had actually rendered the services that were required and there was nothing further contemplated". It was, he agreed, all to do with financing and getting the film ready. When Ingenious personnel were putting together the finance for a prospective film Mr Clayton regarded them as working for the EP. But that was work done prior to contracting for the film and before the making of the EP agreement.

295. Mr Reid was less clear about the role of the EP. He said that the EP fee was there "essentially for work we were doing closing the film", but also for being available during the production to "troubleshoot". He described the agreement as a way of charging for Ingenious' services as Operator of the partnership (in addition to the Operator's fee) in a way such that the fee was also borne by the other parties to the production (namely the CD); in that respect he saw an overlap – the wearing of two hats by Ingenious personnel – in acting for the LLP and (presumably prospectively) for the PSC. He said that Pathé normally charged a 10% Executive Producer Fee essentially for the services provided by its infrastructure.

296. Mr Bower said that the EP role started around the time of closing, and comprised a period when Ingenious personnel wore two hats: those of the Operator and the EP.

297. Many of those with whom Ingenious dealt appeared to regard the Executive Producer as a large financing fee. Miss Rossolini of Fox said that the fee was, by a multiple, higher than any "co-financing fee" she had seen; and Paula Jalfon of Ingenious said that Film Finance regarded the LLPs as financiers and so did not have to hold back the EP fee until production commenced. The correspondence showed the fee as being required as part of the deal by Ingenious personnel.

298. Although we received evidence of what Ingenious did in putting together the parties and the agreements for a film before the agreements were signed, there was sparse evidence of any services rendered by the EP after the signing of the Executive Producer Agreement. Whilst, once the film had been signed, consents were given by Ingenious personnel under the PSC, and under the CDA receipts were monitored, these were activities for the LLP and not for the PSC. Yet the EP fee was large: for example the *Golden Compass* EP fee represented 7 man years' work at £400 per hour (although Mr Reid made the point that in the film world people would not look at fees in that way).

299. We conclude that the EP fee was not in return for any service rendered to the PSC in the making of the film. The words of the Agreement were misleading. We accept that in Ingenious' hands it might be described as a fee received for bringing the financial support of the LLP to the film, and it is likely that the CD so regarded it. We are not concerned with the tax treatment of the fee from the PSC's perspective. If we were we would regard it as at best a fee of a capital nature for arranging finance, and at worst as not incurred for any service.

300. Mr Milne suggested that the fee was deductible in the LLP's computation either as a fee it had to pay to keep its trade going or as part of the film budget. We address these questions in Chapter IX Expenditure.

CHAPTER IV. THE LLPS' FILMS – the Films, the Move to Studio Films, Shortfall Financing, Co-production and The Avatar Hedge

1. The Films and the Move to Studio Films

301. *ITP's Films.* In 2002/3 ITP undertook 7 films of which one, *Wimbledon*, was a Studio film, two were wholly independent, and four were independently produced and distributed by Pathé. The cost of the 6 Independent films was recorded by Mr Forster as £36m, and that of the Studio film £31m.

302. *IFP's Films.* In 2004/5 IFP contracted for 12 films of which we think 7 were Studio films and 5 independent. Mr Forster records the total cost of those seven films as £348m, which was 91% of the total recorded cost.

303. *IFP2's Films.* In 2005/6 IFP2 contracted for 22 films of which 8 were independent and 14 Studio. The cost of the Independent films was recorded by Mr Forster as £44 million and that of the Studio films as £993 million. Thus some 96% of the expenditure was on Studio films. Of the 14 Studio films eight were with Fox, two each with Universal and Time Warner, and one with each of Paramount and Working Title (part of Universal).

304. Thus the number of Independent films and the average expenditure on them (about £5m) remained constant.

305. These figures show a proportionate move from Independent to Studio films across the period.

306. Mr Reid told us about trips to the US from 2002 to court the big Studios. They were eventually successful. Mr Clayton, who it will be recalled joined Ingenious in 2003, explained to us how in the years thereafter the team involved with the LLPs grew in numbers and sophistication. He was involved in the development of the IFP model, in trips to Los Angeles to meet representatives of the Studios, and in many contacts with film-makers over potential films. Mr Clayton became Ingenious' principal contact with Fox and developed a good working relationship with Vicki Rossellini at Fox. This enabled discussions between Fox and Ingenious about the films Fox was preparing to make, and the funds which the LLPs might raise to apply in the production of those films. Mr Clayton described Fox as being the anchor of IFP and IFP2's slate; he and Miss Rossellini spoke four or five times a week.

307. Figures Mr Crossley produced for Mr Reid in February 2005 show the advantages for Fox for doing a deal with Ingenious. The principal advantage was cash flow: the LLPs provided 30% or so of the cash needed to make the film (perhaps less after taking account of the EP fee); but there was also an effect of the standard waterfalls on Fox' risk and reward. If a film did badly Fox was less exposed to losses, at the expense of doing less well after a break-even point.

308. Fox had its own green-lighting procedure, and the LLPs would commit only to Fox films which had passed that test. We believe the same was true for the other Studios. We obtained the impression that Ingenious and the green-light committee

relied quite heavily in making their decision about a film on the fact that the Studio was intending to make it (or was willing to make it with additional capital supplied through Ingenious). Nevertheless we accept that there were occasions on which the green-light committee expressed preferences or reservations about films proposed by Fox.

309. There seem to us to have been a number of reasons for the increase in Studio films. One was that the arrangements Ingenious developed with the Studios, in particular with Fox, enabled a flexible allocation of large amounts of money at fairly short notice.

310. One of Ingenious' difficulties was predicting the influx of capital into an LLP from individual investors. Many such investors were likely to invest close to the tax year end and it was not possible to predict how much would be raised until late in the tax year. There were two opposite problems: either insufficient funds would arrive to finance those films which Ingenious had lined up, or more than expected would arrive without films to put the money into.

311. The first of these difficulties had been met for some films by incorporating into the contracts a right for the LLP to withdraw if its funding did not arise (an "unwind letter")[13]. Also some films had a "Shortfall funding" mechanism. We describe that below.

312. The second problem made it necessary that there be some scope for adding to a prospective film portfolio. Otherwise the subscribed capital would have to be returned to investors as required by the Members' Agreements: and that would be embarrassing for Ingenious and would also reduce the fees it would earn (via the Operator and the Executive Producer). We note in this context that Mr Bower said that they would never approve a bad film just to earn their fee, but to our minds there is a difference between taking on a bad film and not being assiduous about assessing its potential for contributing to the LLP's profit.

313. It seems to us that, especially in the context of IFP2, this difficulty was addressed by having a flexible pot of Fox films into which money could be deployed. In the context of other later operations Mr Bower described such films as "valve" films. Mr Clayton said that they had a template agreement with Fox. That meant that much of the documentation for additional films could be prepared moderately quickly. But in which films? It appeared that the practice developed of green-lighting a number of proposed Fox films and giving Fox flexibility to decide in which of them the LLP should invest.

314. Thus in an e-mail of 28 March 2006 to Miss Rossellini, Mr Clayton explains that Ingenious had an order of priority of films to use the (expected) available funds in and that because another producer might "pull the prestigious UK film we want" he had been able to promote the Fox film *Used Guys* in the list. As a result he could

[13] Thus the agreements for *Notes on a Scandal* and *A Good Year* were signed in August 2005, a while before the year end, and were subject to unwind letters

make a firm commitment "to give you $60 million in direct costs now ...", "I know", he says, "*Used Guys* is more than this, but $60 million was the lower end of your indicative range". (The eventual budget for *Used Guys* appears to have been £84 million.) He continues: "In terms of the shortfall on *Used Guys* I'm afraid we would not be able to top up ... however across *Die Hard 4*, *Used Guys*, there's an aggregate commitment of $184 million of direct cost which you can allocate between the films as you wish ... I appreciate that this isn't the full Flex that you're used to".

315. This appears to have been given voice in the Aggregate Funding and Allocation Side Letter of 31 March 2006 in which IFP2, Fox and others agreed that Fox must allocate funding of £42m so that it covered the full amount of the Initial Payment for *Fantastic Four* but the balance could be allocated between *Used Guys*, *Life of Pi* and *Die Hard 4* as Fox thought fit.

316. This of course meant that the portion of each budget of those other films which was to be funded by the LLP might be less than 30%. This possibility was taken care of by the Shortfall Mechanism.

317. This flexibility enabled the LLP to use all the amounts subscribed, but it also meant that it became Fox's decision to decide how the available funds would be allocated between the selected films. Mr Clayton agreed that Fox were more likely to allocate Ingenious' money to the films they thought less commercially promising, but he said that Fox's view may not have been Ingenious' view. Nevertheless we conclude that in giving Fox this flexibility the LLPs were prioritising the investment of subscriptions over their assessment of their likely possible profitability.

318. A second reason for the move towards a greater proportion of Studio films may have been that there was less work for Ingenious to do. Independent films required putting together; Studio films came packaged by the Studio. Ingenious' staff were largely bankers, lawyers, and accountants, although some like Mr Bower were seriously interested in film. Contracting with a Studio took away the need to consider the creative aspects of a film package and left only the finance.

319. We have noted that the numbers of Independent films undertaken remained much the same while the number of Studio films increased. The activity of Ingenious therefore became proportionately weighted towards Studio films.

320. Mr Clayton said that some films were "oven ready". Ingenious had standard form contracts for deals with Studios. The contractual structure for Independent films was more complex: there were more parties involved in financing the film and in distributing it, and each had their own angle. Thus there was more work involved in Independent films not only in putting the deal together – ensuring that all the parties were ready to go – but also in the negotiation of the documentation.

321. A third reason was in our view the profile of Studio films. There is a hint of that in Mr Clayton's e-mail quoted a few paragraphs above, that Ingenious might lose a "prestigious UK film" and also in an e-mail to him from Miss Rossellini in which she sets out a list of prospective films wanting to give comfort that Fox had "plenty of

top, high visibility, commercial films from which we could find films to partner you on". High visibility films, the sort Studios made, looked good.

322. A fourth possible reason may have been the absence of presales. For Independent films the effect of presales was to increase NRV; since the film had been pre-sold the NRV could not be less than the aggregate presales. If presales were sufficiently high then NRV could be more than 20% of Budget. If the LLPs were to deliver the 80% tax loss in the first year, presales of 20% or more could be a problem. On the other hand, Ingenious sought Independent films which had some measure of presales because they validated the commercial prospects of the film. It is likely that there was some tension between these two considerations. Mr Reid said that presales were a good thing. Overall, we do not regard this possible tension as significant either as a factor in the move to Studio films.

323. A final reason was that one might expect that Studio films were less likely to be loss making. A safer bet.

2. Shortfall Financing

324. Certain of the agreements with Fox (e.g. *Life of Pi* and *Avatar*) contained Shortfall provisions. In the PSA there was a provision[14] that if the LLP was unable to find the Initial Funding (its 30%), the PSC might procure another party, a Shortfall Financier, to finance the Shortfall. (The LLP was entitled to repay the Shortfall before the film was completed and to restore the *status quo ante*). Correspondingly schedule 7 of the CDA provided for the Shortfall Financier to receive the Shortfall Percentage (the Shortfall divided by the Initial Funding) of GDI (and of sums which would become payable under the gross corridor).

325. By this mechanism the Shortfall Financier and the LLP shared part of GDI in proportion to their direct contribution to the Film. The effect was that where it applied the LLP funded less than 30% of the cost of the film and received proportionately less GDI. Indeed as the Aggregate Funding and Allocation Side Letter – described above – indicated, the LLP's percentage could fall to nil. Thus it could also be very small[15].

3. Co-production with another LLP

[14] This was Clause 3.6. It is not completely clear in its drafting, but it seems to us that it provides that the Shortfall Financier is to provide the part of the Initial Funding which the LLPs could not provide – that is to say the part of the 30% they could not find – rather than the related portion of the whole of the film budget. But the reward for financing 30% of residual percentage of the budget is to take 30% of that percentage of the income.

[15] For example the 2006 NRV paper shows that the budget for *Die Hard 4* was £98m and that by the year end the LLP had committed (in total – i.e. together with the amount of the CM loan) to only £2m.

326. As we shall explain in relation to *Avatar*, it appears that from 2006 some films were undertaken by more than one LLP. Thus Mr Forster's Exhibits show that IFP2 and IFP were both involved in *DragonBall*, *I Love You Beth Cooper*, and *Wolverine*.

4. The Avatar Hedge

327. *Avatar* had the largest worldwide box office takings of all time. More than one LLP was involved in its production. It was contracted for by IFP2 in its second year (2006/7) and was released in 2009. Mr Forster's figures showed that by 5 April 2013, over four years later[16], IFP2 had recognised a cost of £149m and receipts of £129m, a book loss of £20m. The figures are more complex than this and Mr Milne told us that there had been an error in the calculations, which when corrected gave a profit of £9m. We return to the figures in more detail in section 11 of Chapter VIII. At this stage we relate the history of the LLPs' involvement in the context of the way in which their funds were deployed.

328. Mr Clayton told us that he had first heard from Fox of the development of *Avatar* before 5 April 2006 (the end of IFP2's first year), and later in 2006 had been told of the work that Fox were doing on its script and budget and that those working on it at Fox were hoping to get the internal green-light in September 2006. It did not form part of the IFP2 year 1 slate.

329. That slate had included the films *Used Guys*, *Life of Pi* and *Die Hard 4*, all of which had shortfall provisions.

330. The Completion Guarantee for *Used Guys* provided that the guarantor could by notice abandon the film and repay the funding. This it did by a notice of November 2006, although earlier intimation of its decision had been given to Ingenious: Mr Clayton records that a decision was made to apply the remitted funds in contracting for *Avatar* alongside IFP3, which would be raising new capital in 2006/7, and that work on documentation started in September 2006.

331. As a result in November 2006 IFP2 and IFP3 (acting jointly) entered into a single CDA, PSA and related documents with Fox for the production of *Avatar* with an Approved Budget of £185m. In a letter of 6 November 2006 – contemporaneous with the *Avatar* CDA etc. – Fox and IFP2 agree that the amount to be paid to IFP2 on the abandonment of *Used Guys*, £19.14m, would be applied by IFP2 in making payment of the Threshold Funding of *Avatar*.

332. The sum of the ordinary members' capital allocated to the film and the CMs' loans did not amount to £184m. In total they amounted to £84m or 45.6% of the budget.

333. The balance of the funding was to be provided by a "Shortfall Financier". Schedule 7 of the CDA provided for what would have been GDI to be reduced by the

[16] The IFP2 Information memorandum described peak profitability as arising about 4 years after release.

Shortfall Percentage before being split between the Studio and the LLP(s), and for that percentage of GDI to be paid to the Shortfall Financier.

334. Thus under the November 2006 documents the Shortfall Financier would take 54.6% of what would have been GDI, and the remainder divided between the Studio and the two LLPs (in accordance with schedule 7 and the Deed of Acknowledgement etc.).

335. IFP3's fundraising was, however, curtailed by changes in the availability of sideways loss relief in March 2007. Ingenious decided that IFP2 would assume IFP3's contractual obligation and IFP2 would raise additional funds from existing members for *Avatar*, *Life of Pi* and *Die Hard 4*.

336. During the remainder of the 2006/7 tax year IFP2 raised further capital as a result of ordinary member subscriptions. Mr Bower told us that the green-light committee did not want to put all its eggs in the *Avatar* basket, but that Fox wished the monies to be employed in *Avatar*. The solution was the Avatar Hedge.

337. This took effect under the following documents, which were executed by the relevant parties on 5 April 2007, varying the agreements of 6 November 2006:

338. A Deed of Amendment which added IFP as a "new producer".

339. A Deed of Termination, Release etc**.** which released IFP3 from all obligations and rights under the agreements for *Avatar*, set a new budget for the film of £182m, and divided that budget between Budget A of £89.37m and Budget B of £92.59m. It provided that IFP2 was to provide "supplemental Funding" of 27.37% of Budget B, and for it to pay to the Production Account 100% of the Initial Funding for Budget A.

340. A Funding Side Letter. This created the 'Avatar Hedge'. It provided:

(a) for new budgets for *Life of Pi and Die Hard 4*;

(b) for IFP2 to pay the (27.37% x £92.59m =) £25.32m to the Production Accounts of the three films;

(c) for Fox to allocate the whole of the additional expenditure to *Avatar* and to direct that the 27.37% x £92.59m = £25.32m be paid to the *Avatar* Production account;

(d) but for the purpose of the determination of rights to Receipts from the three films the additional monies should be treated as if they had been applied:

(a) 54.58% for *Avatar*,

(b) 4.07% for *Life of Pi*,

(c) 41.35% for *Die Hard 4*;

(so that, as we understand it, the shortfall in the funding IFP2 had thitherto provided in respect of those films would be reduced by the additional contribution, and accordingly so that the Shortfall Percentage, by which rights

to GDI was reduced, should be correspondingly smaller in respect of each of those films);

(e) for schedule 7 of the CDA for each film (the waterfall provision) to be divided into a Budget A and a Budget B, and for the Shortfall under Budget A to be nil and to arise only under Budget B. The division of the Gross Receipts between the A Receipts waterfall and the B Receipts waterfall was specified as:

(a) *Avatar*: A: 49.17%; B 50.83%,

(b) *Life of Pi*: A: 84.97%; B: 15.03%,

(c) *Die Hard 4*: A: 22.45%; B: 77.55%;

(f) and for the Shortfall to be allocated only to the B Receipts calculation.

341. Mr Bower described the effects of these transactions thus:

(a) before March 2006 IFP2 had deployed £84m in *Avatar* (including therein the CD's contribution via the CM), being 45.6% of the budget;

(b) by March 2007 IFP2 had raised additional capital of which £65m (calculated to include the CD/CM element) was to be spent on film production;

(c) IFP2 agreed to deploy all of that on *Avatar*;

(d) but it was agreed that it would receive income as if it had deployed it in agreed proportions between the three films.

342. Mr Bower said that *Avatar* had been more successful than *Life of Pi* and *Die Hard 4*, and if the Funding Side Letter had not been entered into IFP2 would have recognised by 30 April 2013 some £20m of additional income, and that the lifetime projections would have shown an increase in IFP2's profit of some £132m.

343. Mr Bower produced calculations showing the computation of these figures. We accept the logic of the calculations. We set out the way they were done in Appendix (so that any interested party may see the reasoning we have accepted), but there is no advantage to the current exposition in setting them out here.

344. There are a number of conclusions which we draw from the circumstances of the Avatar Hedge:

(a) had IFP2 not entered into the Funding Side Letter, it would, on the basis of the figures in the Appendix 6, by 30 April 2013 have recognised £20m of additional income, and the Ingenious lifetime projections for IFP2 (the '2010 Ultimates') would have been £132m greater.

(b) IFP2 entered into the Hedge because the green-light committee put its foot down. It was not toothless or moribund.

(c) It was not inimical to the LLP's business models not to provide or procure the provision of all the finance for a film:

(i) IFP2 and IFP3 were the initial co producers of *Avatar*. Their liabilities were stated to be joint and several but each was clearly to provide some of the finance;

(ii) Shortfall finance was an element of the November 2006 and the March 2007 *Avatar* agreements and of the *Die Hard 4* and *Life of Pi* agreements. The shortfall financier obtained an income stream calculated on the same principles as the LLP's entitlement and in proportion to the amount financed (but without the 70% loan mechanics or the Studio deductions).

(d) By entering into the Hedge, IFP2 was in effect buying interests in the income streams from the films rather than the right or obligation to produce them.

(e) It was not essential to IFP2's business model that the completed films be delivered to it for onward delivery to the CD: para (c) of the Funding Side Letter provides that the delivery of the completed film by the PSC to any one of IFP, IFP3, IFP2 satisfied the PSC's obligation to deliver to each of them.

(f) It was acceptable for any creative influence over the production of the film residing in the LLPs to be exercised jointly with one or more other LLPs (see (a) of the Funding Side Letter).

(g) The negotiation of these agreements would not have been a simple process. They are complex arrangements. It was not analogous to buying an investment.

(h) The funding provided by IFP for some of the films, even after including the CM's loan contribution, was less than 50% (see *Die Hard 4*).

The transaction provides an indication of the financial nature of the LLPs' businesses. These conclusions are referred to later in particular in Chapter VII: With a View of Profit, and Chapter VI: Trading.

CHAPTER V. INGENIOUS GAMES – Special Considerations

345. IG was involved in the production of video games. It was also involved in non-production activity but, as with IFP2, it did not rely on that activity to support its argument that it was trading with a view to profit. We therefore confine our attention to the production of games.

346. The structure of IG's contractual interest in Games was not significantly different from that of IFP2. Some of the evidence about the way Ingenious operated will be relevant to IG but there are particular aspects of its activities which differ from those of the film LLPs

347. In Chapter XII we consider the particular evidence in relation to IG, and set out our conclusions on the issues raised in the intervening Chapters.

CHAPTER VI: TRADING

1. What Did the LLPs Do?

348. We have discussed the monetary rights and obligations of the LLPs in Chapter II above.

349. We conclude that the obligation of the LLP to deliver the film to the CD was almost meaningless since all the material rights in the film were held by the CD or the PSC at all times. As we noted in section 3(d) of Chapter II the rights the LLP held in the film – both the IP rights and in the physical film – were nugatory. Whilst there might be a formal assignment of the film to the CD at the end of production, there was no further action needed by the LLP to convey any vestigial rights it held to the CD.

350. In section 4 of Chapter II we concluded that the contracts gave effective creative control over the production of the film to the CD (through the LLP) and provided an incentive for the LLP not to interfere.

351. In Section 4 of Chapter IV we concluded that:

(a) By entering into the Hedge, IFP2 was in effect buying interests in the income streams from the films rather than the right or obligation to produce them.

(b) It was acceptable for any creative influence over the production of the film residing in the LLPs to be exercised jointly with one or more other LLPs.

(c) The negotiation of these agreements would not have been a simple process. They were complex arrangements. It was not analogous to buying an investment.

352. From Mr McKenna's evidence we find that in practice Ingenious regarded the creative aspects of the production of the film as settled at the time the agreements were signed. After that, people making the film would not want the LLP to interfere, and in practice the LLPs did not interfere in any substantial way, although occasionally Ingenious personnel offered their views on certain matters. Mr McKenna said that he regarded any creative control as exercised at the time that the nature of the films was written into the agreements. In like vein we concluded in Chapter IV that the LLPs were content to exercise any creative influence they may have had during filming jointly with other Ingenious LLPs.

353. Although Mr McKenna had wide experience in the commercial and financial side of the film industry, and other Ingenious personnel (like Mr Bower who had a library of screen plays) had an informed interest in film production, the only person with any previous experience in film production was Paula Jalfon, and we obtained the impression that her contribution to the making of a film after the documentation was signed was nominal.

354. Under the Operator's Agreement the LLPs appointed the Operator who undertook matters on their behalf. The Operator agreed to provide defined Services.

These included evaluating and identifying suitable films for recommendation to the green-light committee, and negotiating and making agreements on behalf of the LLPs. Clause 14 (ITP: 14) of that agreement provided that nothing in it made one party the agent of the other, but that clause in our view must be read subject to the express inclusion in the Services of the Operator's duty to negotiate and execute on behalf of the LLP. Thus, whereas the activities of finding films were not necessarily conducted as agent of the LLP so that they cannot be attributed to the LLPs, the activities of negotiation were undertaken by the LLPs through the Operator. In turn the Operator's work was carried out by Ingenious' staff. What then did those staff do for the LLPs?

355. In Appendix 1 we set out the conclusions we draw from the evidence on this question. There we conclude that activity conducted by the LLPs through those persons can be described as constituted by the following principal elements:

(a) Considering for green-lighting films proposed by Ingenious entities. In that context we note here that we do not regard the LLPs as having gone out to search for new films save perhaps in the discussions Mr Clayton had with Fox close to 5 April when new films were sought to mop up subscribed capacity, or a "valve" operated to cope with situations in which subscriptions were insufficient;

(b) Complex, serious and detailed negotiation of the commercial terms of agreements for the making of films;

(c) Entering into contracts for the making of films and in relation to their exploitation under which substantial sums were put at risk;

(d) Keeping an eye on what was going on in the making of the films and in particular paying some attention to the costs of production but without any significant involvement in the creation of the films.

(e) Receiving revenue and reviewing revenue statements from films;

(f) Accounting and administration.

356. In section 1 of Chapter IV above we described the increasing proportion of Studio films which formed part of the LLPs' slate. We explained that the work involved in putting together a deal for a Studio film and finalising its documentation was less than for an Independent film. For a Studio film Ingenious had a lesser role in the film: the Studios were huge, diversified multinationals with all the requisite resources to produce films without reference to anyone else; they wanted the involvement of the LLPs for their money and to lay off risk; the LLPs and Ingenious had no role in putting the film together, what they did was by comparison closer to buying an income stream in a complex way.

2. Legal Principles

357. Apart from including a "venture in the nature of trade", "trade" is not defined by the statute. It is left as a word of common understanding. As Lord Wilberforce said in *Ransom v Higgs* [1974] STC 539 at 554:

> "Trade has for centuries been, and still is, part of the national way of life; everyone is supposed to know what "trade" means …
>
> "Trade" cannot be precisely defined, but certain characteristics can be identified which trade normally has. Equally some indicia can be found which prevent a profit from being regarded as the profit of the trade. Sometimes the question whether an activity is to be found to be a trade becomes a matter of degree, of frequency, of organisation, even of intention, and in such cases it is for the fact-finding body to find on the evidence where the line is passed ...
>
> "Trade involves, normally, the exchange of goods, or of services, for reward ... there must be something which the trade offers to provide by way of business. Trade, moreover, presupposes a customer (to this too there may be exceptions, but such is the norm), or, as it may be expressed, trade must be bilateral – you must trade with someone ..."

358. In considering whether an activity is trade it is necessary to "examine what it was exactly that the person did" (Lord Reid: *Ransom v Higgs*). That means what the LLPs did, not their members, and not what was done by Ingenious for itself or other persons. It will involve a weighing of a number of factors, the relevance and importance of which will depend on the circumstances. There is no complete list of those factors and no rule that any one or more of them are decisive; some of them, the "badges of trade", are set out in *Marson v Morton* [1986] STC 463 at 470 ff, others, with particular relevance to transactions which have an element of fiscal advantage, in the judgement of Millett J in *Ensign*.

359. Whatever else in determining whether something is a trade, the tribunal must stand back and take an unblinkered view of all the circumstances: the totality of the person's activity and enterprise. That is not a result of any particular facet of the *Ramsey* doctrine but of the nature of the word "trade" – archetypically whether someone is trading is a conclusion based on commercial substance rather than form. Trade is not a narrow legal concept but a broad commercial one: transactions planned and executed as a single transaction must be viewed as a whole.

360. We shall return to those factors, but given the prominence of *Ensign* in the arguments before us we should now say a little more about the judgements in that case (which are also relevant to the Expenditure issue discussed in Chapter IX).

361. In *Ensign* the Special Commissioners noted the tax motivation of the scheme, the projections which showed that the taxpayer (rather than the partnership itself) did better in cash terms if the films performed badly, the lack of evidence of negotiation over the financial return, and the lack of evidence of activity or expenditure control after the signing of the agreements, and concluded that the paramount fiscal motives of the transactions prevented them from being trading transactions.

362. In the High Court Millett J held that the partnership was trading:

(a) he said that whatever the financial substance, the legal structure was that the Victory Partnership acquired a 100% interest in the film, not a 25% one, and

paid 100% of the cost, not 25%, although it did so with the assistance of the non-recourse loan (759G);

(b) "The production of a 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";

(c) at (762D), he set out nine propositions of which the following is a summary:

(i) in order to be trading a transaction "must possess not only the outward badges of trade, but also a genuine commercial purpose";

(ii) the presence of a collateral fiscal purpose does not denature a commercial transaction;

(iii) but if the sole purpose of the transaction (not the taxpayer's motive) is fiscal it cannot have a commercial purpose (by definition);

(iv) the purpose of the transaction is to be objectively determined considering it as a whole in the light of all the circumstances;

(v) a transaction whose purpose is to make a profit does not cease to be commercial because those who provide the finance may have a fiscal purpose;

(vi) in some cases the shape and character of the transaction is so affected by fiscal considerations that it ceases to be a commercial transaction;.

(d) he said that the Special Commissioners:

(a) were wrong in treating the distinguishing criterion as being whether there was a "paramount" rather than a sole fiscal objective (764E);

(b) based their decision on features which threw no light on the question namely:

(aa) the motive of Ensign rather than that of the partnership, and

(bb) the lack of evidence of activity after the agreement was signed, the lack of interest in controlling expenditure and odd provisions in the agreements. These were merely "footling" considerations;

(e) he said that in his judgement the only possible conclusion was that Victory Partnership was trading. If Lorimar had, as must have been the case (767F) a commercial hope of profit, so would Victory Partnership. (Effectively as to 25% of the total.) The only conclusion could be that the transaction entered into by Victory Partnership was a commercial transaction;

(f) at 768C, he said that the facts that a person obtained financing from investors who were motivated by fiscal considerations and that the transaction was structured to achieve a fiscal advantage "without ceasing to be commercial

or jeopardising the prospects of profit" did not prevent a commercial transaction entered into with a view of profit from being a trading transaction;

(g) the transaction had all the characteristics of a typical though speculative trading transaction and none of those of investment – he mentioned the purchase of an uncompleted film, the arrangement for its completion with a view to exploitation, and the uncertain profit and negligible residual value (768J).

363. In the Court of Appeal, Browne Wilkinson V-C came to the conclusion that Millett J had wrongly regarded the Special Commissioners as taking the motive of Ensign as the motive of Victory Partnership and had therefore based his decision on wrong grounds. He regarded it as permissible, when the commerciality or purpose of the transaction was equivocal to look at evidence of the subjective motives of the taxpayer as itself evidence of the purpose of the transaction. That he thought was what the Special Commissioners had done, although, quite wrongly, they had directed themselves that paramount rather than sole fiscal purpose was enough to deprive the transaction of trading status.

364. The case was therefore to be remitted to the Special Commissioners but an appeal to the House of Lords intervened. Lord Templeman gave the leading speech with which the others agreed. The appeal took a different turn because the question of whether Victory Partnership had "incurred" the full 100% of the cost which had lain dormant since Millett J's decision was resurrected by a cross appeal. Lord Templeman records (at 232 CD) the Revenue argued that the Victory Partnership did not generate any first-year allowance because it was not engaged in trade, and, alternatively by cross-appeal, that it contended that any first-year allowance should be limited to 25%. That was the argument that Victory Partnership had incurred expenditure of only 25%.

365. Before turning to what Lord Templeman had to say we should mention what Lord Goff and Lord Jauncey said in their concurring speeches.

366. Lord Goff said that he accepted that title to the film's negative did indeed vest in Victory Partnership although "the distribution arrangements which formed part of the same composite transaction deprived that legal ownership of any meaningful effect" (245A): "the transfer or vesting of title to the negative had no function other than to give colour to a tax avoidance scheme": since the net profits were to be shared 25:75 it could be "treated as irrelevant" (247B). He regarded it as a misuse of language to describe the payments made to the bank account which bounced back to Lorimar as a loan to Victory Partnership to finance Victory Partnership's investment. It followed that the money paid back to Lorimar could not be regarded as expenditure incurred by Victory Partnership on the film.

367. Lord Jauncey limited his remarks to the question of whether the trading transaction of 25% investment for 25% of the profits had been so eclipsed by the non-trading measures designed to inflate the allowances claimed that it could no longer be treated as a trading transaction. He concluded that was not the case.

368. Lord Templeman started his analysis by saying (231G) that Victory Partnership had incurred 25% of costs, that the negative belonged to it subject to Lorimar's exclusive rights to distribution, and that there also belonged to it 25% of the net receipts. In those circumstances it was entitled to a first-year allowance of 25%. But the taxpayer claimed 100%.

369. He explained that Victory Partnership only ever expended 25% and was "never liable" to pay more. He criticised Millett J's description of the transaction and said "the transaction was a joint-venture and contains no element of loan".

370. At 234g he recited the Crown's arguments:

> "The Crown on the other hand argues that a tax avoidance scheme is ineffective and taints the transaction involved in the scheme. In the present case Victory Partnership entered into a scheme with the object of avoiding tax and not with the object of trading. In the course of the scheme Victory Partnership contributed [25%] to the cost of the film and became entitled to 25% of the net receipts; that transaction in isolation would admittedly constitute trading in the making and exploiting of films. But the transaction was only part of a tax avoidance scheme. It follows that the conditions of section 41 of the 1971 Act are not fulfilled. ... Victory Partnership did not carry on trade and did not incur capital expenditure for the purposes of trade ...
>
> "There are therefore two rival submissions. Mr Gardiner submits that the taxpayer may enter into any transaction in any form he pleases and the court is confined to that form and cannot have regard to the rights and obligations which flow from the transaction because the court cannot consider the substance of the transaction. The Crown on the other hand appears to look upon tax avoidance as a corporate cancer which infects and destroys any fiscal effects advantageous to the taxpayer."

371. It is not wholly clear that in the third sentence of the first quoted paragraph Lord Templeman is expounding the Crown's submission or setting out his own conclusion. If the Crown were accepting that a 25%:25% transaction would be trading, then the question of whether it was trading did not formally arise. There is no record in the decision that the question was argued. Taking his statement only as a recital of the Crown's acceptance of trading is consistent with his description of the rival submissions in the following paragraph. On the other hand, as we show below, there are many occasions on which the view that it was a trade does appear to be accepted.

372. He then considers *Duke of Westminster* [1936] AC 1 and concludes that it does not assist Victory Partnership: "In the Duke of Westminster case the fiscal consequences claimed by the Duke corresponded to the legal consequences of the transactions as construed by the majority of this House. In the present case the fiscal consequences claimed by the taxpayer do not correspond to the legal consequences of the scheme documents read and construed as a whole."

373. Turning to *FA & AB Ltd v Lupton* [1972] AC 634 he recited the Crown's reliance on it because the House of Lords had held tax avoidance was not trading. He then said:

> "But in dividend stripping cases the tax avoidance scheme negatives trading because on the true analysis of the transaction the trader does not trade at all. In *FA & AB Ltd v Lupton* where there was neither a profit nor loss the House did not consider *the present situation in which on the true analysis there was trading* involving an expenditure of [25%]. The financial consequences of that scheme ... produce ... a first-year allowance of that sum. The task of the courts is to construe documents and analyse facts to ensure the taxpayer does not pay too little tax or too much tax but the amount of tax which is consistent with the true effect in law of the taxpayer's activities. Neither the taxpayer nor the Crown should be deprived of the fiscal consequences of the taxpayer's activities properly analysed." [our italics]

374. The italicised words indicate that Lord Templeman considered that the 25%:25% transaction was trading.

375. Lord Templeman then moved on to discuss the *Ramsay* line of cases. After discussing *Chinn v Collins* [1981] STC 1 he says that "in the present case Victory Partnership claims to be a borrower of [75%] and to have expended that sum borrowed in making a film. However on the true construction of the documents Victory Partnership was not a borrower and expended [25%] only". At 239C "It is crucial, when considering the tax avoidance scheme in the present case to take the analysis far enough to determine where the expenditure on the film is really to be found. The expenditure of [75%] is really to be found to have been incurred by [Lorimar]".

376. He later discusses the passage in which Browne Wilkinson V-C distinguished between the Commissioners' finding that the *sole* object of the transaction was a fiscal advantage – which could lead only to one conclusion, and a conclusion that a paramount intention was a fiscal advantage where a weighing exercise might be necessary and says:

> "My Lords I do not consider that the commissioners or the courts are competent or obliged to decide whether there was a sole object or paramount intention nor to weigh fiscal intentions against non fiscal elements. The task of the commissioners is to find the facts and to apply the law, ... the facts are undisputed and the law is clear. Victory Partnership expended capital of [25%] for the purposes of producing and exploiting a commercial film. The production and exploitation of the film is a trading activity. By section 41 of the 1971 Act capital expenditure for a trading purpose generates a first-year allowance. The section is not concerned with the purpose of the transaction but the purpose of the expenditure. It is true that Victory Partnership only engaged in the film for the fiscal purpose of obtaining a first-year allowance but that does not alter the purpose of the expenditure. The principles of *Ramsay* and subsequent authorities do not apply to the expenditure of 25% because that was real and not magical expenditure by Victory Partnership.

377. As Mr Gammie says, Lord Templeman deals in this paragraph with two issues (1) whether something which was unequivocally a trading transaction was prevented from being such by a fiscal purpose and (2) the extent to which the *Ramsay* principle affects the understanding and application of the word "incurred".

378. Mr Milne said that the issue of whether or not Victory Partnership was trading was squarely before the House of Lords. It seems clear to us that the focus of the argument before the House was on the Crown's two arguments (1) that the fiscal motive denatured trading activity, and (2) that only [25%] was incurred. There is no indication of any detailed argument as to whether the transaction, understood as a 25%: 25% deal, was a trading activity although it is clear that Lord Templeman (and in the High Court, Millett J) instinctively considered that it was. Although Millett J overturned the Special Commissioners' decision he did so because he considered they had applied the wrong test in relation to fiscal purpose. It seems to have been assumed without argument before him that a simple transaction under which 25% of the film rights were acquired for 25% of the cost and 25% of the income received would be a trading transaction.

379. Overall we do not therefore regard *Ensign* as holding that as a matter of law the acquisition of film rights and their exploitation in return for a share in the receipts is a trade. But it is, we accept, a strong indicator that a transaction such as that undertaken by Victory may be a trade.

380. Mr Milne says that the LLPs were in a position closer to the trading paradigm than was Victory Partnership: (i) almost all the LLPs' films had started filming after the agreements were signed; *Outland*'s filming had been finished when its contracts were signed, *Victory*'s filming had started by the time the contracts were signed; (ii) Victory Partnership did a lot less than the LLPs: the LLPs selected films, negotiated the terms of the contracts in what had been acknowledged to be a hard-headed way, monitored the production and checked receipts.

381. Mr Gammie says that in *Ensign* the partnerships acquired the rights to the negatives in the films; Victory Partnership contracted for the completion of production and for the exploitation of the film. Under Victory Partnership's distribution agreement the title to the negative was to belong to Victory; the distributors merely had licences to exploit it. The LLPs by contrast had no interest in the film other than perhaps the bare legal interest of a constructive trustee. In *Ensign* Victory Partnership contracted with the equivalent of the PSC to acquire the negative; the LLPs contracted with the PSC because they (and the CD) wanted to divest themselves of production responsibility.

382. We do not think that the precise distinction between the rights to the negative which were held by the Victory Partnership, and those rights in the film held by the LLPs provides any real commercial distinction between the two. Lord Goff said that the Victory Partnership distribution arrangements deprived its ownership of any meaningful effect; we have found that an LLP has no more than the rights of a constructive trustee.

383. Whilst some form of ownership of the negative was relevant to Victory Partnership's claim to capital allowances, it seems to us that in relation to the commercial question, "was it trading?", the difference in ownership rights between Victory's legal ownership "without meaningful effect" and the LLP's limited rights is not of significance.

384. Nor is it possible in our view to characterise the Victory Partnership's transaction as an acquisition *and then* something akin to a sale; there, as in the current appeal, everything was agreed at the same time. Under the single composite transaction Victory became obliged to pay 25% and obtained the right to 25% (or so) (and retained a right in the negative which had no meaningful effect).

3. Comparison with *Eclipse 35, Samarkand* and *Degorce*

385. Each of these cases involved a transaction in one or more films which resulted in the expenditure of a sum of money in return for an income stream. In each case the FTT found that the activity was not a trade. In each case that conclusion was not disturbed on appeal.

386. Mr Milne distinguishes the facts in *Ensign*, and those in the present appeals, from the later cases of *Proteus and Samarkand* [2012] SFTD 1, *Eclipse* 35 [2012] SFTD 823 *Eclipse Film Partners No 35 v HMRC* [2015] EWCA 95 and *Degorce* [2013] SFTD 806 FTT. By contrast he says that the transactions under consideration in those cases were single composite transactions which had the form of a purchase of film rights and their exploitation, but in which the asset acquired and sold was commercially immaterial, and by which the taxpayers merely acquired an income stream (of a substantially fixed nature in the first two cases but of a more speculative nature in *Degorce*) for a capital sum.

387. In *Proteus and Samarkand* a transaction "had the nature of the payment of a lump sum in return for a series of fixed payments over 15 years". The FTT held that was not a transaction in the nature of trade. The consequences of the transactions in those appeals are, we agree, quite different from those in the LLPs' appeals and, even if regarded purely as monetary transactions, the return on the LLP's outlay on any film is uncertain and speculative. Further the way in which the transactions were undertaken by the LLPs and the surrounding activity distinguishes the LLPs' transactions from those in *Proteus* and *Samarkand*.

388. Mr Gammie relies on *Eclipse*. In *Eclipse* an LLP took a licence from Walt Disney of rights in two films and granted a sub-licence to a Disney subsidiary. Under the sub-licence the LLP was entitled to a fixed royalty and "contingent receipts". As part of the arrangement Eclipse entered into a marketing services agreement with another Disney subsidiary under which that company would assist with marketing plans and help supervise distribution. The FTT found that, given Walt Disney's own expertise, this latter agreement had little effect in practice (and did not make the subsidiary an agent of the LLP). They were unable to conclude that Eclipse had a meaningful part in directing the release of the films by the distributor.

389. The FTT concluded that the prospect of contingent receipts being payable was remote. As a result they found that the transaction lacked the speculative element normally expected in a trading transaction. They said it was difficult to see what services Eclipse offered to Disney by way of business and regarded the "customer" test as not satisfied. They held that Eclipse was not trading. That finding was not disturbed on appeal to the Upper Tribunal or the Court of Appeal.

390. Mr Gammie says that the LLPs were similar: in practice they had nothing they could provide, and nothing they did provide towards the making of the films other than finance.

391. To our minds what principally distinguishes the LLPs from Eclipse 35 is the nature of the LLP's receipts. Eclipse received a fixed royalty whose amount was independent of the success of the film and had the right to contingent receipts: the only element of its return which could be called speculative was the right to the contingent receipts and that was nugatory; but the LLPs' whole return was speculative and substantial. There are also differences in what the LLPs did. Eclipse entered into agreements in relation to two films; the LLPs evaluated films, and negotiated and entered into many agreements; Eclipse had a marketing services agreement which was moribund; the LLPs played a small administrative role: they also gave approvals – albeit fairly automatically, they interfered a bit, they looked at budgets; they may have done this in order to look like producers, but the question is not why they did it, but what they did.

392. Mr Gammie does not accept Mr Milne's dismissal of the relevance of *Degorce*. In that case the taxpayer became entitled to a speculative return as a result of "prearranged contracts which were designed to, and did, follow each other in very quick sequence", and as a result of which it was clear that at the end he "would be left with only the income stream". The UT upheld the decision of the FTT that the transaction was not a trade and distinguished *Ensign ([99])*. Mr Gammie says that the LLPs were in a similar position to Mr Degorce.

393. In *Degorce* the taxpayer purchased film rights and immediately sold them for a share of the film receipts determined by a contractual waterfall. The taxpayer asserted that he was trading and that he had suffered a trading loss by reference to the written down valuation of his rights under the waterfall. Those rights depended on the performance of the film and were not fixed as in *Samarkand* or *Eclipse 35*. The FTT held that despite the speculative nature of the transaction the taxpayer was not trading. The UT did not disturb that finding.

394. In *Degorce* the FTT first considered the *Marson v Morton* badges of trade. It found that there was no repetition and no link to any existing film production of the taxpayer. It found of significance that the purchase and assignment of the film rights took place simultaneously and were entered into without regard to the true value of the rights: the transactions amounted to nothing more than the payment of a lump sum for an income stream. It concluded that the only real understanding that Mr Degorce had of the (complicated) scheme was in respect of its tax implications. It concluded

that the actual asset purchased under the scheme (the film) was irrelevant to Mr Degorce.

395. The FTT's recital of the factual background gives a clear impression of a complex packaged scheme sold to Mr Degorce to reduce his tax bill and put into effect over the course of three or four days.

396. By contrast the LLPs through the Operator conducted complex negotiations for their contracts, in varying degrees they evaluated the films – they were not just any old films, and were concerned about the size of their budgets. They entered into more than one contract. The nature of what they did was different.

4. "Production": What's in a Name[17]?

397. The Information Memoranda speak of the LLP's "producing" films and games. The relevant agreements speak of the LLP as the Producer. Those negotiating the agreements wanted the LLP "to be seen as the producer". In their evidence Messrs McKenna, Reid, Clayton and Bower spoke of the LLPs as the "producers" of the films and games and Mr Olsberg thought that the LLP could be described as a producer.

398. Further we have little doubt that some of the actions taken by Ingenious' staff after contracts had been signed were designed to give the impression that the LLPs were involved in the actual production of the film during its filming. Details of telephone numbers were received, requests were made for information they would not use etc. But the motive for these actions does not take away from the fact that they took place and were a part of the activity which must be objectively evaluated, even if a fairly pointless or less weighty part.

399. Mr Finney described the work a traditional producer might do: organising the development of the screenplay; finding a director, cast and crew; arranging finance; putting everything together; and managing the organisation of the actual making of the film. That sort of activity we think would normally be a trade, but it is different from the activity which was undertaken by the LLPs.

400. But Mr Milne made clear that the LLPs were not arguing that they were producers in that sense. This was not a dispute about a name. Instead they relied on what they actually did as being the activity of a trade by whatever name (if there was a name) that activity could be described.

401. In a similar vein we recall Mr Milne describing the LLP as "seeking commissions" for films and we note that the CDA starts by saying that the CD "has commissioned" the LLP to make the film. We would not call the LLP's activity seeking commissions or being commissioned, but the question is: was what they actually did a trade? Not, what sort of trade was it?

[17] …that which we call a rose, by any other name would smell as sweet.

5. The Relevant Factors

402. In the following headings we shall address the factors which the precedents have indicated may be relevant to the assessment of whether an activity is a trade.

(1) A Customer

403. At [355] above we cited Lord Wilberforce's comment in *Ransom v Higgs*, that trade presupposes a customer or, as it may be expressed, trade must be bilateral – you must trade with someone. In *Eclipse* the Court of Appeal explained that that comment (and a similar comment by Lord Reid) was made in a context where the taxpayer did not have a counterparty. They said: "[116] Undoubtedly, trading activity involves a counterparty of some description. We do not find it helpful however, in a complex transaction … to seek to identify whether the counterparty is … properly characterised as a customer."

404. It was clear to us that despite the way in which the relevant agreements had been drawn to give the impression of the acquisition by the LLP of rights in a film and their later sale to the CD, such was not their substantial legal, or commercial effect. Not only were the agreements part of a single deal but the LLP never acquired any substantial interest in a film. The most that could be said is that it contracted for a film to be delivered to the CD for a share in the income arising. It did not sell the film to the CD: but it provided finance to the CD.

405. But it seems to us that however one describes the nature of the LLPs' activity there is not such an absence of a counterparty as to deprive its activities of a trading nature. The CD was a counter party with which each LLP had commercial relations under which it agreed to do things and obtained substantial rights to receive money. The PSC was also a party to which the LLPs paid money in return for its agreement to make the film. The LLP's financial activity was the exchange of a sum of money paid to one party for a potential future financial reward from another.

406. We accept that the LLPs' counterparties may have regarded them as sources of finance rather than as film producers (and that, on occasions, Ingenious personnel so described the LLPs' activities), but nevertheless those counterparties did deals with the LLPs.

(2) Organisation

407. This again is one of Lord Wilberforce's factors[18]. This may be in the way in which things are done or in the resources used to do them. A well-run ordered activity with well defined strategies, and a business which employs serious resource and effort exhibit characteristics of traders.

[18] Echoed in *Clark v Trustees of British Telecom Pension Scheme* [1998] EWHC Civ 296: "an activity which is frequent (or habitual) organised as well as extensive, businesslike and for profit bears the hallmarks of trade", Lightman J.

408. This factor is present. The Ingenious personnel provided not insignificant resource for the selection, negotiation, and follow up of film contracts. The work undertaken in putting together Independent film projects may have been greater than that in negotiating with Studios, but in each case there was an organisation geared towards promoting the business of contracting for films and receiving the income from them.

409. This factor in our view points towards trade.

(3) Repetition

410. This is one of the *Marson v Morton* badges of trade (as are (4) to (11)).

411. There was repetition. Each LLP undertook a number of films or games. They generally tended to be contracted for quite close to the 5 April year end, but there were a number of distinct transactions in the case of each LLP.

412. Mr Gammie says that repetition does not alter the character of an activity, but we think it may form part of the character, or at least illuminate that character.

(4) Is the transaction related to an existing trade?

413. For each LLP's first year it could not be said that it had an existing trade of which its transactions in that year were a part or an expansion. IFP2 continued contracting for films after its first year. That continuation was not clearly indicated as an intention in its Information Memorandum and cannot retrospectively affect the first year's activities.

414. Consideration of this factor does not point to trade.

(5) The nature of the subject matter: was the subject matter the kind of thing which is normally the subject matter of trade or can only be turned to advantage by realisation?

415. Mr Gammie says that viewing the facts realistically the composite transactions consisted merely in the acquisition of rights to possible future revenue. Indeed in some correspondence Ingenious personnel speak of their contribution as arranging finance for films (though it is not always wholly clear whether that activity was carried on for Ingenious or an LLP).

416. We agree that this was the financial effect of the rights and obligations which arose under the contractual matrix. The Avatar Hedge illustrated this. There was, realistically (and we would say legally) speaking, no acquisition of any beneficial right in a film or game of any value and no disposal of it. But a bank trades in making loans. A bookmaker trades in money and risk. Each of them tends to do it over a long period and with a degree of organisation.

417. Overall we think that consideration of this factor may not point to trade but does not point away from it in the circumstances. We note that in *Ensign* Lord Jauncey said

that as Lord Templeman had pointed out expenditure "of [25%] on the making of the film in return for 25% of the net receipts carried all the characteristics of trade". Yet Victory Partnership's transaction was not substantially different from many of the film transactions carried out by the LLPs, and the LLPs had, through the Operator, more going on than ever Victory Partnership did. Victory Partnership's "meaningless" right to the copyright in the film makes no commercial difference. We conclude it does not in the case of the LLPs point away from trade.

(6) The way in which the transactions were carried through: was it done in a way typical of a trading in that subject matter?

418. If the subject matter of the transactions is regarded as a film, then they were conducted in a novel manner: the CD Model was an innovative structure. Mr Finney told us it was (at least initially) unusual. Mr Antoniades told us that it later became a recognised structure. But it does not seem to us to be a structure for dealing in a film but one for the acquisition of an interest in the proceeds of exploitation of a film.

419. What was typical of the transactions was the effort involved in their arrangement and negotiation. Overall we think this consideration points towards trading, or at least not away from it.

(7) The source of finance. Borrowing to buy may point to resale in the short term.

420. The LLPs did not borrow. They were financed by the capital subscriptions of their members. This factor does not point towards trade.

(8) Was work done on the object? Work done may point to a trade.

421. The form of the contracts was that the LLP took on a liability to produce a film. The legal effect of the contracts was that once the LLPs had paid they had no obligation to do anything further in relation to the making of the film: they were liable only if they interfered with what the PSC was doing (See section 4 Chapter II above). The LLPs did not add anything substantial to the making of the film once the contracts were signed.

422. Mr McKenna's evidence was that the LLPs' creative input took place before the contracts were signed. We accept that there may have been some such activity in relation to Independent films but we saw no relevant evidence of it in relation to Studio films where the film was developed by the Studio and was ready to go when Ingenious stepped in.

423. For Independent films we accept that Ingenious paid a greater role in putting together the finance for the film and that to an extent the Ingenious personnel undertaking that activity may have done it in part for the LLP (although it was also clear that in part it was also done for other Ingenious vehicles as, for example, where a sale and lease back of the film was also organised).

424. Overall we think it can be said that there was some work done by the LLPs which was akin to work done on an object which was to be sold.

(9) Breaking down into lots may suggest trade.

425. Consideration of this factor does not point to trade.

(10) Whether the purchaser intended to sell at the time of purchase "if before the contract of purchase is in place a contract for sale is already in place that is a very strong indicator of a trading deal rather than an investment."(per Browne-Wilkinson V-C at 471 in Ensign).

426. If the asset is viewed as the film, then this points towards trading; Mr Gammie says that viewed realistically the rights acquired were future revenues designed to be held for the long term.

427. Browne-Wilkinson V-C's explanation of this factor may at first sight seem to encompass the arrangements made for the film, but it seems to us that he is considering the situation, not where by virtue of the contractual matrix the acquisition is merged into the sale, but where there is a contract of sale followed at a later time by a purchase: a speculative short.

428. We agree with Mr Gammie, the commercial (and legal) reality was that the right acquired was the right to income and the LLP did not intend to dispose of it although the right was realised (so in effect consumed) as monies flowed into the LLP.

429. Consideration of this factor does not point to trade.

(11) Did the asset provide enjoyment or an income pending resale? If so it would be more likely to be an investment.

430. We do not regard any satisfaction the members of the LLPs had in knowing that they were indirectly associated with well known films as relevant. We do not think it realistic to regard the LLPs as acquiring a film or game which they held pending resale. Viewed as a right to income the asset *was* income pending exhaustion, but it was not the type of income one expects from an investment, which would normally have some residual value. Consideration of this factor does not point to investment but on balance does not point towards trade.

(12) Speculation: the possibility of profit; the undertaking of risk.

431. In *Ensign* Millett J regarded the speculative hope of profit as indicative of trade. (But we note that in *Harrison* 40 TC 281 at 293 Lord Reid says that absence of profit motive may not be fatal to a conclusion that a person is trading.) In *Eclipse* (at [398]) the FTT regarded the speculative hope of profit as an important factor.

432. This factor is present. There was a possibility of profit and a risk of loss. We discuss the nature and the measurement of the likelihood of such a profit later in this decision, but we conclude that there was a speculative hope of profit of some kind.

433. *(13) A genuinely commercial purpose: a transaction must possess not only the outward badges of trade but also such a purpose. This may be regarded as a*

requirement rather than a factor to be accorded appropriate weight. This was the first of Millett J's list in his judgement in Ensign.

434. It was clear that in *Ensign* Millet J regarded this condition as satisfied. In that case the Victory Partnership acquired as a result of the composite transaction an interest in 25% of the film revenues. In the instant appeals the LLPs acquired as a result of the composite transaction a specified interest in the film revenues. In each case there is a possibility of profit. In *Ensign* the Victory Partnership acquired the film negative beneficially; in the instant appeals the LLP had no beneficial interest in the negative. But Lord Goff regarded the interest in the negative as "irrelevant"; it is thus difficult to see that as a distinguishing feature.

435. We find this requirement is satisfied. In commercial substance the LLPs paid and were obliged to pay 30% (35%) of the budgeted cost and received and were entitled to receive 30% (35%) of GDI. That was a genuine commercial deal.

436. If we were wrong and the legal effect or commercial substance of the transactions was that the LLPs bought the film or game for 100% of budget and became entitled to at best 54.45% of GDI we would find that the deal was not commercial, and that this test was not satisfied.

Overall

437. We must now stand back and look at the whole picture having particular regard to what an LLP actually did.

438. In relation to Independent films there was more substance to the LLPs' activities; for Studio films the activities had more of the characteristics of arranging and monitoring investments in an income stream (that was particularly the case where an LLP came into the picture at a very late stage when almost all the elements of the film had been pulled together and principal photography was about to start). But the two activities were part of the one business.

Taking all this together we conclude, on balance, that the LLPs were trading: the Operator did more than act as an investment manager of a portfolio of investments: through its actions and those of its agents the LLPs engaged in speculative, organised, repeated transactions in a way which involved work beyond that which would have been involved in the mere making of an investment.

6. Fiscal Motive

439. If the taxpayer's acts are equivocal his purpose may be a material factor in weighing the total effect of all the circumstances, and if the shape and character of the transaction is so affected by fiscal considerations that it ceases to be a commercial transaction it will not be a trading transaction.

440. There was no doubt in our minds that the obtaining of loss relief for investors in the LLPs was understood, and regarded as important, by those at Ingenious who managed the LLPs. The Ingenious organisation was well acquainted with tax-based

products and promoted a number of them. There was no lack of tax experience in the organisation. Other persons such as HSBC obtained the impression from their dealings with Ingenious that its business included devising tax-advantaged products.

441. For the reasons which follow we have concluded that one of the purposes of IFP2 in entering into the CDA/PSA format for the agreements for films was to attempt to secure a tax benefit for the investors.

442. Mr McKenna told us that the ability for investors to claim loss relief was an important part of investment in an LLP. Investment in film was very risky and it was irrational not to offer investors an opportunity for loss relief.

443. If the tax results of investment into an LLP turned out to be as anticipated by the Information Memoranda, then the effect of the tax repayment or reduction following sideways loss relief would be that the investors' subscriptions would be substantially matched by a repayment or reduction in liability within a few months. Thereafter the investor would suffer no further loss (ignoring for the moment the non-film business) but would realise a net after-tax profit on any distribution by the LLP. It seems to us that when Mr McKenna described it as a business opportunity with a tax advantage, he understated the benefit of the tax advantage – which was substantially to remove, rather than to mitigate, the risk of investment.

444. It is true that as an LLP receives money from a film, the initial tax benefit is unwound, and that if an LLP becomes profitable that benefit is completely unwound. But that does not affect the removal of the investment risk afforded by the initial tax repayment or reduction.

445. The LLPs were, as Mr McKenna accepted, promoted on the basis of models which assumed their tax efficiency. Third parties described them as tax funds, and on occasion they were similarly described by Ingenious personnel. They were promoted to those high-net-worth UK resident individuals who paid tax at 40% and could make best use of the losses. A calculator supplied to financial advisers steered the investment decision by reference to the amount of the investor's taxable income which could be sheltered by the first year losses. A letter for financial advisers to send to their clients in relation to IG explained that "tax relief alone could return your cash investment". The Information Memoranda set out the anticipated tax results. Mr McKenna retorts that that investment in an LLP was not a tax shelter but a *bona fide* business opportunity with tax advantages. But it is a large tax advantage.

446. Mr McKenna accepted that, when in 2007 sideways loss relief was withdrawn, a number of Ingenious staff were made redundant in the expectation that there would no longer be a market for investment in the LLPs: one needed the tax relief for investment in a high-risk area.

447. The businesses of the LLPs were managed with the loss relief in mind. There was, as Mr McKenna accepted, a policy of signing deals before 5 April but not afterwards. (Indeed the Members' Agreements provided for the refund of members' subscriptions if made after the relevant 5 April.) It was clear to us that this was to

ensure that the losses arose in the year of investment rather than in subsequent years (where they would have been delayed and possibly diluted by the receipt of income). Further as we explain in Appendix 9 the calculations of NRV were made on a very conservative basis, which would enhance the tax losses. That suggested an approach which was at least consistent with ensuring tax losses.

448. It was also clear that a significant factor in the development of the IFP2 structure (the addition of the Tranche A and B loans for the investors and the non-production activities) was to enable loss relief to be obtained at the rates which had previously been obtained in ITP by reference to the same funding from the investors' own resources.

449. It seems to us that the Commissioning Distributor Model was designed at least in a material part to obtain greater loss relief by routing, or purporting to route, the full cost of the film through the LLPs. That is for the following reasons:

(a) the model is shown in two facets of its actual use not to require the LLP to be responsible for 100% of the cost. Those facets are: (i) the shortfall financing when, because the LLP could not raise the full 30%, additional finance was provided by a Shortfall Financier who took a proportionate share of GDI as a result (see Chapter IV section 2); and (ii) the occasion, such as happened in the case of *Avatar* where another Ingenious LLP "co-produced" the film, each provided part of the funds;

(b) the desire to be at the heart of production could have been achieved by having the same rights and obligations in relation to production but having the CD and the LLP being obliged to fund the PSC separately and directly without the arrangement for the CM loan. There was nothing in the evidence which indicated that those rights and obligations could not have been the same in the relevant agreements if the funding obligation had been changed.

(c) the aspects of the model which limited development risk, financing risk, and distribution risk would have been unaffected by a change in the expressed funding obligation; and

(d) in fact a proper construction of the rights and obligations imposed by the contractual structure reveals that in law and in practice the LLP was only obliged to fund 30% (35%).

450. Thus we conclude that those managing IFP2's business arranged for the particular 100% contractual arrangement in order to deliver (enhanced) tax losses to the members.

451. Mr Gammie says that the way the transaction has been fashioned gives the game away, and that fiscal considerations informed almost the entirety of the design of the Commissioning Distributor Model: those considerations explain its awkwardness and contrivance. In this way he says that the "shape and character" or "form and content" of the transactions can be seen to have been so affected by fiscal considerations as to mean that they are fiscal and not trading in nature. In the alternative, if the application

of the normal factors or badges produces an equivocal result, the shaping of the transactions effectively tips the balance and denies them trading status.

452. It does not seem to us that this analysis can stand in the light of *Ensign* and our conclusions as to the rights and obligations which arise under the agreements. In *Ensign* an ordinary 25%: 25% transaction was dressed up as a 100% investment using money which bounced through Victory Partnership's bank account. The ordinary transaction was a trading transaction. When the clothes of the dressed up transaction were removed, the transaction which remained was the ordinary transaction. The House of Lords held that the attempts to dress it up did not denature it.

453. The same is true in this appeal. The ordinary transaction is a 30% (35%) investment for a 30% (35%) share of GDI. It is dressed up to look like 100% investment for a share of GDI of no more than 54.55%. On examination of the composite agreement it is seen that the legal obligation is to make a 30% (35%) investment and the legal right is to receive 30% (35%) of GDI. Once the clothes are removed, the ordinary transaction is revealed. If that ordinary transaction is a trading transaction then attempts to dress it differently do not prevent it from being a trading transaction.

454. We referred earlier to Millett J's summary of the law applicable when there was a fiscal purpose. Applying the relevant parts of that summary to the 30:30 transaction actually entered into by the LLPs: objectively it was a transaction which had a commercial purpose; despite the fiscal motive of the LLP in entering into it and dressing it up as something else, it was not denatured and could fairly be described as a trading transaction; the objective nature of the transaction had at its core a 30% investment for 30% of GDI; the shape and structure of that transaction was not determined by the fiscal purpose.

455. Mr Gammie says that the question of whether or not the LLPs were trading has to be answered by reference to the tax construct which was designed to give the impression of a 100% investment when only 30% (35%) was contributed, not by reference to the commercial aims of all the other parties. We agree that the aims of the other parties are not relevant, but we consider that the transaction which must be examined is that which is embodied in the actual rights and obligations of the parties and their practical implementation, not the clothes in which they have been disguised, or by reference to a story designed to provide a sequential picture of the acquisition and disposal of rights and obligations, which is not relevant to the ascertainment of the nature of the LLPs' rights and obligations or their financial consequences.

456. If we are wrong and the legal effect of the agreements is as the Appellants contend (100 of expenditure for no more than 54.55% of GDI etc), then we would conclude that the transactions lacked commerciality and that the fiscal motive of the LLPs (acquired by them from Ingenious personnel through the Operator) when taken in the balance would mean that they were not trading.

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CHAPTER VII. WITH A VIEW TO PROFIT – Part 1: The Law and the Arguments

457. **"Nobody knows anything ... Not one person in the entire motion picture field knows for a certainty what's going to work. Every time out it's a guess and, if you're lucky, an educated one"** (William Goldman: *Adventures in the Screen Trade*).

458. "It is generally recognised that investing in the production of feature films is a high-risk enterprise. The great majority of such films lose money, that is to say they fail to generate sufficient net receipts after deducting the marketing and distribution costs to recoup the costs of production. The rewards of investing in a successful film, on the other hand, can be enormous. Investors may be persuaded to put their money into several films rather than one in the hope that they will thereby increase their chances of profit by enabling them to recoup their losses from a series of failures by a single success. This, however, only increases their exposure …" Lord Millett *Peterson* [8].

459. In *Ensign* the Special Commissioners said: "740 H: ... (iii) It is impossible to evaluate in advance with any degree of certainty whether a film is likely to be a commercial success, but judgements are commonly made on the basis of the quality of the story or the screenplay, the fame of the members of the cast and the director and, crucially the level and effectiveness of financial control .... (v) filmmaking is an exceedingly risky business but most films generate a sufficient level of receipts to repay their loans and make money for their distributors though few films make money for their producers."

460. If putting money into films is that risky, can any investment in film be with a view to profit? We think that the business of doing so can be, but that whether or not it is depends on the method of selection of the film and the negotiated commercial deal – the way the business is carried on.

1. The Legal Principles

461. An LLP is a body corporate. Without special legislation it would be subject to corporation tax on its profits and its members would not bring into account its profits or losses. Section 863 (1) ITTOIA 2005 and section 1273 (1) CTA 2009 (and its predecessor section 118Z TA88) provide instead for an LLP to be treated for income and corporation tax purposes as a partnership between its members if it:

> "carries on a trade, profession or business with a view to profit".

We call this the "with-a-view-to-profit condition". As we have noted HMRC say that it was not satisfied.

462. Where that condition is satisfied the LLP is not itself liable to corporation tax but, subject to certain constraints, its members bring into account for the purposes of

their income or corporation tax computations the profits or losses of the LLP as if they were partners conducting its business.

463. In these appeals the LLPs have treated themselves as partnerships and made partnership tax returns which showed losses which have been allocated among the members in accordance with the LLPs' profit-sharing arrangements. The members claimed relief for the losses allocated to them on that basis.

464. If the LLPs did not satisfy the with-a-view-to-profit condition then the members would not be entitled to the benefit of tax relief for those losses.

465. These appeals have, however, not been brought by the members of the LLPs against amendments to their individual self-assessment returns denying the set off of the LLP losses, but by the LLPs against amendments to their partnership returns.

466. Section 12AA TMA permits HMRC to require a partnership to deliver a return for the purposes of establishing the amounts in which its partners are charged to income or corporation tax. Section 28B permits HMRC to amend such a return (and the members' returns) on closure of an enquiry into the return, and section 31 gives a right of appeal against such an amendment.

467. One of the arguments advanced by HMRC is that the LLPs were not trading with a view to profit. That presents a technical conundrum: if the with-a-view-to-profit condition was not met, the LLPs were not partnerships for the purposes of TMA and so could not be required to submit partnership returns. If what they submitted were not partnership returns section 28B could not apply to empower HMRC to give a closure notice or to amend the return, and, if as a result the amendments made were a nullity, the tribunal would not have any jurisdiction over any appeal purportedly made in relation to the amendments.

468. It seems to us that the technician's answer to this problem is that if we find that the with-a-view-to-profit condition is not satisfied then either (i) we should strike out the appeals on the basis that we do not have jurisdiction to consider them, or (ii) we should hold that the return was properly amended by the excision of all the entries in it because none of the amounts related to the income or corporation tax liabilities of a partnership or of its members.

469. In *Eclipse Film Partners 35 LLP v HMRC* [2012] SFTD FTT (TC) 823, an appeal which raised similar issues to the instant appeals, the FTT regarded this issue as an "adjunct to the issue of" whether Eclipse was carrying on a trade and decided the point [415]. Before us both the Appellants and HMRC contended that the tribunal was seized of the issue and should decide it. We consider that we should decide whether the condition is met.

Membership-level Issues

470. The right of an LLP's members to claim relief for losses allocated to them is dependent not only upon the LLP satisfying the with-a-view-to-profit condition, but also upon whether any trade conducted by the LLP was conducted on a commercial

basis. Because the appeals before us are not made by the members this question is not directly relevant to the determination of the appeals. HMRC say it is a member-level issue and the tribunal is not seized of it. Any decision made by the tribunal on this issue would be binding on the members only if a representative member were joined to the appeals. The Appellants say that the tribunal will have heard all the evidence which could possibly be relevant to the issue and that it would be an inordinate waste of resources to have to go through all that evidence at a future hearing on an appeal by one or more members: they urge us to decide the question.

471. We acknowledge that any view that we might express in relation to the question of commercial basis would not be binding upon persons who were not parties to these appeals, but as HMRC point out in relation to whether the LLPs were trading, Millett J in *Ensign* said that in order for a transaction to be in the nature of trade it must possess a genuine commercial purpose; thus the issue of commerciality was at least to some extent before us in relation to the trading issue. We also accept the Appellants' point that we have heard extensive evidence relevant to the issue. Given that our views would carry as regards the members no legal force, we have decided not to extend this overlong decision by setting them out (save as relevant to the issues we have to decide), but on application by a party after the release of the decision we would be willing to do so.

Issues of Construction

472. The parties were broadly agreed as to the fundamental requirements of the test. Mr Milne expressed it as a requirement that the person concerned (in the case of the LLP through its guiding minds) had the subjective purpose or intention of making profits coupled with a reality check: so that if there was no realistic possibility of the LLP making a profit the test would be failed. He regarded the test as sharing something of the approach to the question of whether an expense was incurred for the purposes of the trade, in which connection Millett J in *Vodafone Cellular Ltd and others v Shaw* [1997] STC 734 said:

> "those [purposes] are not limited to the conscious motives which were in mind at the time. Some consequences are so inevitable that they must be taken to be the purpose for which the payment was made."

473. HMRC regarded the test as subjective but considered that subjective intent must be found from an objective appraisal of the evidence. In the context of these appeals they said that amounted to the same test as that proposed by Mr Milne since, if there was no realistic prospect of profit, successful experienced businessmen, such as those at Ingenious, could not have had any view or intent to profit. The position could be different if the tribunal were dealing with amateurs.

474. The parties were also in agreement as to the times at which the test must be satisfied. Section 863 is written in the present tense: "carries on" a trade. Section 863(3) provides that if the conditions in 863(1) temporarily cease to apply, section 863(1) may continue to apply. Those factors indicate that, apart from temporary blips, the condition must be satisfied continuously if the effect is to apply continuously. We agree.

475. Mr Gammie took us on a helpful tour of the origins of the words used in section 863 and 1273 CTA. We agreed: (1) that the words "with a view to profit" were intended to reflect the words "with a view of profit" in section 1 Partnership Act 1890, so that it is appropriate to have regard to partnership law and other provisions of the Partnership Act 1890 in construing them; and (2) that the intention and effect of the Limited Liability Partnership Act 2000 ("LLPA") and the related Taxes Acts provisions was to create a new form of legal entity (an LLP) such that the choice between an LLP and an old-fashioned partnership as the vehicle for a business should be tax neutral.

476. In particular it seems to us that: (i) the name of the new entity – a Limited Liability *Partnership*, (ii) the similarity of the words used in the test, (iii) the fact that the tax treatment of partnerships was originally contained in the LLPA, and (iv) the setting of the new provisions as explained in the Explanatory Notes to the LLPA (see *R v Chief Constable of South Yorkshire Police ex parte LS and Maipe* [2004] HL), together make clear that "with a view *to* profit" has the same meaning as "with a view *of* profit" in the Partnership Act 1891.

"Profit"

477. "Profit" is not defined in the Partnership Act 1890 nor in section 863. We accept the following principles in relation to its meaning:

(a) It does not mean whatever the taxpayer thinks it means but has an independent meaning. Thus, for example, a taxpayer who considers herself to make a profit equal to the proceeds of sale of goods, would not, by intending to sell, necessarily have a view of profit. As Lord Templeman said in *Street v Mountford*,

> "The manufacture of a five pronged implement for manual digging results in a fork even if the manufacturer, unfamiliar with the English language, insists that he intended to make and has made a spade."

(b) It means the excess of the business's income over its expenditure: *Partnership*, Lindley & Banks 19 Ed 2 - 07 states that by profit is meant the net amount remaining after paying out of the receipts of the business all the expenses incurred in obtaining those receipts; and section 2(2) of the Partnership Act 1891 makes clear that gross returns are not profits by providing that the sharing of gross returns does not itself create a partnership.

Mr Gammie points to the meaning of profits of the trade for the purposes of Schedule D (where the word "profit" similarly lacks express definition in the Taxes Acts) given by Lord Templeman in *Beauchamp v Woolworth* 1990 1 AC 478 who said that it was "only possible to arrive at the computation of the profits of a trade after setting against the receipts the expenditure necessary to earn them according to ordinary principles of commercial accounting."

For the purposes of the taxation of profits it is important to allocate income and expenses to particular periods. Many of the principles of commercial accounting are concerned with this allocation process. We do not consider that the "profit"

which is referred to in section 863 has to arise in any particular fiscal or accounting period. As a result in that context it does not seem to us that all the principles of commercial accounting are as important to its determination. Nor do we believe that the technicalities of modern accounting are appropriate to the application of the test of some antiquity. It seems to us that a cruder, everyday understanding of "profit" is intended, an understanding which will naturally encompass some of the principles of modern accountancy but not necessarily all the detail.

(c) It does not mean taxable profit. In *Samarkand* the tribunal regarded "profits" in section 384 TA 88 as not referring to taxable profit but to the excess of business income over its expenditure (although it thought some adjustments might need to be made where the computation was spread over a period subject to significant inflation).

(d) It means profit before tax not after tax. See *Brown v Richardson* 1947 STC SCD 233 at [12] and *Samarkand* at [310].

(e) It may be determined over a period which exceeds or is less than a calendar or a fiscal year.

(f) In particular the fact that a profit may arise in one or more periods may not be enough if linked losses arise in other periods. (Thus, for example, if a film were written down from 100 to 20 in year 1, and had revenues of 30 and 40 in years 2 and 3, a loss of 80 would be recognised in year 1 followed by profits of 10 and 40 in years 2 and 3 respectively, but, by the end of the year 3 there would not, in our view, have been an overall profit of the nature with which the statute is concerned.)

(g) The reference to profit is to the profits of the LLP's business. That is because: (i) the reference to the business being carried on with a view to profit directs attention to the business, (ii) where the test is applied to the LLP attention is directed to its profits, (iii) in the context of the Partnership Act 1890 "it is a necessary condition of partnership that the business of the partnership should be carried on with the view of profit" *Brostoff v Clark Kenneth Leventhal* March 11, 1996 (unreported) per Dyson J.

The "View" to Profit

478. We accept that the ordinary meaning of "with a view to" contains some element of subjective intention.

479. HMRC cite *Macdonald and Dextra Accesssories Ltd* [2005] STC 111 in this regard. That case concerned whether funds transferred by a company to trustees were "potential emoluments", where that phrase was defined by the relevant Act as:

> "amounts ... reserved in the accounts of an employer, or held by an intermediary [who, in that case were the trustees], with a view to their becoming relevant emoluments."

480. The Special Commissioners had treated the intention of the company which paid to the trustees as determinative of the "view".

481. The High Court held that the "view" was to be found in the terms of the trust deed under which the monies were held, but that as the trust deed did not display a principal or dominant intention that the amounts should become emoluments, the test was not satisfied. In the Court of Appeal Jonathan Parker LJ said at [64] that there were three general points to be made about the expression "with a view to":

> (a) it is less specific than "for the sole purpose of" or "with the principal or dominant intention of"; and suggests a degree of flexibility of meaning and application although it plainly connoted some undefined element of purpose intention or contemplation;
>
> This was confirmed by the fact that "with a view to" was applied by the Act to two quite different situations: to both the sums in the accounts of the employer where the only party concerned was the employer, so that any element of intention referred to the employer's "view"; and also to the amounts held by the trustee, where the "view" could be ascertained only by the terms of the settlement;
>
> (b) in the context of the relevant Act, it was looking to the future: the "view" was to potential emoluments becoming relevant emoluments;
>
> (c) the word "potential" indicated that the event was one which had the potential to occur.

482. In the House of Lords, Lord Hoffmann (with whom the remainder of their Lordships agreed), having described Jonathan Parker LJ's reasons, said:

> "17. The Court of Appeal therefore decided that the funds were held with a view to becoming relevant emoluments if they were held on terms which allowed a realistic possibility that they would become relevant emoluments.
>
> 18. I agree with the Court of the Appeal, largely for the reasons given by Jonathan Parker LJ. In the ordinary use of language the whole of the funds were potential emoluments. They could be used to pay emoluments. It is true that ... potential emoluments is a defined term ... [but] if the terms of the definition are ambiguous, the choice of the term to be defined may throw some light on what they mean."

483. Thus the House of Lords applied the phrase in the context of the use of funds held by trustees as if it meant "with a realistic possibility". If that approach were read across into section 863(1), the test to be applied would be: "is there a realistic possibility that the conduct of the business will give rise to profit?". If that were the test in section 863(1) the apprehension of the LLP of the nature of profit or of the way it might be achieved would be irrelevant.

484. We do not, however, believe that the phrase in section 863(1) is to be defined solely by reference to realistic possibility. That is for the following reasons:

> (a) The statutory context of section 863 is different from that which was considered in *Dextra*. Indeed in *Dextra* neither Jonathan Parker LJ nor Lord Hoffmann found any help in ascertaining the meaning of the words from other

statutory contexts (such as section 44 Bankruptcy Act 1914 or section 595 TA 88). On the other hand the parallel between the language of the Partnership Act 1890 and that in section 863 indicates a common understanding of the word "view". *Dextra* was concerned with whether sums were "potential emoluments", and the label "potential" threw light on what was meant (an event which could not realistically happen did not have potential). In section 863(1) this light is not present and there is no replacement for the glow it sheds;

(b) Jonathan Parker LJ accepted that the words had a degree of flexibility and connoted some element of purpose, intention or contemplation: "[67] ... it is not possible to lay down any hard and fast rule as to how the expression ... is intended to apply to any given set of facts. Each case will turn on its own facts in this regard.";

(c) the clear parallel with section 1 Partnership Act 1890 indicates that the interpretation of that section is relevant and, as Mr Gammie noted, in that context intention is material. In *Newstead v Frost* 1981 WLR 135 the Special Commissioners accepted that there was a partnership between Mr Frost and a company. Viscount Dilhorne who gave the leading speech in the House of Lords dismissed an argument by the Revenue that the business carried on in common was simply that of avoiding tax. He said "while it is clear that the partnership was formed with [the tax avoidance object] it must have been formed with a view of profit. It was *intended* that profits should be made ...", therein equating a view of profit with an intention to make profit.

485. Mr Gammie also referred us to *Strathearn Gordon Associates v C & E Commissioners* 1985 VATTR 79 in which the VAT tribunal had summarised the test in section 1 Partnership Act 1890 as requiring "(1) a business, (2) two or more persons, and (3) a profit *motive* on the part of those persons". However, in that case the nature of the "view of profit" required by the Act was not at issue, for the tribunal based its conclusion on its finding that there was no agreement to carry on the business together. Nevertheless, we accept that the tribunal's unargued approach to the phrase indicates that, as Jonathan Parker LJ said, it imports some element of purpose, intention or contemplation.

486. Mr Gammie argues that the test requires there to be a real and earnestly pursued objective of ultimate profit. In this respect he relies on *Acornwood LLP and others v HMRC* [2014] UKFTT 416 TC in which the FTT was concerned with four statutory provisions which were not uniformly drafted. All imposed a two-part test: (1) a condition requiring a view or expectation of the realisation of profit, and (2) a condition that the business be carried on on a commercial basis. But in relation to the first of these tests, two of them had a tighter version of the test restricting it to being satisfied only when "profits could reasonably be expected to be realised" and two had a broader test "with a view to the realisation of profit", but with a rider that the test would automatically be satisfied if the trade was carried on "with a reasonable expectation of profit."

487. The FTT said at [368] that the provisions implied a two-part test, and at [369] that the legislation was intended to exclude from loss relief those who, despite their

desire for profits, "do not conduct their trading activities in a manner which is conducive to the generation of profits". Thus it said ([370]) that "on a commercial basis" meant in accordance with ordinary prudent business principles not as an amateur who might be content with a loss because the pleasure of the activity was the reward in itself. The tribunal continued:

> "[371]. In essence the difference between the parties can be resolved only by an analysis of the evidence in order to determine whether the making of trading profits ... was a genuine, meaning real and earnestly pursued, objective, or, even though there was a hope and potential for trading profits, any profit which did result would be little or nothing more than a potential incidental benefit of an activity in reality pursued for other reasons."

488. Mr Gammie adopts these tests. He says that in order to establish that activities were carried on "with a view to profit", profits must be a real and earnestly pursued objective so that none of the following will suffice:

(a) a mere hope of profit, and

(b) a profit which is simply a potential incidental benefit,

(c) being indifferent or ambivalent about profit,

(d) not being interested in profit,

(e) not being averse to profit,

(f) carrying out an activity which is genuinely thought to be capable of profit,

(g) even welcoming a profit or thinking there was a realistic possibility of profit.

489. We are not able to draw all those conclusions from decisions in relation to the meaning of the phrase in the Partnership Act 1890 or from the tribunal's decision in *Acornwood*. It seems to us that in that appeal in the quoted passage the tribunal was addressing the question of whether the trade was conducted on a commercial basis rather than whether it was conducted with a view to profit. In [369] the tribunal describes the test as excluding those who, despite a desire for profit do not carry on their trade in a commercial manner. In [370] the tribunal then addresses the phrase "on a commercial basis", distinguishing the non-commercial amateur and the commercial person. In that context it seems to us that in the quoted passage the tribunal is considering the commercial limb of the particular tests: whether there was a serious interest in profit, not whether there was a view of profit.

490. That is supported by the way in which the FTT's conclusion is framed at [414 – 416] that there was no reasonable expectation of profit with the result that the profit test was not satisfied: "aiming at or hoping for profit is not be equated with a reasonable expectation of profit"; and that the commercial limb was not satisfied because of the lack of revenue forecasts and expertise and the virtual certainty of loss.

491. Mr Gammie also referred us to *Patel v HMRC [2015]UKFTT 13 (TC)* where, in the context of section 66 ITA the tribunal held that the test to be applied in determining whether a taxpayer had a view to the realisation of profits was a

subjective one. But that provision contained in subsection (3) a direction that if (objectively) there was a realistic expectation of profit, the business was to be treated as conducted with a view to profit. That deeming suggests that the main condition may be more subjective. The same deeming words do not appear in sections 118Z, 863(1) and 1273(1), which suggests to us that the test in those provisions may not be a wholly subjective test.

492. We come to the following conclusions in relation to the nature of the "view":

(a) the test requires some element of purpose, intention or contemplation. That is apparent from the word "view" and the approach to it by other courts and tribunals;

(b) whether or not a taxpayer has a subjective intention depends on all the evidence: a mere assertion of intention may not be enough;

(c) The test does not require an overriding objective of making profit or its pursuit to be the main or predominant purpose of the activity. As Lord Hoffmann said in *Dextra*, had that been intended Parliament would no doubt have used such expressions "which are by no means unfamiliar in tax legislation".

(d) Thus the existence of other hopes or intentions in the conduct of the business need not prevent the carrying on of the business having a view of profit.

(e) Having an intention to make profit is not enough; the taxpayer must *conduct* the business with a view to profit. The nature of the conduct of the business is relevant. The test is about how the trade is carried on and how the taxpayer intends to carry it on. That focuses on the activities of the business and their possible future income, and that focus is a counterweight to a purely subjective analysis of the taxpayer's motives or hopes.

(f) A "view" looks to the future – to the intentions as to the conduct of the business and the results which will flow from it. The taxpayer's intentions as to the conduct of the business are part of the subjective elements of the test.

(g) *Dextra* indicates that there may be some objective element in "with a view to" although in a different statutory context. In the present context "profit" has a meaning independent of what the taxpayer considers it to be: that indicates an objective element in the test: an assessment of whether the intended conduct of the business has a realistic possibility of delivering a profit.

In *Vodafone* Millett LJ said (742J) that the determination of purpose in section 74 TA 88: "… does not involve an enquiry of the taxpayer whether he consciously intended to obtain a trade or personal advantage by the payment. The primary enquiry is to ascertain what was the primary object of the taxpayer in making the payment. Once ascertained, its characterisation as a trade or private purpose is a matter for the commissioners, not the taxpayer". The same principle applies in relation to the question of whether something is done with a view to profit. The enquiry as to the object of the activity is not into the way in which that object is described at the time or later by the taxpayer.

(h) As a result, if the conduct or intended conduct of the business is such that there is no realistic possibility of profit, the business cannot be said to be carried on with a view to profit, no matter what the subjective intentions of the taxpayer as to profit are.

(i) That objective test is, however, about whether the conduct is such as to give a realistic possibility of profit, not about whether it is businesslike or commercial.

(j) If the conduct of the business is such that it is inevitable or almost certain that a profit will be made that will be the carrying on of the business with a view of profit. We accept Mr Milne's submission that Lord Millett's dictum that purpose is not limited to conscious purpose and that some consequences are so inevitable that they must be taken as a purpose applies here. If it is true for "purpose" it seems to us that it must also apply to "view". If Miss Mallalieu had bought her black clothes with a view to satisfying the court dress rules, it seems inevitable that she must also have bought them with a view to decency and warmth. If a person intends to travel in an aeroplane from London to New York it is inevitable that they will travel with a "view" to crossing the Atlantic Ocean whether or not they consciously considered it when buying a ticket.

(k) Between the two extremes, no realistic possibility of profit and almost inevitable profit, there is a hinterland in which the hopes and expectations of the taxpayer will be a significant factor and where the flexibility of the phrase "with a view to" permits the weighing of the subjective intentions of the taxpayer as to the financial results (not the "profit") of the business and the likelihood of the intended conduct and so those results yielding a profit.

Whose View?

493. To the extent a subjective determination of the view of the LLP has to be made the parties were agreed that it would be that of the controlling minds of the LLPs: the LLPs delegated their running to the Operator, so if one asks about the conduct of the business it is the Operator's conduct of it which is relevant, and that in turn is that of its directing minds.

2. The Arguments

494. In summary the Appellants argue that the following features of the evidence demonstrate that the business of the LLPs was conducted with a view of profit.

495. (1) The intention of those running the LLPs was to make them profitable: that was the clear evidence of Messrs McKenna, Reid and Clayton: to produce "best-of-breed" films for a worldwide theatrical audience with the aim of making as much profit as possible.

496. (2) The way in which the LLPs did business was such that they were set up so that they had a realistic chance of being profitable:

(a) the CD model provided a structure which was more likely to produce profits than the traditional structure. The use of the model demonstrated the intention to make profit. The negotiation of lower distributor fees and the gross corridor showed the perseverance of that intention;

(b) the selection and approach to films by the green-lighting committee and the criteria it applied evidenced the choice of commercially attractive films. In particular Mr Olsberg's evidence was that it would not have been unreasonable to expect the selected films to be profitable;

(c) the evidence of Mr Briggs and Mr Divnich, and the exercise in which *Notting Hill* was substituted for *Wimbledon* showed that the financial elements of the model were such that it was capable of delivering profitable LLPs.

497. (3) A number of films were already profitable; IFP2 was projected to be profitable overall. The LLPs' hit rate was greater than average.

498. HMRC say:

(a) the individuals' evidence is equivocal. It must be tested against a background that what mattered to investors and to Ingenious were losses and receipts, not profits;

(b) the only evidence that the LLPs conducted any assessment of the likelihood of profitability was in the illustrative figures shown in the IFP and IFP2 Information Memoranda. But examination of the underlying computations showed that these had been prepared on erroneous assumptions which, if corrected, delivered a loss, or required unrealistically good film performance for LLP profit. At the time IFP2 was promoted, Ingenious would have known, from its own track record with ITP, that its selection of films did not deliver such profits.

(c) The nature of the waterfalls for which the LLPs contracted were such as meant that profit for a film or for an LLP was unrealistic.

(d) The projection that IFP2 would be profitable depended upon an unsound projection for *Avatar*. If participation in the highest grossing film of all time did not make IFP2 profitable, profit cannot have been intended or realistically expected.

CHAPTER VIII WITH A VIEW TO PROFIT – Part 2: The Evidence

499. We should start by making clear that we do not consider that merely because it was expected or hoped that the receipt of income from a film in say year 2 was more than the NRV of the film at the end of year 1, the LLP had a view of profit. To our minds it would be profitable only when the aggregate receipts from the films exceeded the aggregate costs. The accounting recognition of profit in year 2 was merely the write back of a loss, and not profit for the purposes of the statutory test.

1. The LLPs' Actual and Projected Film Profits and Losses

500. None of the LLPs was profitable as at 5 April 2014.

501. Mr Forster presented tabulations showing the profit or loss on each film/game undertaken by ITP, IFP, IFP2 and IG from their inception to 5 April 2013. The figures in these tabulations were prepared on a basis consistent with the LLPs' accounts, therefore treating the LLP as incurring 100% of the budget and receiving up to 54.45% of GDI and valuing the films at the year end at NRV in accordance with Ingenious' practice of treating NRV as the virtually certain future income.

502. To these results Mr Forster added figures for future projected income from the films to give a projection for the total lifetime profit or loss on each film. These projections, of course, were not prepared on the virtually certain future income basis.

503. The figures for future projected income were drawn from a projection prepared by Ingenious in 2010 for HMRC (the "2010 Ultimates") for the films in the year 1 (2002/3 for ITP, 2005/6 for IFP2) slates for the LLPs (we understood corrected for the intervening years). To these were added projections prepared on a broadly similar basis for the films in later years' slates.

504. Mr Forster's figures showed that: at 5 April 2013 only *Hot Fuzz* (IFP2) and *Shaun of the Dead* (ITP 2) were, in sterling accounting terms, profitable, but that *Die Hard 4* (IFP2) was profitable if accounted for in US dollars; all the remaining films (62) were loss-making; and the year 1 slates of films for each LLP had in aggregate given rise to losses at 5 April 2013. The table below shows those (depressing) losses and the effect of adding in films undertaken in later years.

At 5 April 2013	Year 1 slate	All films
ITP	£(57m)	£(57m)
IFP	£(284m)	£(323m)
IFP2	£(600m)	£(715m)

505. The effect of adding the future projected lifetime income was that over their lifetime five further films were projected to be profitable (in sterling) and another one in US dollar terms. The remaining 56 films were projected to be loss-making over their life. The effect of adding future projected income to the figures to 5 April 2013 was that the LLPs' results from the films would be:

Lifetime Projection	Year 1 slate	All films
ITP	£(55m)	£(55m)
IFP	£(171m)	£(206m)
IFP2	£**290m**	£**206m**

506. Not quite so depressing.

507. Thus the projections indicated that IFP2 would be profitable over the life of all films (even though there were some £60 million of running costs to be deducted). The projected further income for IFP2 was £922m of which the largest component (£557m) related to *Avatar*.

508. The figures in Mr Forster's evidence are prepared on the basis that the LLPs funded 100% of the Budget of the films and received income equal to that which would arise under schedule 7 without deduction of BDR/BR (so generally approximately up to 54.45% of GDI[19]). His figures show actual and projected future income, and cost of sales as 100% of the budget of the film. A crude adjustment of those figures prepared by the tribunal (and gratefully taking account of the correction of an error spotted by HMRC's counsel) shows that if the LLPs were treated as receiving 30% of GDI and paying 30% of the film cost, the year 1 slate results would give rise to the following aggregate profits and losses:

Forster: Adjusted to 30:30	To 5 April 2013	Lifetime
IFP	£(59m)	£**1m**
IFP2	£(90m), but £(116m) without *Avatar*	£**399m** but £**66m** without *Avatar*

509. Even less depressing.

510. In Chapter IV section 4 and Appendix 5 we drew the following conclusion from the circumstances of the Avatar Hedge: that had IFP2 not entered into the Funding

[19] See [259]

Side Letter, it would by 30 April 2013 have recognised some £20m of additional income, and the 2010 Ultimates would have been some £132m greater. Thus there is evidence that, if the 2010 Ultimates are reliable, IFP2 could have made a substantial profit on the Ingenious basis if it had not entered into the Hedge, in other words that profit was possible.

511. All the projected figures rely on the 2010 Ultimates. These were considered by Mr Sills and Mr Briggs. Mr Briggs considered them in relation to all films and Mr Sills in relation to *Australia*, *Hot Fuzz* and *Avatar*. We set out their evidence and our conclusions on it in Appendices 2 and 3. There we conclude that Mr Briggs' evidence gave some little support to the 2010 Ultimates calculations, that Mr Sills' evidence was optimistic support for the *Hot Fuzz* and *Australia* Ultimates, but that it was unlikely that the *Avatar* would achieve the WWBO of $8bn necessary to support its lifetime projection, and that a more reasonable view would be $4bn. We discuss the *Avatar* figures further in section 11 below. We conclude that with WWBO at that level IFP2 would continue to be projected to be loss-making as regards films over its lifetime to the tune of some £175m.

512. Mr Forster's evidence also indicated that of 65 film contracts:

(a) 9 were forecast to be profitable,

(b) 56 were forecast to be loss-making of which:

  (a) 12 were projected to recover 50 to 75% of cost,

  (b) 13 were projected to recover 25 to 50% of cost,

  (c) 29 were projected to recover 1 to 25% of cost, and

  (d) one did not generate income.

513. These calculations of profitability were on the Ingenious basis of calculation (for IFP2: 100% of cost, up to 54.45% of GDI).

514. Both Mr McKenna and Mr Reid acknowledged that there could be a point for a film at which the LLP had lost money but the CD had made money. Mr Reid referred to some calculations he had asked a colleague to do about a week before he first gave evidence. By these calculations his colleague had calculated that out of 65 films in which the LLPs had been involved there were only 7 in which the Studios made a profit and the LLP did not. We were shown a list of the films. It showed 8 films where both the CD and the LLP had been profitable, 7 where CD had profited and the LLP had not, and 50 where both had made a loss.

515. We did not see the underlying computations so could not be certain what elements had been included in computing profits and losses. However this evidence suggests that for a Studio 15 out of 65 films making a profit may be enough to sustain an overall profit for the production side of its business. The same rate would nourish the LLPs – regarded as 30% contributors for 30% income – and calls into question whether an LLP, regarded as 100% contributor for up to 54.55% of GDI, could be profitable overall.

516. That suggests that had Ingenious calculated profits on the same basis (30:30) a further seven films would have been profitable for it. On that basis therefore:

(a) 16 would have been forecast to be profitable;

(b) 49 would have been forecast to be loss-making with various levels of recovery.

517. That to our minds seems a healthier result.

518. Were we applying a test of hindsight, we would find that it was very unlikely that the LLPs would have made profits from their portfolio of films if those profits were calculated on the Ingenious basis.

519. Of course we are not applying hindsight, but the actual figures provide a useful test of the evaluation of whether something could have been regarded at a past time as a realistic possibility: for if the actual result turns out to be very different from the original hope or expectation it calls for an explanation of what caused the departure from the original expectation. As we describe in section 6 of this Chapter the Information Memorandum for IFP2 contained an illustration which suggested that over a five year period the LLP would make a modest profit. The results recounted above show that even seven years after launch no LLP was actually in profit and therefore call for a careful examination of that illustration and of any evidence that there was a real hope or realistic prospect of profit.

2. Third-party Evidence of Film Profitability

(i) Independent Films

520. An Inside Track brochure of about 2005 acknowledges that, and it seemed to be generally accepted that, British Independent films rarely recoup their production budgets**.** Mr Reid accepted that Independent films usually lost money.

521. In 2013 Mr Steele of the BFI indicated that of 613 films produced between 2003 and 2010 the information he had collected showed that profitability varied with their budgets:

Budget	Percentage Profitable
£0.5 – 2m	4.1%
£2 – 5m	4.6%
£5 –10m	12.1%
>£10m	17.4%

We saw no indication of how "profit" had been calculated but we assumed that it meant that production costs had been recouped. Most of the LLPs' Independent films had budgets of over £5m.

522. The BFI statistical yearbook for 2013 indicates (at 8.7) that analysis had shown that if a low to medium budget UK film achieved WWBO of 2x budget it was likely to be profitable (taking into account ancillary revenues), but not otherwise. It indicates for 2003-6:

Budget	Percentage Films Released Achieved 2x
£2 – 5m	3.2
£5 – 10m	10%
>£10m	20%

and that only about half (44.6%) the films made were theatrically released.

We conclude that investing in an Independent film with a budget of £5m or more and which has some backing from others with commercial expertise in films may give rise to a reasonable hope that WWBO will exceed 2x budget, and, if the investor is appropriately placed in the waterfall, his chance of recouping his investment may not be fanciful.

(ii) Studio Films

523. We had no direct evidence of the profitability of films made by the Studios. Mr Reid said that Fox was generally profitable but had a low return on capital employed (RCE) ratio. However their continued existence and output suggests that overall they make profits, although some profit may come from their distribution activities as well.

524. We conclude that investing in a film alongside a Studio may give rise to a reasonable hope that receipts will on average exceed the cost – if the investor recoups proportionately with the Studio.

3. The Commissioning Distributor Model

525. Mr Milne placed some reliance on the adoption of the CD model as evidence of the LLPs' intention to make profits. He pointed to the advantages of the model as described by Mr McKenna over the traditional independent producer model. Mr Finney described the traditional model as very poor and as a lifestyle choice rather than a business.

526. The traditional model required a producer, having accepted a script for a film, to develop the concept: to arrange or improve the screenplay, to find a director, talent and finance. It was a speculative business with high risks of failure. At the other end of the spectrum of those involved in producing and financing films, were banks which took a less risky position and a fixed interest return.

527. The Appellants pointed to the advantages of the model in the headings *(i)* to *(viii)* which follow. But in this context we recall the conclusions which we drew from the circumstances of the Avatar Hedge:

(a) It was not inimical to the LLP's business models not to provide or procure the provision of all the finance for a film:

(i) IFP2 and IFP3 were the initial co-producers of *Avatar*. Their liabilities were stated to be joint and several but each was clearly to provide some of the finance;

(ii) Shortfall finance was an element of the November 2006 and the March 2007 *Avatar* agreements and of the *Die Hard 4* and *Life of Pi* agreements. The shortfall financier obtained an income stream calculated on the same principles as the LLP's entitlement and in proportion to the amount financed (but without the 70% loan mechanics or the Studio deductions).

(b) It was not essential to IFP2's business model that the completed films be delivered to it for onward delivery to the CD: para (c) of the Funding Side Letter provided that the delivery of the completed film by the PSC to any one of IFP, IFP3, IFP2 satisfied the PSC's obligation to deliver to each of them.

(c) It was acceptable for any creative influence over the production of the film residing in the LLPs to be exercised jointly with one or more other LLPs.

(d) The funding provided by IFP for some of the films, even after including the CM's loan contribution, was less than 50% (see *Die Hard 4*).

The benefits of the CD Model claimed by the Appellants:

(i) There was no requirement to invest time or money in development: the LLPs benefited from the risks already taken by others.

528. We accept that this is true, although we note that the cash flows included early payments (such as the £956,369 preproduction expenditure for *Hot Fuzz*, which included £311k for "writing") which may well have provided some compensation for work already done by others. Further Mr Reid explained that where the development was not abortive its funder would expect a significant return – normally their funding plus a 50% premium which was charged to the budget of the film. Whilst the contractual obligation of the PSC to make such a payment was unclear from the evidence, it was clear that it was treated as part of the cost of the film and as giving rise indirectly to an expense for the LLP.

529. As Mr McKenna said, it is generally possible to reduce risk only at the expense of the potential for reward.

530. Thus the LLPs benefited from the reduced risk and paid a premium for doing so which would reduce the profit they might otherwise have made.

531. We conclude that this feature of the model enhanced the prospect that a film would deliver some receipts, but by increasing the cost, meant that profitability would come only at higher levels of performance.

(ii) there was less financing risk since the LLPs committed only to projects where (at least) 70%/65% of the finance came from the CD.

532. We accept that the LLPs did not agree to provide finance unless the balance was committed. We agree that this increased the chance that the film would be made and released. It was a prudent policy. We do not see it, however, as a strong indicator of a structure designed to deliver profit for the LLP.

533. We discuss under heading *(vi)* below the 70% (65%) requirement. We do not believe that this specific ratio was designed for profit.

(iii) The risk of the film not finding a route to market was mitigated because commitments were made only where a Studio was attached or there was a market-leading agent and key territory presales in place. The LLPs point to the fact that 98% of the Ingenious films were made and distributed in cinemas and that the BFI average was 44.6% (2003-2010).

534. We agree that committing only in these situations reduced considerably the risk that the film would not be adequately distributed. It reduced the risk of failure and increased the chance of income (and thus profit). It could fairly be said to be designed for profit.

(iv) IFP2 recouped, through the gross corridor, in an elevated position.

535. The genesis of the later LLPs' requirement for this feature was in *Closer* and then *Wimbledon* where WWBO was £42m but IFP received only $1,332, and then only after nine years. This was in part because of the size of distribution expenses. The corridor avoided this disaster and provided early cash flow to investors.

536. We accept that the gross corridor provided some measure of protection against a film which flopped and failed to make gross revenues which exceeded distribution costs etc. But it did not ensure a profit for the film, rather it mitigated losses and provided early cash flow. We accept that some cash is better than none and that it ensured that even a failure contributed something. But it was a small amount (only amounting to income of up to 9% [54.55% x 16.67%] of Gross Receipts reduced further by BDR). The mechanism did not affect the flow of funds once the gross revenues exceeded distribution costs etc.

537. There was some evidence that in negotiating for the gross corridor the LLPs were willing to accept lower returns once the films were profitable.

538. In discussing a proposal put to Disney Mr Clayton said that, in the context of IFP where investors had the Ingenious loan hanging over them, it was understandable that they would want Ingenious to try to maximise revenues and thus accelerate recoupment by a gross corridor. He wrote: "ordinarily [we] would be looking for a pro rata share [which we understood to be 30:70] at the backend, but to the extent we are recouping our equity [earlier] we'd take less at the backend." In other words if they got cash sooner than they would otherwise have, they would take less profit later: the total receipts would be smaller if the film was successful.

539. We accept that mitigating the loss on badly performing films improves the LLP's chances of making overall profit (or lessens its losses) to some small degree, but it also provides revenue to pass on to investors. We regard it as having more than one function.

540. In passing we should note that the receipt of sums through the gross corridor could give rise to the recognition of profit by the LLP *in the year of receivability* where the sums receivable exceeded the NRV for the film (a loss having previously been recognised). Whilst the recognition of such later profits may have been an object of the IFP LLPs in negotiating and obtaining the gross corridor, the hope or expectation of that later single year profit does not seem to us to be the kind of profit with which the statute is concerned; a longer term view of the overall profit is required.

(v) The LLPs shared in gross income in perpetuity, and in particular in gross video/DVD rentals rather than sharing in income on a royalty basis. Mr McKenna said that in their experience video/DVD rentals less the associated costs exceeded typical royalty income.

541. We accept that seeking and obtaining a share in gross (or net after expenses) DVD/video rentals may have given greater income and increased the chance of profit as compared to a royalty, particularly when a film is successful, but observe that films were not always successful.

(vi) With sufficient capital each LLP could adopt a "slate approach" and increase their chances of a hit. The 2005/6 slate of IFP2 consisted of 22 films. In later years it

added a further 5 films to its stable. Mr Milne says that if you get a hit it will make up for many losses.

542. We find this a difficult argument. We agree that a big hit may make up for a number of losses, and that the chances of a hit are increased by doing more films, but we are not convinced that the chance of an overall profit for the LLP profit is necessarily *significantly* increased, that is to say changed from being unrealistic to being realistic.

543. Whether or not it would be depends upon the probability distribution of profits and losses.

544. Thus, for example, if the distribution of films and profits is this:

Eventual profit	£(10)m	£nil	£100m
Number of films	60	39	1

Then, assuming a random selection, producing three films rather than one increases the likelihood of a profit only from 1% to 3%, which we would not regard as creating a realistic possibility of an overall profit[20]. This is not to say that producing more films will never give rise to a realistic probability of overall profit, we merely say that whether or not it does depends on the distribution of profits and losses in the population.

545. There was no evidence before us upon which we could conclude that the distribution of profit or loss making films made the likelihood of an overall profit *significantly* greater than investing in single films. Indeed the fact that it was accepted that real hits were like hen's teeth suggested that the slate approach did not provide a realistic reason for thinking that real hits would form part of the slate and affect its eventual outcome.

546. Further, the example assumes a random selection, and takes no account of the ability or otherwise of the LLP to choose films from those available which produce a better overall result than a random selection. We were not convinced that the LLPs showed that they had the ability to do better than random selection from those films available to them.

547. We accept, however, that the slate approach might reduce Ingenious' overhead costs per film, and that the larger the operation, the more expert it might be and the better the terms it might obtain.

548. In this context we should mention that it was put to Mr Clayton that the policy of requiring the CD to put 70 (65) through the structure was to get an enhanced level

[20] We should point out that the example relates to the *probability* of profit, not the expected result (being the result of each possibility times the frequency of that possibility).

of tax relief for investors. He disagreed and said it was "so that we could mitigate our risk and spread what capital we had across the largest slate of films. Otherwise we could easily have spent 100% of the capital we had on one film." However, this answer was: (i) inconsistent with a later answer in which, having said that it was an absolute requirement for contracting for a film that the CD put up 70 for the LLP's 30, and that "by having 30% in each film you can take the pot of capital … and spread it across a greater number of films to achieve a portfolio effect" he agreed that this could have been achieved by putting the same cash sum, rather than the same percentage in each film, thus spreading the financial risk more evenly; and (ii) did not sit easily with ITP's portfolio in which nearly 50% of the expenditure was on *Wimbledon*.

549. Mr Clayton said that the reason they had chosen 30 was that "30 was a good number … and it gets us a seat at the table and that is a proportion we are happy with across all films". It seems to us that putting 40% or 60% in would secure a seat at the table with even greater influence but would reduce the relative tax benefit to investors. Further when a Shortfall Financier put up a percentage, the LLP's percentage of the budget could fall well below 30% (although the model still applied to treat the LLP as paying 100% of the proportionately reduced budget for up to 54.45% of the proportionately reduced GDI), so that 30% was not the magic proportion for the desired influence. It seems to us that it is likely that Ingenious considered that if it put in less than 30% of the cost but claimed losses by reference to 100% of the cost that might have been regarded as over-aggressive tax planning.

550. We conclude that the fixed 70:30 (65:35) divide in the model was to obtain the expected accounting and tax losses, and was not on its own designed to contribute to profit; although we accept that the presence of another substantial commercial entity contributing to the finance in some proportion provides comfort about the commerciality of the film.

(vii) That it put the LLPs at the heart of production.

551. Some reliance was placed on the fact that the CD model placed the LLPs at the heart of production.

552. See the comment at the beginning of this section about our conclusions from the Avatar Hedge.

553. Mr McKenna said that the commissioning distributor model enabled Ingenious to be engaged in the production process. This he said was crucial: they would not want to sit passively outside of films; they wanted to be at the heart of production. That way, he said, "you get access to information and you have influence and control." Mr Bower said that the model gave them involvement, contractual rights, and conferred on the other parties greater obligations than if the LLP were merely an investor. Mr Milne described the advantage as a greater quality of involvement in the film.

554. It seems to us that being close to, or at the heart of, production in this sense may have had the results that: (i) Independent films were made which would not have been made but for Ingenious' involvement, (ii) it may have made involvement in the LLPs more attractive to investors, (iii) it may have provided contacts, links and exposure for Ingenious companies, and (iv) it may have fitted Ingenious' image; but we cannot see how it promoted the LLPs' profitability.

(viii) That it ensured the alignment of the interests of the CD and the LLP.

555. The nature of the model was such, Mr Milne said, that the interests of the LLP and the CD were aligned: both shared the same income and costs.

556. HMRC point out that the LLPs had no control over P&A expenditure, and that a Studio was permitted to add a 10% overhead to this. The Studio and the LLP were not precisely aligned.

557. We agree that to an extent this is true. Each party had the same interest in increasing sales and in reducing external costs. But (i) although two persons may have the same object they may differ on the best way to achieve it, and the CD had the only vote, and (ii) in relation to, for example, the pre-production elements of the budget, the overhead charges in P&A, and the retention of any underspent contingency by the PSC, the CD or its parent company might well have interests opposed to those of the LLP.

558. We conclude that it was not shown that this aspect enhanced the prospect of the making of profits by the LLPs.

The Commissioning Distributor Model: Conclusions

559. We conclude that there were features of the CD model structure which gave some protection to the LLPs against the losses which could arise under the traditional model (particularly of the sort suffered by Mr Finney at Renaissance Films – see Appendix 6) and which improved the chance of receipts, and thus of profits. We accept that those features evidence an intention to achieve greater income and some motivation to profit, but whether or not the activities to be put into action under the model had a realistic possibility of profit depended on the financial terms of the waterfalls under the agreements and the commerciality of the films selected to which the model structure would be applied.

560. It also seemed to us that any advantage of being at the heart of production could have been obtained by a fairly simple joint venture agreement giving the LLP the same quality of involvement as it had under the CD Model without the complexity of the model occasioned by the provision in relation to the payment of 100% of the budget.

4. Green-lighting

561. Before an LLP would contract for a film, the project had to be approved by a green-light committee ('Exco' in the case of IFP2). The procedure adopted was more formal for IFP2 than for ITP.

562. ITP had a committee consisting of Patrick McKenna, Duncan Reid and Kevin Mead (who was then CEO of the Ingenious group). Mr Reid explained that at this time they were quite a small team and the procedure was fairly informal.

563. IFP2 had a more formally constituted committee, three of whose five members had significant media business and film industry expertise and were independent of Ingenious (Mr Finney described David Heyman (who joined the committee in July 2005) as a seasoned and successful producer and James Mulville as similarly successful and experienced in TV, but regarded the committee as lacking film marketing expertise). The independence of this committee had accounting advantages. To this committee more formal proposals for green-lighting were made. Mr Clayton told us that the members of the committee were investors in the LLPs and were therefore motivated to ensure that the money went into the best films.

564. The IFP2 Information Memorandum set out a list of criteria the committee would apply for green-lighting a film:

(a) a producer and a director with a successful record;

(b) attractive cast preferred;

(c) for Independent films, a recognised satisfactory sales agent;

(d) again for Independent films, one significant major territory presold.

565. In Chapter IV section 1 we described the move towards a greater concentration on Studio films. In it we noted four conclusions relevant to some degree to the approach of Ingenious and the committee:

(a) some flexibility was given to Fox to allocate IFP2's capital between films. This may have resulted in Fox allocating the LLP's monies to those films they considered would be less profitable – and gave no weight to any view IFP2 might have had about potential profitability;

(b) there was likely to have been some prioritising of the investment of members' subscriptions before 5 April over the assessment of the likely possible profitability of the films and the LLP;

(c) there was some leaning towards high visibility Studio films;

(d) whereas Independent films were generally not profitable, Studio films were less risky.

566. Mr Clayton told us that his approach was to try to find films to submit to the committee which were capable of hitting a hurdle of 2.2 x budget = WWBO (see also section 6 and 7 of this Chapter) by reference (mainly) to the ingredients of the film listed above, and that the Ingenious team member working on the film would submit a

paper to the committee containing key information, but that in the early days of ITP there were also informal communications between team members and members of the green-light committee. Mr Clayton accepted that on occasion documentation could start before formal green-lighting.

567. We were not clear how Mr Clayton came to his conclusion that a particular film would achieve this multiple, and indeed there was some confusion in his evidence as to whether the desired multiple was 2.2x or should be higher (since the Information Memorandum for IFP2 presupposed that Studio films would achieve 2.9x multiple). There was no evidence that he conducted a comparative analysis against other films. We conclude that he assumed that a film would be sufficiently successful if it met the green-light criteria.

568. Mr Clayton explained that for ITP 1 and 2, there had been a shortlist of 48 films of which 13 were green-lit, and for IFP the shortlist was 138 out of which 22 were green-lit. We noted in our discussion of the circumstances of the Avatar Hedge that IFP2 entered into the Hedge because the green-light committee put its foot down. It was thus not toothless or moribund.

569. Mr Bower said that the committee did not consider a list of comparable films. He did not think that an analysis of profitability was considered because how could one say what profitability would be? For later vehicles he had seen some green-lighting papers which compared various cases: low, NRV, and basic case.

570. The papers for the films which were put up to the IFP2 committee for approval consisted of three pages on which there were details of the writer, the director and those actors who had been engaged, the distributor and the budget. These pages included a box in which a short description of the plot – not more than about 6 lines (that for *Avatar* said "A science fiction epic using ground breaking technology"), and boxes for the name of the CD and contact details.

571. Attached were illustrative figures, all in much the same form. They included the budgeted cost of the film, a waterfall analysis showing the revenue accruing to the LLP at different levels of Distribution Income (which seemed to be Gross Receipts less distribution fees and expenses). These waterfalls, because they generally assumed broadly the same schedule 7 scheme, showed that when Distribution Income rose to about 200% of budget the LLP's receipts would exceed the cost of the film. A sheet headed Payment Instruction showed some of the deductions projected in calculating Distribution Income from Gross Receipts.

572. For example, the paper for *Australia* showed the total of distribution costs and fees as 30% of gross receipts. Thus a reader might conclude that if Gross Receipts exceeded 2.85% (= 200%/70%) of budget the LLP would receive more than budgeted cost. Assuming the accuracy of these tables an appraiser only had to decide whether there was a decent chance that Gross Receipts would exceed 2.85 x budget, and if so by how much (see further section 7 where we discuss this parameter in relation to the 2.2x approach and other rules of thumb).

573. The meetings lasted between one and two hours. Mr Bower said that he recalled a meeting in which there had been over an hour to talk about three or four films. Sometimes non-production proposals might be discussed but the time involved in them was not material. In addition to the approval (or occasionally otherwise) of films there would be an update in relation to films in hand and some discussion of what might be in the pipeline.

574. We saw minutes for some of the meetings of the committees. For example, those for IFP2 of 29 November 2005 described themselves as minutes of the inaugural meeting of the committee. They declared that the purpose of the committee was: "To examine and approve a number of films that could be produced by IFP2 subject to contract and available funds". There was a note of a discussion about the basis of approval:

(a) the film had to satisfy a qualitative test;

(b) there had to be available funds; and

(c) the film had to have been evaluated by Ingenious staff and, broadly, found to meet the criteria in the Information Memorandum.

575. Those minutes describe the discussion in relation to the proposed films. Matters such as the reputation of the director and actors were noted. There was some note of the plot. Five films were approved.

576. The next meeting was on 9 February 2006. The only members of the committee who were present were Mr Reid, Mr Mead and Mr Mulville. They approved 9 films.

577. In an e-mail of 4 April 2006 Mr Clayton updates the committee members on the progress of the slate for IFP2. He explains that a number of deals have closed but that negotiations over *The Golden Compass* and *Hairspray* have been difficult and slow, and that there is a possibility that they will not get the deal done on time (i.e. by 5 April). He explains that there is a back-up plan to do another film with Fox. He states the budget, the director and the genre of the film, and says he will call each of them to get their thoughts.

578. Mr Clayton copied the e-mail to Kevin Mead. Mr Mead replied "Get their thoughts? Blimey, this is an invitation to say no!!"

579. One member of the committee replies by return (apparently within 2 minutes although the time line on Mr Mead's reply casts some doubt on the accuracy of the times), "fine with me", and Mr Clayton copies the reply to Mr Reid and Kevin Mead, advising Mr Mead that "you have to make them feel that it's a genuine process, not just a rubber stamping". Mr Mead replies "Fuck off".

580. Films were rejected by the committee: Mr Clayton gave examples of films rejected because of concerns over commercial success, suitability for the screen rather than TV, and lack of presales. We accept that many films were considered and rejected by Ingenious personnel and not submitted to the committee.

581. The minutes of an IFP3 committee held on 23 June 2007 show: that of the 6 films approved by the committee, 4 had already been "opportunistically closed subject to Exco approval", that a reason for favouring another approved film was that involvement in it "would strengthen IFP's relationship with Capital Films and BBC Films", and that the two films rejected had "a very depressing storyline" and a sales agent which, "as it had already made a number of presales [was] unlikely to relinquish the project". Although these minutes relate to IFP3 we regard the indications therein of the approach adopted by the committee as likely to have been applied in relation to IFP2.

582. There were examples of a few IFP2 films having been signed up before the committee gave its approval, although the documentation generally made undertaking the film conditional upon the LLP having the funding. IFP committed to *Life of Pi* before the screenplay was finished.

583. We note that the terms of the Commissioning Distributor Agreements did not depend to any extent on how good the committee thought the films would be. Better terms were not sought for a film about which there were doubts or worse ones accepted for a film which was thought to be a real winner. That suggests that the committee did not have profit at the forefront of their thinking.

584. In section 1 of Chapter IV above we related the arrangement which Mr Clayton reached with Fox for the allocation of IFP2's funds across a selection of films as Fox wished, and noted that this meant that Fox might allocate the LLP to those films it thought less promising. It also meant that if the committee had any preference as between the films its views could not be taken into account, and suggests that the committee either did not care or regarded Fox's internal green-lighting as sufficient for its decision. But that ignored the difference in the division of flow of income from the film between Fox and the LLP: for as we note elsewhere for a film to make a profit on the Ingenious basis it probably had to do better than it would have had to do to make a profit for Fox (or on the 30:30 basis).

585. In addition, as explained earlier, we gained the impression that there was a need to use the funds raised by the LLP before 5 April – hence the list of Fox films and the "flex", or the assumption that Studio films would be OK. That cast some doubt on whether the committee really aimed at a profit for the LLP.

586. HMRC suggest that the green-lighting process was simply the rubber-stamping of decisions already made by Ingenious employees.

Green-lighting: Conclusions

587. We believe that generally films were not signed up before they had been approved by the committee, and that it is likely that the internal requirement for green-lighting by the committee introduced an element of rigour into the film selection process. We accept that the committee members were experienced and would have had a better idea than most people as to whether a film would be successful. That was more so in the case of IFP and IFP2 than ITP.

588. The papers presented to the committee were formulaic and quite Spartan. They would not have permitted, on their own, an evaluation of the appeal of a particular film. Although the committee members had expertise, there was no report from someone like Mr Briggs, who had explained to us that by looking at comparables he was on occasion asked to address the question: if this film performs well, will I make money?

589. There was no evidence that the committee considered the expected range of financial outcomes for any of the proposed films, and whether what they regarded as success would translate into profit for the LLP for the particular film. Although Mr McKenna said that they considered the performance of comparable films, there was no evidence of a detailed quantitative assessment of comparable films of the same genre or with the same cast or director. We saw no indication (save in the formal papers) that the committee measured success against a 2.2 multiplier (or even a 2.9x multiple). There seemed to be limited discussion of whether they considered the mix of films was such that overall they gave the LLP a prospect of profit in the foreseeable future, although the story of the Avatar Hedge indicated an unwillingness to put all their eggs in one basket. We concluded that the committee did not conduct a rigorous appraisal of LLP profitability as they approved films particularly having regard to the very large amounts of money committed to individual films.

590. It is true that Mr McKenna and Mr Clayton said that the LLPs only green-lit films where they thought that they had a realistic chance of making a profit, or when they thought the film was capable of achieving WWBO more than 2x (or 2.2x – see section 7 below) budget, but those criteria do not shine from the recorded proceedings of the committee. That of course leaves open the possibility that these were filters which were applied by Ingenious staff before they put a film up to the committee, but we were not convinced that any rigorous quantitative assessment was conducted by Ingenious staff.

591. Nevertheless the LLPs were involved in many high-profile films which were generally regarded as successful. Ingenious described then as successful in its communications with intermediaries and investors. Thus, in 2005, Mr Reid wrote to an investor enclosing a newsletter which he said gave a flavour of the "breadth, width, quality and success" of the films.

592. If the relevant test were: did the LLP aim to make films which were regarded as box office successes or which achieved critical acclaim, we would regard the actions of the committee as evidence in favour of that conclusion. But if the test is whether the committee, and through it the LLP, had an intention or reasonable hope that the production of the films as a slate would mean that the LLP received more than it paid, then we did not find that the evidence of the committee's process supported such a conclusion.

5. The Evidence Given by the Controlling Minds of the LLP's

593. Each LLP's Operator was an Ingenious company. It was clear to us that the controlling minds of those companies, and thus of the LLPs were Mr McKenna, Mr Reid, and, after 2003, Mr Clayton. Mr Bower joined in 2005: we did not regard him as a controlling mind, but his evidence assisted in evaluating the evidence of the other three.

Mr McKenna

594. Mr McKenna spoke in his witness statement about the balance between risk and reward. He said that to focus on maximising profit is usually to accept an unsustainable level of risk. Their aim, he said, was to mitigate risk to the fullest extent possible "while still preserving the ability to profit from successful films". He says that when green-lighting each film they believed "that they were capable of delivering profits".

595. The business model, he said, was designed to enable the LLPs to scour the market for the best and most commercially promising projects with the greatest potential for making profit. Their aim he said was to produce best-of-breed films for a worldwide audience with the clear aim of making as much profit as possible. He told us that they cherry-picked films because only certain films had the potential to make a profit. They only green-lit a film which they believed had a realistic chance of making a profit. That was the threshold. He preferred making hit films: seeking hits was what Ingenious did. He suggested that seeking profits was an essential part of the model, because unless they sought profits investors would have no access to the tax losses.

596. Mr McKenna also told us that:

(a) films which produced a substantial return for their backers were like hen's teeth. British films rarely recouped their budget;

(b) one of the objects of having a slate of films was to increase the likelihood of securing a hit, and to mitigate the effects of disasters. For an LLP to make a profit the hits had to make good all the losses;

(c) in the case of IFP, but not ITP, the "first dollar corridor" from gross receipts increased the likelihood that a film which did not make a profit for the LLP would provide some contribution to the LLP even if its performance was dire;

(d) the first dollar corridor and presales would mean that investors would receive some return of their investment even if a film did not make a profit for the LLP;

(e) the Ingenious film personnel knew that unless an LLP was managed with a view to profit it would not deliver to the investors the tax benefits advertised in the Information Memoranda. As a result the LLPs were managed with a view to profit;

(f) Ingenious' rule of thumb was that a film was likely to be profitable for an LLP if, in the case of a Studio film WWBO > 2x budget, and in the case of an Independent film, collected gross receipts > 2x budget.

597. We note that even a casual glance at the composition of the list of the films in which the LLPs participated shows that the LLPs took part in many high-quality, high-profile films. Many were involved in Oscar and BAFTA nominations and wins, and many of their titles will be known even to infrequent film watchers. That success, however, is different from profit: *Closer* proved that – it was an Oscar-winning film but never recouped its P&A expense and the LLP got nothing from it.

598. We comment on Mr Mckenna's 2x budget rule of thumb in section 7 below.

599. We have four comments on Mr McKenna's evidence:

600. (i) First, that he spoke mainly of the capability or ability or potential to make profit rather than the likelihood of profit. We accept his evidence that there is no way to guarantee the performance of a film in advance, but there is a difference between thinking that something is possible and that something is likely or realistically possible.

601. (ii) Second, there is a difference between profit for the CD or Studio, profits for the LLPs computed on the Ingenious basis, and profit for the LLPs on the 30:30 basis. Mr McKenna illustrated his expectation that WWBO of more than 2 x budget would deliver a profit on the film for the LLP by some "kitchen table calculations". We return to them later, but inherent in the Ingenious basis of profit computation is that the LLP is at a disadvantage compared to the CD, and thus in order for a film to be profitable for the LLP it has to perform even better than it would have to be profitable for the CD. We accept that Mr McKenna sought successful films, but there was no indication in Mr McKenna's evidence of any recognition that the measure of success needed to deliver a profit on the Ingenious basis was thus higher than that required for a Studio.

602. (iii) Third, Mr McKenna described real moneymaking films (like *The Full Monty* or *Four Weddings and a Funeral*) as like hen's teeth. There were many more losses than hits in the business. He said that it was easy to express a view on a finished film, but much more difficult to say with any certainty how a film would turn out. The LLPs were picking films which could make a loss or could make a profit but where the chance of a real hit was low. That raised the question of whether the LLPs seriously considered the overall position rather than film by film. If it was unlikely that they would choose a real hit but likely that a material proportion of the films would make a loss (however computed), would the profits of the moderately successful films make up for the losses? Save in relation to the illustrations in the Information Memoranda (as to which see below) we saw little evidence that the LLPs had given serious or detailed consideration to this issue.

603. The "slate approach" did not provide an answer: as we noted earlier its ability to deliver a better chance of an overall profit depended upon the distribution of probabilities of possible outcomes. This dependence on the distribution of probability

of profitability was alluded to in an e-mail Mr McKenna sent Mr Reid on 25 July 2003 in relation to a proposed project in which Ingenious would not participate in the receipts from the start. He said that the message to be delivered to the promoters of the other project was that:

> "1. One big film in the slate doesn't pay for the others when you don't participate in the first 70% of income arising from the other films, and 2. You can still make a full recovery of the slate budget and a handsome profit/return when you get one hit and participation in income arising at different levels from other films in the slate."

604. Thus one unlikely big hit coupled with early access to receipts might ensure profits, but if there was no big hit would the slate be profitable? And how big a hit did it have to be to deliver under the waterfall enough income to mop up the losses?

605. (iv) Fourth, we accept that it is likely that Mr McKenna, Mr Reid and Mr Clayton knew the importance for investors' tax position of the LLPs being managed with a view to profit. They knew that they had to have that intention, but knowing you have to do something is only the beginning, and not its execution.

Mr Reid

606. In his witness statement Mr Reid said (in parallel terms) that IFP2/IG "worked very hard to ensure that every [film/game] it produced had the potential to be a hit, and only green-lit [films/games] it genuinely believed could deliver substantial profits in success."

607. He said that despite the tax benefits which the structure delivered to investors "the driving concern of each Inside Track partnership was to make money from the commercial success of films. To that end they needed to identify commercially successful films which would generate profits for our partnerships."

608. He gave an example in relation to *Blackball*: that additional expenditure on changes to the film was authorised because they thought it would enhance the chance of larger revenues.

609. He explained how Ingenious used its growing commercial strength to obtain better terms – he gives examples of a reduction in the distribution fee from 20% to 15% for IFP2 and the gross corridor in the IFP deals.

610. Mr Reid provided a list of about 200 films which had been rejected by Ingenious for Inside Track. He said that proposals were rejected for a variety of reasons including the following:

(a) the developer had failed to attract the 70% finance required for Ingenious' involvement;

(b) doubts over the quality of the proposed financial commitments of others;

(c) failure to attract a sales agent;

(d) failing to sign the star or director needed.

611. He explained that Ingenious was searching for films which could be "made ready to go into production in the short term and which met certain objective criteria:

(a) commercial viability (by which he meant that the project involved well-known actors or directors);

(b) an experienced day-to-day producer;

(c) market validation (in the form of presales or other market finance);

(d) a sales agent for Independent films.

612. We had reservations about this evidence which were similar to those we had about Mr McKenna's evidence:

613. (i) The evidence was generally of the potential to make profit, rather than the likelihood of profit.

614. (ii) There was no recognition that, on the Ingenious basis of determination of profit, it was more difficult for the LLP to make a profit: that a film had to be more than usually successful.

615. (iii) Improved terms may deliver profits or make more profits, but may also limit or reduce losses and provide income (not profits) to investors.

616. (iv) The likelihood of profits for the LLP depended on the distribution of the likelihood of profits and losses of the films or games.

Mr Clayton

617. Mr Clayton said that in working for the LLPs they had both the LLPs' and the individual investors' interests in mind: "[t]he overarching aim was to optimise both the [LLP]'s chances of profitability and returns for the members." He explained that the structure gave access to revenues in the waterfall which had previously been the preserve of banks. We comment that optimising the chance of profit is not quite the same as having a realistic aim of profit, and that returns for the members are not the same as profit for the LLP.

618. Mr Clayton was an investor in an LLP. Mr Stafford asked him what he was expecting from his investment and whether he expected distributions in excess of his original investment. He said that he knew he would get sideways loss relief and his cash back, "I knew that on the Independent films we had contracted presales would deliver a positive return and then I hoped that my upside would come from further presales and hit movies from the Studios driving revenues and profit through the partnerships and then out the other side into my hands."

619. We comment that the returns for members arose well before the LLPs became profitable because drawings were paid from immediate receipts. Although income received by the LLPs after the initial write down to NRV gave rise to the recognition

of a profit, the LLP did not become profitable until that income exceeded the cost of the film. Mr Clayton's hope as an investor was in effect to get something more than his tax back, not to invest in an LLP which recouped in aggregate more than its original investment in the films. This understanding of the position of the investors would, in our view have affected the way in which the business of the LLP was conducted.

620. Mr Clayton said that ITP sought (i) top-end cinema films, (ii) with a strong creative pedigree (well-known major participators), (iii) distribution arrangements, and (iv) a strong commercial deal. Taking these together he says "we believed the films in question were capable of making a profit for the relevant LLP". Mr Clayton did not go so far as to say "likely" or realistically possible.

621. It seems to us that top-end cinema films with well known artists and other participants may be likely to draw cinema goers and give rise to revenues, but whether the film is profitable for the LLP depends on its cost and on the waterfall. Most of the characteristics Mr Clayton lists ensure visibility. Good distribution was linked to profitability, but crucially profitability depended on the terms of the waterfall.

622. Mr Clayton said that had they not been interested in profit this hearing would have been considering films no one had heard of that generated no revenues at all. This in our view shows that big well-known films were the objects of the LLPs' desire. Such films were likely to bring revenues in, but that is not the same as making profits.

623. Mr Clayton, who had heard some of Mr McKenna's evidence, said that his approach was to "try to find and submit films to the green-light committee that were capable of hitting the 2.2 x box office hurdle". This he said was done by reference to the quality and track records of the producer, the film making team and the distributor). A hit was more than 2.2 x box office. We comment on this in section 7 below.

HMRC's Criticisms

624. Mr Gammie says that the evidence of Messrs McKenna, Reid, Clayton and Bower must be viewed with some caution since they knew they had to show a view of profit. He says that the surrounding circumstances show that in fact they were not concerned about profit for the LLPs no matter how they might have painted the picture at the time, or in their evidence.

625. *First*, he says that for the Ingenious organisation, profit for the LLPs was unnecessary. Ingenious received its Operators fee (2.81% of total capital contributions (including the amount treated as a CM contribution) – so 5.6% (IFP2) or 4% (ITP) of individual members' contributions and the Executive Producer fee (5% of the film cost) up front. Ingenious was dependent upon overall subscriptions not profits. In the IFP structure the CM was a member of the Ingenious group and made an after-tax profit of at least 5% of the net distributed income (see Chapter III: The Tap). That was

the spur to get as much income as possible for the LLP and that was different from having a view that such income (in aggregate) would exceed the LLP's expenses (in aggregate).

626. We accept that this required a guarded approach to their evidence. For most commercial organisations achieving a surplus of income over costs is essential to their continued existence. If they want to continue in business they must aim for a profit. This was not the case for the LLPs. They were vehicles set up to deliver returns to investors which would be good even if they did to make profits. They were set up as single-year vehicles, as Mr McKenna said, one for each year (although there were originally unplanned later investments in IFP2), and did not need profit to survive.

627. Nor did those running the LLPs (through the Operator) or who provided their services to the Operator who provided the results of their activities to the LLPs need the LLPs to make profit to secure their continued employment. That was dependent on the continued profitability of Ingenious, and Ingenious' income came from: the one-off charges made by the Operator and the EP (which required no continuing profit of the LLP), the 5% or more of GDI retained by the CM (and in the case of ITP an Operator's success fee, which was rather unlikely to materialise). Those sources of income might motivate a seeking of receipts for the LLP but did not require LLP profit.

628. Thus those managing the activities of the LLPs were not subject to pressure from investors to achieve a profit or subject to the usual commercial incentives to conduct the business with a view of profit.

629. *Second*, he says that there was no pressure from investors for the LLP to make profits. A list "of complaints received in the past" in one of Mr Bower's notebooks contains grumbles about entry costs, responsiveness, complexity and a perception of arrogance, but makes no mention of lack of profit even though there had been none. That result is not surprising – the returns the investor made (if they obtained the tax loss relief) were positive from Year 1 onwards when all or substantially all of their original investment would have been refunded by tax repayments or reductions, and thereafter every £1 of receipts (£5 of drawings less £4 tax) was further bounty. They were interested in more income but not on whether the LLP was profitable.

630. He says that the commercial pressure on the Ingenious personnel running the LLPs was to ensure that there was some modest level of receipts for the LLP – to provide the investors with their easy profit – and that there was no pressure to manage an LLP so that it made a real profit: to aim for a flow of receipts which exceeded the cost of a film.

631. He says that Ingenious' interest was really in the flow of income from the films rather than in income which exceeded the cost of the films (or income which in aggregate exceeded the cost of all the films). That was evident in the CM's 5% retention referred to above, in the returns to the members, and in a negotiation in relation to the gross corridor when in order to obtain some fairly small share of

revenue before P&A expenses had been recouped, a lower share of profit after recoupment was offered.

632. We accept that the LLP did not have to recoup its costs before the investors started to make a positive after-tax return. Almost any amount of film income from a film's waterfall secured a profit for an investor.

633. In this context we note the e-mail from an Ingenious investor (no 1105) who asks whether in the light of the good box office figures and the reported budget of a particular film, the film would be profitable for IFP2, bearing in mind that it looked profitable for the Studio. An Ingenious employee sent an e-mail to Mr Clayton with a draft for a reply to this e-mail in which he said "I guess the key point is that the investors just need partnership receipts to be profitable anyway as they are already at cash breakeven." (No doubt because of their tax recovery).

634. We accept that in some of their evidence Mr Reid and Mr McKenna conflated the concept of profits for the LLP with revenue (for example Mr Reid's statement that an LLP would have substantial taxable income because it was trading with a view to profit; when revenues were received in a year in excess of the NRV of a game or film the partnership would recognise a profit in that year, but it would not realise an overall profit on the film or game until the total revenues exceeded its cost).

635. A number of elements of the evidence indicated the importance of receipts rather than profits:

(a) in the IFP2 Information Memorandum it was said that "IFP2 will only produce films where … it is able to secure participation in sales receipts, not just profits." That was a recognition that sales receipts – income – would be more important for an investor than the LLP achieving a profit. Aiming for receipts is part of aiming for profit but only if the aim is to obtain receipts which cover costs;

(b) the IG Information Memorandum spoke of "maximising the return through participation in revenues arising from games exploitation receipts rather than profits": a recognition of the comparative importance of receipts;

(c) the reply suggested to the investor's e-mail about the possibility of profit recorded at para [628] above;

(d) Mr Clayton's description of his hopes for the results of his own investment in an LLP and his answer to Mr Stafford's question recorded in section 5 of this Chapter;

(e) an e-mail from Mr McKenna to a Richard Harris about the advantages of investing in Inside Track. Mr McKenna said that it represented "an opportunity to participate in the gross sales income (not, non-existent profit!) arising from a portfolio of films with a minimum net of tax return of 6% and with the investment being returned within 6 months." The words in parentheses are those of Mr McKenna;

(f) the negotiation of the gross receipts corridor. Not only was there some suggestion that later benefit (and thus a greater possibility of profit for the LLP) could be given up for participation in earlier receipts, but the effect was to provide receipts for the benefit of investors even if a film did badly. It evidences an aim of income even if it also mitigated losses and could assist in LLP profits (after all, all income assists in the path to profit).

636. To our minds the evidence indicates that revenues were important and were sought by the LLP, but this does not mean that an overall profit was not also sought.

637. *Third*, Mr Gammie says that Ingenious' main interest was to secure the tax relief for investors. It was that relief which provided the recoupment of, and return on, their investment. The nature of the film agreements put in place under the CD Model was intended to secure that relief by having the result that 100 was treated as invested in the film for each 30 (35) provided by the investor, but the nature of that agreement came with its effect that although 100% was treated as expended only at best 54.5% of the distributable income after expenses was received. The importance of the tax relief meant that getting a good deal on profit was put in second place.

638. Mr Gammie also notes an e-mail Mr Gardiner of Ingenious wrote to Mr McKenna saying that a high level of presales would mean "that the return to investors in the tax write-offs is considerably reduced". HMRC suggest that films which sales agents were willing to back – films which were thought by experts to be likely to be successful – were eschewed by the LLPs.

Conclusions: Controlling Minds' Evidence

639. We agree with Mr Gammie that the first two considerations lessened the commercial pressure on Ingenious to seek profit for the LLPs, but set against that was the undoubted knowledge which all the relevant people had that the LLPs had to have a view of profit in order to deliver the tax benefit. That too was a commercial pressure. The question is whether Ingenious took steps to alleviate the pressure rather than just persuading themselves that they had that objective.

640. We have addressed the question of tax motivation in Chapter VI: Trade. We agree that obtaining the advertised tax results for the investors was a real concern of those at Ingenious and that it resulted in income (on the Ingenious basis) at a level which made it much harder for the LLPs to make a profit and easier for them to make a loss.

641. Taking this together with our earlier evaluation of the evidence of Mr McKenna, Mr Reid and Mr Clayton, we were not convinced that the controlling minds' evidence was enough to conclude that the LLPs had a material intention that the business would be so conducted as to have a realistic chance of making a profit on the Ingenious basis.

6. The IFP/IFP2 Information Memoranda

642. Each LLP produced an Information Memorandum for the benefit of prospective investors. Mr McKenna, Mr Reid and Mr Clayton (the "three individuals") had responsibility for these documents.

643. The Information Memoranda for IFP and IFP2 each contained a table which illustrated the potential profit and loss account of the LLP over the first five years of its life. An Information Memorandum was also produced for ITP but it did not contain any such quantitative illustration.

644. Much time was spent during the hearings examining the way in which the IFP2 and IFP Information Memoranda had been prepared, and the responsibility of key members of Ingenious staff for their preparation.

645. Our first interest in the figures in these Memoranda is in relation to the light they shed on the financial aims or intentions of the LLPs, and whether they indicate that at the time of their issue (and thereafter) the LLPs had a realistic prospect of profit.

646. The IFP Memorandum was issued for subscription by 5 April 2005 and the IFP2 Memorandum for subscriptions before 5 April 2006. An Information Memorandum was also issued for IG. It is discussed in Chapter XII section 4(vi).

647. If the business of an LLP was in fact conducted on the lines indicated by the Memorandum, then at times after the launch of the LLP the financial illustration in the Information Memorandum could indicate whether those businesses operated with a realistic possibility of profit at those times and may illuminate the subjective view of those controlling those businesses.

648. The illustrated five-year profit and loss in the IFP2 Information Memorandum is set out in the following table. The figures relate to the combined results of the film and non-production activities. The figures were predicated on a number of assumptions including the raising of capital of £200 million.

£m	2006	2007	2008	2009	2010
Turnover	nil	11.9	66.8	74.2	60.8
Cost of Sales	(89.9)	(9.2)	(40.7)	(28.2)	(17.1)
Gross Profit	(89.9)	2.7	20.1	46.0	43.7
Management Fee	(5.6)				
Operating Profit/Loss	(95.5)	2.7	20.1	46.0	43.7

649. The 2006 cost of sales figure represented the effect of the write down to NRV of the full budgeted cost of all the films contracted for in that year. The turnover in subsequent years represented receipts from those films and also receipts from the proposed non-production activities. The illustration suggests that a combined aggregate profit from both activities could be made in years 2 to 5 of £112.5m so that over the five-year period a gross profit of £22.6m, and an operating profit of £17m, could be made.

650. If these figures were a realistic appraisal of the results of IFP2's intended activities they would suggest that, at least for the activities which took place in 2006 (the contracting for 22 films), those activities could realistically have been, and be considered to have been, undertaken with a view to profit.

651. The structure and much of the content of the IFP2 Information Memorandum followed that of the IFP Information Memorandum.

652. The IFP2 table shown above was based upon a spreadsheet, LS202, which illuminated the assumptions underlying the figures in the table. The calculations in that spreadsheet shared some common features with those used for the IFP memorandum.

653. LS202 shows the composition and derivation of the figures in the illustration. We note at this stage that LS202 shows that £118.6m of the total turnover in the table related to film production, and that, of the total cost of sales in the illustrative table, £112.4m related to film production. Thus LS202 indicates that a 6% profit margin was being illustrated for film production over a 5 year period. That is only a modest profit, and a modest profit may be more susceptible to variations in circumstances than a large one, and if there are many uncertainties it may not be a reliable illustration of a realistic outcome.

654. The balance of the figures in the table was attributable to non-production activities. They were projected to provide a slightly higher profit margin of about 8.6%.

655. We understood that the Appellants do not rely on the effect of non-production activities. As a result our enquiries relate only to the film production part of the illustration.

656. The IFP Information Memorandum was based on a spreadsheet entitled Financial Model 13; we shall call it LS101. There were a number of iterations of LS101 before a version was settled upon whose outputs were used in the IFP Information Memorandum. It appears that initially assumptions were made about matters such as the spread of films undertaken, their box office success, the ratios of various costs to budget or to box office and the effects of the waterfalls. Applying these assumptions to LS101 the net receipts of the LLP were calculated. This was described as the "top-down" method.

657. We were referred to 8 versions of the IFP Information Memorandum. These reflected the effects of changes to:

(a) the number of films on the slate and the split between Studio and Independent films,

(b) the ratio of gross receipts to budget,

(c) the ratio of box office to budget,

(d) variations in the timing of receipts and expenses.

658. After about four iterations the mechanics were changed. Rather than starting at the top with assumptions about film performance and predicting profits, a particular level of overall profit was put in at the bottom, and the film performance was 'backsolved' on the basis of the intermediate assumptions built into the model. Thus in broad terms, assuming the fairness of the intermediate assumptions, the model became an indicator of what level of box office performance would be required to deliver the chosen profit. Mr McKenna said that a modest level of profit was selected and the resultant levels of film performance reviewed.

659. Mr Hellier thinks that this is a perfectly sensible way of preparing a budget. If you start at the top in preparing your budget for a year using particular assumptions about your income and expenses and you come out with a disastrous deficit, or an unbelievable profit, you may well go back and revise the figures to get an end result you can live with. But (generally) budgets are used to guide expenditure. Here we are interested in the illustrative projections as evidence of what the LLPs may have had in view and of the likelihood of fruition. Mr Stafford thinks that it is quite the wrong way round and that the starting point for most budgets is expected sales, and that costs and profit or loss follow from that starting point.

660. To our minds the illustrations were explanations to investors of what might happen. "Our aim" wrote Mr Reid, "was to illustrate the performance required to achieve a modest level of profitability", or as he said "let's show a modest profit and

then benchmark the key assumptions about income". They do not appear to be statements of the LLPs' expectations or intent. The description of the figures as illustrative, the selection of a modest profit, and the working back to film portfolio and performance, are redolent of a mind-set of telling investors: "all being well these are the sort of results which could arise, and look, these results are not implausible because the assumptions we have made are within the bounds of possibility." They were statements of what they thought could be achieved not of expectation or intention. Thus we regard the presentation of the illustrative figures as not itself providing evidence that the LLPs had a view of profit.

661. But the illustrations may also be a way of examining whether it would have been realistic to have expected a profit. If the assumptions were, at the time they were made, realistic, then it would have been realistic to expect a profit, and if not, and if, on the basis of realistic assumptions a profit would not have resulted, then the adjusted results may show that it cannot have been realistic to expect or hope for or have a view to a profit.

662. Further, if it could be shown that Ingenious knew that the assumptions or estimates were unreasonable and that corrected assumptions or estimates would deliver a loss, that would be evidence that the LLPs did not have any subjective hope of profit (because they knew it was likely that they would make a loss).

663. HMRC advance a number of criticisms of the assumptions underlying the illustrative figures for IFP2. In brief these are:

(a) that the DVD cost ratio was too low;

(b) that the P&A ratio was too low;

(c) that the effects of the waterfall were not properly modelled;

(d) that other assumptions were made which were inconsistent with data which was held by Ingenious; and

(e) that even if the illustrations did not suffer from these defects, the performance they required from the LLP's films in order to make the modest profit was unrealistic, and ignores Ingenious' own data in relation to the performance of films previously undertaken by ITP.

664. We address these concerns and the witnesses' replies to them in the following headings.

(1) The DVD/Video Cost Ratio

665. In LS202 a figure of just over 23.1% was used as the ratio of video and DVD costs to video and DVD income (the "DVD cost ratio"). In the spreadsheets for ITP, a figure of 35% had been used; in the NRV calculations for IFP2 made after the Information Memorandum had been promulgated, the 35% ratio had also been used. HMRC showed that if a 35% DVD cost ratio had been used in LS202 it would have resulted in an 11% loss over the 5 year period (leaving all other assumptions fixed).

666. The 35% ratio used in the IFP calculation had been based on data supplied to Ingenious by a consultant, Julian Stanford, who had been formally engaged by Ingenious in 2004.

667. Mr Reid demonstrated that the 23.1% figure had been derived from some data prepared by, or in collaboration with, Focus (which, it was not disputed, was a reputable media consultant respected as a revenue and cost forecaster). Ingenious had obtained the Focus material from Mosaic in June 2005. This data included a table showing the components of revenue and costs for 7 films produced by Chuck Roven and Atlas Entertainment between 1992 and 2004. The table showed individual and total figures for domestic and foreign video revenues and for the associated video/DVD costs. The 23.1% DVD cost ratio used in LS202 was obtained by dividing the total video distribution costs for those seven films by the total video revenues from those films.

668. Notes to the table relating to those films from which these figures were taken indicated that five (possibly six) of those films' video income had been calculated by grossing up the amount of a 20% royalty which had been attributable to Chuck Roven. For a further film, the amount of domestic rentals had been similarly obtained, although the foreign international video rental element appeared to be that actually received.

669. The notes also indicated that in two, possibly three, cases, the video costs had been calculated thus:

> "video costs @ 20% of domestic revenue & 25% of foreign revenue".

670. This formula had not been applied in relation to others of the seven films[21].

671. Mr Reid told us that the use of this formula indicated that Focus' view was that the overall DVD cost ratio would be between 20% and 25%. Precisely where it fell in that interval would depend upon the ratio of domestic and foreign video revenue. If all

[21] The 20%/25% formula had not been applied to all the films:

(a)	City of Angels	44,500@20% =	8,900	
(b)		27,100@25% =	6,775	
(c)	Total		15,675	(as per table £15,700)
(d)	Three Kings	48,000@20% =	9,600	
(e)		27,100@25% =	6,775	
(f)	Total		16,375	(table figure: 14,900)
(g)	Scooby Doo	120,700@20% =	24,140	
(h)		898,200@25% =	22,300	
(i)	Total		46,440	(table figure 49,600)

the DVD cost figures in the table had been calculated on that formula then the overall DVD cost ratio would have been a weighted average of 20% and 25%.

672. But because the 20%/25% formula had not been applied to all the seven films in the Mosaic table, the ratio of total DVD costs to total DVD revenue was not determined solely by the weighted average of 20% and 25%, but also by those other figures which it seems likely that Focus had gathered from the actual costs. That could, in theory, have meant that the average fell outside the 20% – 25% interval.

673. There was some discussion as to whether the calculation of the DVD revenue made by grossing up royalty income affected the reliability of the overall ratio obtained from the seven films' data. We should say that we do not think that it would have had any effect *if* the 20/25% cost formula had been applied across all seven films. If for each film DVD cost is obtained by applying 20% and 25% to domestic and overseas income respectively, then the DVD cost ratio will lie between 20% and 25% depending on the ratio of those packets of income. And if the 20/25% formula had been applied to each film then any inconsistent basis in the calculation of DVD income would only have affected the point on the 20% to 25% scale at which the average lay.

674. There were, however, a number of more serious criticisms of the use of the 23.1% figure in LS202:

(i) it is the result of a particular ratio of overseas to domestic income which may not be reflected in the films which the LLP was to make. In particular we note that LS202 uses 23.1% for both domestic and foreign DVD costs;

(ii) it is a result *in part* (because some of the figures for DVD costs in the table were not plainly derived from the application of Focus' 20% or 25% formula) of actual figures (or possibly figures determined in some other way) for three films released between 1999 and 2004, all of which were made by Chuck Roven/Atlas and distributed by Warner Bros, and in part of figures based on Focus' 20/25% applied in the context of films released between 1992 and 1998, all of which were also made by Chuck Roven/Atlas, and three out of four of which were distributed by Warner Bros. That does not look like a representative sample;

(iii) it is unclear whether Focus' use of 20/25% was geared to the period 1992 to 1998. In that period DVD was in its infancy and so may not have been the ratio Focus would have used after 2004;

(iv) elsewhere in the Mosaic material are some forecasts for income and expenses for proposed films. There are six such forecasts and all infer or use a DVD cost ratio of nearly 28%. This material bears the Focus' imprimatur;

(v) 35% continued to be used after the preparation of the IFP2 Information Memorandum in calculating NRV figures including those for IFP2. Mr Crossley though had used the 23.1% ratio in some other work he had done at the time in relation to *Mamma Mia*;

(vi) Mr Bower, when explaining to us the workings of the waterfall, said that "DVD costs at 35% of revenue is, broadly speaking, the ratio one usually observes, something in that ballpark"; and

(vii) Mr Stanford's advice was that the DVD cost ratio was 33% both domestically and internationally.

675. Taking these considerations together, we do not consider that the Mosaic material gave any realistic comfort that the DVD cost ratio should be anything less than 28%. We are comforted in this conclusion by the fact that Messrs Olsberg, Briggs and Sills gave ranges for the DVD cost ratio of: 30 to 40%, 25 to 37.5% and 30 to 40% respectively, although we accept that they gave these views in 2014, not 2005.

(2) A Contingency

676. Mr Reid noted that in LS202 distribution fees for domestic distribution were assumed to be 15% of gross domestic income, but those for international income were taken as 30% of that income. The average, weighted by the respective income, was 22%. He said that in 2005 they knew that they could negotiate distribution fees of 15%: as a result there was in the 22% weighted average figure a contingency margin. Mr Reid told us that he was aware that the forward-looking statements in the Mosaic/Focus material contained DVD cost ratios exceeding 23.1% (he said that he thought these statements used 25%; but, at (iv) in the paragraph before last, we have noted the figure of 28%), and that perhaps that was one of the reasons why they felt some contingency provision in the (international) distribution fees was a good idea.

677. Mr Reid also explained that in the work Mr Crossley was doing at the time for *Mamma Mia* 23.1% was used for the DVD cost ratio, 15% for the US distribution fee (assuming a Studio distribution) and 30% for international distribution fees (assuming independent distributors). The independent distribution attracted a higher distribution fee. These figures are replicated in LS202. It does not seem that this was accidental since, in a note to Mr Reid, Mr Crossley spoke of having "been more prudent in the costs of distribution" in the IFP2 Information Memorandum. On the other hand, as Mr Reid acknowledged, independent distribution may involve a higher distribution fee and LS202 does not make any allowance for that. Mr Reid said, however, that Independent films were projected to provide only a minority (30%) of IFP2's income, so that the additional distribution fee which would need to be provided in respect of such films would not be a full 30% for the slate as a whole. (We offer a figure of at most an extra 4.5%, being 30% of the slate (taken as Independent films) times (30% - 15%). On which basis the weighted average fee would be 19.5%, so that the contingency element would be 3.5% of Gross Receipts.)

(3) Use of Other Mosaic/Focus Ratios

678. In addition to the use of the Mosaic data for the DVD cost ratio, LS202 used that material for the ratios of:

(a) Theatrical Rentals: US and international box office

(b) Pay Per View: US and international box office

(c) Other: US and international box office

(d) Print Expense: US and international box office

(e) Advertising Expense: US and international box office

(f) Other Expenditure: US and international box office

679. But the following ratios for income from DVD/video, cable, network and TV as a percentage of US and international box office were not used:

%	Ratio Used by Ingenious	Mosaic Ratio
US Video Income/Box Office	110%	72%
US Cable Income/Box Office	20%	16%
US Network Income/Box Office	15%	10%
US TV/Box Office	5%	4%
International Video/Box Office	110%	46%

680. In each case Ingenious used higher income ratios than those indicated by the Mosaic data. Mr Reid, unprepared for the question, was unable to explain why this was.

681. Mr Reid suggested that the way in which the DVD/video figures in the Mosaic material had been obtained – in part by grossing up a royalty payment, and the changing landscape of video and DVD sales meant that the Mosaic video ratio "might not have been a very good source to estimate sales income going forward", so that other sources were used.

682. Otherwise Mr Reid was not able to offer an explanation for this approach other than to venture that because the Mosaic film data was old the relationship between cable and TV to box office may have been different by 2005. That was a weak explanation in the context of the acceptance, for example, of the international cable ratio from the Mosaic data and the rejection of the domestic cable ratio.

683. We conclude that there was some unwarranted optimism built into these ratios.

(4) P&A Assumptions

684. LS202 assumes that P&A costs will be 37.5% of gross box office on average. This figure was derived from the information about the seven Chuck Roven films in the Mosaic data. The data indicated an average P&A to gross box office ratio ("P&A/GBO ratio") of 47% for domestic P&A and 28% for international. 37.5% is the average of the two (LS202 applies 47% and 28% individually to US and international box office to obtain the related P&A costs).

685. We have related that in 2004 Ingenious engaged a consultant, Julian Stanford, to provide it with information on likely P&A and DVD costs. Mr Stanford advised that the P&A/GBO ratio would depend on the level of GBO. He provided a table dividing GBO into seven levels or "buckets" each with a different P&A/GBO ratio. Ingenious used Mr Stanford's analysis together with some figures from the Motion Picture Association of America (the "MPAA") in LS101 with the result that in that spreadsheet P&A amounted to 50% of GBO. Ingenious also used these results in 2006 as a starting point in computing NRVs for IFP's accounts, but in view of the known actual performance of nine films undertaken by ITP multiplied each of Mr Stanford's ratios by 1.76 (see Appendix 9: NRV) thus using an even higher ratio than followed from his advice.

686. Ingenious say that the Mosaic data on P&A ratios was the best available to them at the time of preparation of the IFP2 Information Memorandum because it was film specific. This seems to us to make sense only if there was some correspondence between the Chuck Roven films and the LLP's films but no particular parallel was apparent or suggested to us.

687. Mr Reid agreed that in parts of the Mosaic information following the Chuck Roven film data there were forward-looking simulations in which a higher blended average P&A/GBO ratio appeared (something like 40% he said) but he said that was another reason for building in the contingency in the distribution fee. HMRC say that the ratio used was too low (and that Ingenious deliberately or recklessly picked a low figure).

688. A number of issues therefore arise in relation to the P&A/GBO ratios used in LS202.

689. *First*, as mentioned in the antepenultimate paragraph, the Mosaic data also contained six forward-looking analyses for a venture involving 10 films. These analyses or forecasts were separated into those covering four and five-year periods and were given for a Best case, a Base case and a Break-even case. From each forecast a P&A/GBO to ratio may be extracted. For the Best case it was 39% (47% domestic, 30% International), for the Base case 40%, and for the Break-even case 46%. These figures, taken together with the fact that the seven Chuck Roven films were fairly old and had features in common, suggest that Focus' then current estimation of the P&A/GBO ratio would generally have been higher than 37.5%.

690. *Second*, Mr Bower told us that the Julian Stanford methodology was still used by Ingenious and "actually it tends to be very reliable in practice in getting to the right ballpark number in most cases." But he accepted that Mr Stanford's ratios had been

adjusted upwards in NRV calculations for actual known film performance. That suggests that the same view might reasonably have been held in 2005/6.

691. We accept, however, that the NRV calculations were done to determine the "minimum value" rather than a possible or illustrative outcome, and that the choice of higher ratios for them does not of itself indicate that the ratios chosen for LS202 were unrealistic.

692. *Third*, in preparing LS101 the Julian Stanford bucket analysis was used coupled with the use of figures from the MPAA which indicated that P&A was on average 61% of budget. The ratio for P&A/GBO used in LS101 was the weighted average (1 part Stanford; 2 parts MPAA) of the results of these two approaches. The MPAA ratio, combined with the average GBO/budget ratio in LS101 of 1.96, meant that the MPAA figure suggested a P&A/GBO ratio of 31%. The addition of the Julian Stanford bucket ratios brought the average P&A/GBO ratio for the slate up to 50%. That all suggests that the ratio of 37.5% may be on the low side.

693. *Fourth*, Mr Briggs told us, and we accept, that generally the P&A/GBO ratio would be lower for films with high box office although P&A is higher in absolute amount for more successful films (the advertising drove the performance to some extent). This was consistent with Mr Briggs' practice of capping P&A expenditure when box office sales really took off. Mr Stanford's seven buckets reflect that effect: for his ratios diminish from about 200% for a film with box office takings of about £5 million to 36% – 46% for a film taking over £150 million.

694. Further it seems likely that the P&A spend will to some extent depend upon the film's budget: Mr Reid acknowledged that the big budget films tend to have big budget P &A to launch them but that if they flop the P&A expenditure is scaled back.

695. In this context HMRC point to the ratio used by Ingenious in LS101, in which an approximately inverse relationship[22] appears between the box office/budget ratio of the illustrative films and the P&A/GBO ratio. They say that looking at that relationship, while the average box office/budget ratio achieved by the Chuck Roven films of 2.8 was consistent with the P&A/GBO ratio of about 40%, i.e. close to 37.5%, LS202 assumes an average box office/budget ratio of 2.2, which would be

[22] To some extent the inverse relationship will be a result of the component of the LS101 ratio which derives from the MPAA figures, because if (or to the extent) P&A is proportional to budget, then

P&A/Box Office ~Budget/Box Office

i.e. P&A/Box Office ~ 1/(Box Office/Budget)

but that does not detract from the conclusion that a higher P&A/GBO ratio might be expected from films with a lower Box Office/Budget ratio than the Chuck Roven films.

consistent with a P&A/GBO ratio of about 47% (and 37% would be achieved only with a box office/budget ratio of 3).

696. *Fifth*, as we have recounted, in estimating NRVs for IFP2's accounts, shortly after LS202 bore fruit, Ingenious increased the P&A/GBO ratio by some 76% to reflect its own experience on the nine films undertaken by ITP. That suggests that the Stanford/MPAA approach was not thought to be overly cautious at that time.

697. Finally, Mr Reid made the point that with the benefit of hindsight it appeared that the actual P&A costs for IFP2 were less than those illustrated in the IFP2 Information Memorandum: he said that the P&A/GBO ratio had turned out to be 23.5%. Without *Avatar* it would have been 36.3% – very close to the figure used in the illustration.

Conclusion: P&A Ratios: In 2005/6 it seems to us that the fixed estimate for the P&A/GBO ratio of 37.5% was not realistic and that the lowest realistic estimate at that time was 40% (the Base case Focus average).

(5) Modelling the Waterfall

698. HMRC contend, and we accept, that by the summer of 2005 when LS202 was being instructed, Ingenious personnel had been agreeing sets of commissioning distributor agreements for film deals for some time, and had settled on the form of a standard waterfall for those deals – at least so far as concerned Studio films.

699. Those standard forms provided for a 30% distribution commission and for levels of Studio participation which varied with GDI (see section 1 Chapter III):

> 15.45% of GDI until GDI exceeded 165% of budget,
>
> increased to 34.71% when GDI fell between 165% and 204% of budget,
>
> and thereafter 27.14%.

700. (As we have recounted elsewhere these complicated steps ensured that, while the CD continued to receive 70% of GDI, the CM was able to retain at least 5% of GDI after corporation tax; although Mr Reid suggested that Mr McKenna had a plan to eliminate these steps in the waterfall, we think that his recollection was mistaken – see Chapter III The Tap.)

701. LS202 did not, however, take account of the step changes. The effect of its formulae was that if the Distributor Commission was taken as 30% rather than 20% it modelled the Studio participation as a straight 15.45% of GDI. This affected, and increased, its estimation of the revenues which accrued to the LLP in relation to the three Studio films in the illustrative portfolio. Each of these films was illustrated as achieving GDI of 247% of budget – so that the participation commission should have been a weighted average rather than be the 15.45% actually used:

$$\{15.5\% \times 165 + 34.71\% \times (204-165) + 27.14\% \times (247-204)\}/(165+39+43) = \mathbf{20.6\%}.$$

702. HMRC showed to our satisfaction that the combination of an adjustment to reflect a distributor commission of 30% and this change in participations converted the computed profit into a 2% loss.

703. A similar mistake was not made on the IG spreadsheet.

(6) LS202: The Combination of the Factors Discussed Above

704. HMRC's second Note on the Evidence contained a section showing the effect on the illustrative profit and loss of making changes in the assumptions. That note looks at the effects of individual changes but does not look at the effect of eliminating any contingency in the distribution fee or at the combined effect of the changed assumptions.

705. Following this lead we made the following changes to LS202:

(a) we reduced the international distribution fee to 15% (a conservative reduction given our conclusions in relation to the contingency in *(2)* above) to eliminate the contingency (varying cell Film Prodn Income tab C48);

(b) we increased the DVD cost ratio to 28% (Film Prodn Income tab C27 and C54);

(c) we reduced the US advertising ratio to 36% and increased the International advertising ratio to 36% (Film Prodn Income tab C25 and C52) so that the sum of advertising and prints was 40%;

(d) We carried the resultant ratio of total gross receipts (89%) to total box office income arising in D64 of the Film Prodn Income tab to R14 of the Film Production tab.

(e) We adjusted the distribution commission to 30% and the gross participation to 20.6% (R17 and R19 Film Production tab). The increase in GDI which resulted from step (d) meant that this figure should have been somewhat higher (and thus calculated profit somewhat lower).

706. The net result was that, allowing no contingency, LS202 indicated a loss of 2% on film production over the 5 year period. But prior profitability could be restored if the three Studio films in the calculations achieved about 3.3 x budget (rather than 2.9), an average across the slate of about 2.4 x budget.

707. One of the effects of selecting a modest profit is that it is vulnerable to small changes in the underlying assumptions. It would therefore be wrong to conclude that because the changes we made to some of the underlying assumptions resulted in a loss that a loss was necessarily to be expected. But the nature of the exercise conducted above is different: it is designed to determine what film performance, on reasonable assumptions, will enable the LLP to break even. The result is higher multiples of budget than used by Ingenious personnel.

Our Conclusions on LS202

708. We asked ourselves whether the projections in LS202, suitably adjusted, indicated that IFP2 had, or did not have, a realistic prospect of achieving its modest profit over a 5 year period. We took a five year period because: generally the majority of first-cycle income arises in such a period, that was the period Ingenious suggested for the LLPs in the Information Memoranda, and the prospect of income after that seems generally remote.

709. If films were chosen on the basis that on average they would achieve a 2.2x multiple – or as Mr Clayton said films which "were capable of hitting the 2.2 times box office hurdle" – it seems to us that the business was not conducted with a view to profit since that multiple did not appear to be likely to secure a profit for the LLP on the basis of reasonable assumptions.

710. If films were chosen on the basis that they would achieve at least 2.2x budget on average but with a hope that they would achieve a better result, then whether or not that hope was realistic depends on how likely it was that films would perform at that level. The result of LS202 adjusted to reflect realistic assumptions indicates that the three Studio films would have to achieve WWBO of about 3.3x budget for the LLP to have been profitable. For the reasons in headings *(7)* and *(8)* below that seems unlikely.

711. We conclude that LS202 indicates that the LLPs' businesses were not conducted with a realistic possibility of profit.

(7) Ingenious' Own Data on Film Performance

712. It appears that Mr Crossley had maintained a spreadsheet record of the reported box office receipts for the films produced by ITP, IFP and also three other LLPs, IT1, IT2 and IT3. There had been a version of the spreadsheet in existence in September 2005 – thus at around the time of the preparation of LS202. This record permitted the known GBO/budget ratio of films which had been produced by those LLPs to be compared with the illustrative performance in the IFP2 Information Memorandum (the result of the bottom-up exercise).

713. Further, Mr Reid and other witnesses acknowledged that within six months after the release of a film the box office takings would be close to their final amount, so that, having regard to films released before March 2005, and assuming the information possessed or received by Ingenious was up-to-date, that information would give a fairly good idea of the past box office performance of films chosen by Ingenious.

714. It was not clear to us that the Studios were prompt in delivering distribution statements in all cases and we accept Mr Reid's inference that the reporting of box office results for Independent films, particularly in small territories, could be slow. Nevertheless, particularly for films released 12 months or so before September 2005, it seems likely that Mr Crossley's figures would show an amount of GBO close to the eventual final figures. Also Mr Crossley's spreadsheet included tabs in which he had recorded the box office takings week by week for a number of films; Mr Reid

mentioned that Mr Crossley had obtained these from IMBD; that all suggests that these those figures were as up-to-date as the figures provided on IMDB.

715. The films undertaken by ITP had all been released at least 6 months before September 2005. The sole Studio film, *Wimbledon*, had achieved GBO/budget ratio of 0.7, and the four Independent films for which Mr Crossley had entered information, a ratio of 1.07.

716. HMRC added to Mr Crossley's data IMBD data for the Independent films for which Mr Crossley had not recorded GBO. Taking account of this data the ITP Slate had an overall GBO/budget ratio of 0.75, and an Independent films ratio of 0.76.

717. The figures for IT1 involved some films released after February 2005. Removing those films and their figures, and including IMDB figures for *Inside I'm Dancing*, the overall GBO/budget ratio at September 2005 for IT1 was 1.8.

718. For IT2 five out of the six films had been released by January 2005. For those five films the GBO/budget ratio was about 1.6 (the inclusion of IMDB information for the sixth film give a ratio of 1.54).

719. The Appellants say that "the commercial deals entered by the IFP partnerships were generally more attractive than those entered into by the Inside Track partnerships." They refer in this regard to the first dollar gross corridor introduced after *Closer* and *Wimbledon*. But the gross corridor did not enhance the success of the films, it merely ameliorated failure. By contrast had the appellant been able to show that the budgets for IFP films had been more tightly controlled, that would have suggested that better GBO/budget ratios could have been obtained by IFP. But there was no evidence that such was the case.

720. It may also have been the case that, with its increasing experience and expertise, Ingenious may have become better at picking films which did well at the box office. Mr Clayton told us that as the enterprise had grown so had its cumulative expertise. We accept that. That might be a reason for some modest expectation of improved results, as also might have been an expectation of a greater number of Studio films (which were individually more likely to achieve high box office figures, and carried the benefit of a large Studio's assessment and distribution clout), but it seems to us that Ingenious' own experience made an expectation of an overall average GBO/budget ratio of 2.2 somewhat unrealistic.

(8) WWBO to Budget Ratios Required for the LLP to be Profitable

721. The effect of the bottom-up approach to the preparation of the illustrative table in the IFP2 Information Memorandum was that the projected modest profit could be obtained if on average films achieved WWBO of 2.2 x their budget. The Information Memorandum listed six actual films which had achieved that multiple over the period 2000 – 2001, and noted that over the period 2000 – 2004 the top 200 films had achieved an average performance of over 3.7 times budget. It said that an Independent film, *The Blair Witch Project*, had achieved a multiple of over 7,000. The Memorandum said that the most successful films in the slate were assumed to achieve

2.9 x budget. It was also assumed that on average films would generate gross receipts of 4.2 x budget.

722. HMRC advance three criticisms of this:

(a) the assumption in LS202 was that all three Studio films achieved 2.9 x budget. That was unrealistic;

(b) the treatment of Independent films was incorrect;

(c) the reference to *The Blair Witch Project* was misleading.

(a) 2.9 Times Budget

723. HMRC say that LS202 purported to show that the modest profit could be achieved if all three Studio films (representing 61% of the available funds) achieved more than 2.9 x budget and the Independent films achieved between 40% and 190% of budget (so that the weighted average was 2.2). Thus all 3 Studio films would have to perform on average at 2.9 x budget. This meant that all three Studio films would have to perform in such a way as to get a place in the top 180 films of 2000 – 2005.

724. Further, the budgets for IFP2's Studio films were inflated by the addition of the 5% EP fee, the added Studio overheads of 15%, and the contingency of 10% which, if unspent was usually kept by the PSC. HMRC illustrated that the publicly available information about the budget of the (first) 22 films with which IFP was involved showed that the budgeted costs as shown in the relevant agreements were 25% larger than the cost in the publicly available data (these results were not materially contested by the Appellants). Thus it was likely that the publicly available performance data was based on budgets which did not contain the additional items in Ingenious' films' budgets. Had they done so the ratios for the top performing films in the public data would have been lower and there would have been still fewer films which between 2000 and 2005 had performed at the levels above 2.9 times budget.

725. Finally they say that the list of the 200 top-performing films is skewed towards high-budget US Studio films, and Ingenious had striven to focus on British films. It was less likely that such films would appear in the list.

726. Although, by 2005 the relationship with Fox was in full swing and a greater number of high-budget Studio films might have been expected, we accept most of these challenges. Ingenious appeared to accept that it would be less likely that Independent films would make money (although it was possible) so that the real profits had to be made by the Studio films. Although the same gross income might have been received from one Studio film which achieved a 5x multiple and two which achieved 2x or less, the levels of performance needed suggest that it would be possible but unlikely that on average the Studio films would achieve a result of more than 2.9x budget.

(b) Independent films

727. HMRC say that by their underlying blanket assumption that on average films achieved WWBO of 2.2x budget, the calculations assumed a direct relationship between the box office performance of Independent films and what IFP2 would receive. That they say was wrong because of the way Independent films were sold: the receipts would depend upon the terms of the deal with the agents and distributors. If the distributor pays a minimum guarantee or advance, then until the sales reach an agreed level no further amount is received, although thereafter overages may be received. As sales increase the sum of the overages and the minimum guarantee or advance will approach the receipts less a commission, but the relationship between sales and receipts is not linear although asymptotically it becomes such.

728. Mr McKenna and Mr Reid say that box office is a proxy for the nature of the returns on Independent films. HMRC say it is a poor proxy, and, that because the assumption in LS202 is that the 7 Independent films in the slate do not fare particularly well, they would not have been in overage territory so that all that should have been modelled was the minimum guarantee or advance receipts from the distributors.

729. Whilst we accept that Ingenious may have had the data from other Independent films which they could have used to model the effect of sales to distributors, we were not convinced that, as an indicator of how well an Independent film had to perform, the estimates of the box office ratios obtained by working back from a profit contribution were an unrealistic way to benchmark the profit assumption.

730. If one assumes that the distributor is a good commercial judge – and if they were not they would soon go out of business – they would tend to pay a sum equal to their estimate of the likely income from the film less a profit margin. Thus there would be a relationship between how well they thought the film would do and collected receipts. The model replaces the distributor's estimate by one which in effect assumes that the distributor gets it right. The only missing element is the margin the distributor takes for taking on the risk. The distribution fee may be a proxy for that. The 15% or 30% used for the distribution fee in LS202 may be a bit low, but we were not persuaded that the approach Ingenious adopted suggested an unrealistically low estimate of the level of success necessary to achieve the distribution income projected. (The issues of the level of distributor commission and participation which are explored elsewhere in this section of this Chapter remain relevant.)

(c) The *Blair Witch Project*

731. The Information Memorandum notes that smaller films could achieve remarkable multiples of budget at the box office. It notes that *The Blair Witch Project* achieved a multiple of almost 7,000 times box office. HMRC say this was misleading because the budget of that film was so low that the LLP would not have undertaken it.

732. We regard that statement as mere puff. In context it simply says that some small films really do breakout but that is like winning the lottery: the import of the

statement is that people sometimes do win the lottery. But it provides no support for any of the multiples used in the projections.

(9) A Five Year Vehicle

733. The illustration in the Information Memorandum shows the results over a 5 year period. The illustrated aggregate profit for the 5 year period arises only at the end of that period. That profit is based on the accrual of cinematic, DVD/home video and TV revenues. It assigns no figure for the residual value of the film at the end of that period. Indeed in the IFP2 Information Memorandum it is said that "by the end of the third year … the majority of recoupable costs will have been recouped on the successful films".

734. By contrast the 2010 Ultimates (and Mr Forster's figures for lifetime results) and Mr Briggs' calculations take into account income for a much longer period; in particular Mr Briggs' figures take into account second-cycle income, which is income arising after the first 10 years.

735. A residual value (or possible sale value) at the end of the 5 year period might be computed from Mr Briggs' figures with a suitable discount for the time value of money and uncertainty.

736. On the one hand the omission from LS202 of residual values indicates a conservative approach to the estimation of the LLP's results (and the benchmarking of film performance), but on the other hand it prevents the Ultimates from being comparable with the illustrations.

737. It seems to us that five years is a reasonable period over which to hope to make a profit from a film, and that beyond that period the revenues become too uncertain. A film is not like a power station which could reasonably be expected to continue to work for decades, even if there were uncertainties about energy and fuel prices; most films stop producing significant income after 5 years. As a result, regarded as a window onto the LLP's hopes or as a yardstick to judge whether there was a realistic chance of profit, it does not seem to us that the Ultimates or the hope of residual value after 5 years may be prayed in aid.

Our Conclusions on the IFP2 Information Memorandum

738. We have said that we regarded the illustration in the Information Memorandum as a statement of what Ingenious personnel thought possible, not of their expectation. As such it was not an indication that they intended to conduct the business so that it would achieve the illustrated modest profit, but merely an indication that they considered that such a profit was possible.

739. We have concluded that some of the assumptions in the calculations behind the illustration in the Memorandum were unrealistic. When corrected they illustrate a loss (on the Ingenious basis) or that in order to have considered there to be realistic prospect of profit (on the Ingenious basis) the selected films would have had to

perform at levels in excess of those which Ingenious personnel considered sufficient and which were very unlikely to be achieved.

740. We conclude that the Memorandum does not indicate that the business was conducted with a realistic possibility of profit (on that basis) and does not indicate that those managing the LLPs had that aim or view.

(10) LS101

741. HMRC do not launch the same multi-faceted attack against LS101 in which DVD/video costs were estimated at 35% and the P&A ratios were drawn from the Stanford data. HMRC attacked only one assumption, namely the assumption of a distribution fee of 12.5%; they say that a realistic fee would not have been less than 15%, perhaps 20%. Mr Reid agreed that the fee used was lower than that they had achieved in relation to other films at the time but he said that it was their target. Prior to IFP they had been achieving a 20% fee – they thus went in to battle for 12.5% and save in one case where 12.5% was achieved came away with 15%.

742. HMRC showed how a change in the assumed fee to 20% in LS101 caused the overall 5 year result to change from an 8% profit to a 24% loss. Changing the fee to 15% produced a 3% loss.

743. Mr Reid responded that some other assumptions in LS101 may have embodied an element of contingency. We did not have sufficient evidence to test this suggestion, particularly since the calculation of the distribution commission and participation appear to have been made differently in LS101. We also observed that the reduction in the distribution fee could affect the rate of the Studio participation because LS101 showed it varying with different levels of recoupment.

744. Overall therefore, while not satisfied that LS101 on realistic assumptions would predict a loss on the basis of the presumed performance of the illustrative slate, we were not satisfied that it provided support for the proposition that it was realistic to expect a profit.

7. The 2.2x WWBO Multiple

745. In section 5 above we noted that Mr McKenna had spoken about a relationship between WWBO and budget. Mr McKenna told us on 11 November 2014 that in the Information Memoranda they worked on a general rule of thumb that if they had box office takings (WWBO) that were 2x cost, that would essentially be the point at which the LLP would break even (although of course the variables making up the general rule might be affected by changes in the market and the particular film). So, he said, "my shorthand for deciding and contributing to whether we should green-light a film really is a quite a simple exercise. I just have to imagine whether it could do more than 2x at the box office." Then he said "That would be the point at which it would break even. I would be looking for it to do many times more than that." He noted in this context that the BFI's proxy for profit was WWBO of 2x budget.

746. As we have explained in the previous section, the IFP2 Information memorandum LS202 calculations suggested that a modest profit would be obtained by the LLP if, on average over all the films, WWBO of 2.2x budget was obtained, and if WWBO of 2.9x budget was obtained for each of the Studio films.

747. Later, adopting the 2.2x multiple, Mr McKenna took us through some "kitchen table" calculations from which he had taken comfort about the fairness of the IFP2 Information Memorandum illustration as concerned film performance. He took WWBO at 2.2 x budget, Gross Income (theatrical receipts, home video and TV income) he took at just under twice WWBO at 4.2 x budget. From that there fell to be deducted the distribution fee of 20% (ITP). That left 3.4 x budget. From that he deducted distribution costs (P&A and DVD costs) of 30%, giving GDI of 2.7 x budget; the LLP would receive at most 54.45% of that i.e.,1.5 x budget, and would make a profit (on the Ingenious basis) on the film.

748. Those calculations seemed to us to under-rate the deductions necessary for P&A and DVD costs: it seemed to us that P&A costs were normally taken as about the same as WWBO rather than about half that amount, and that DVD costs should be added to that figure. Thus we did not take much comfort from those calculations that making a decision on the basis that WWBO would be more than 2 x budget would deliver a profit for the LLP on the film.

749. Nor were we persuaded by the fact that the BFI used 2 x budget as a proxy for profit that a 2x multiple could deliver profit for the LLP. That is because: first, we understood that the CD Model was at least originally novel, and so other film financiers and producers would have had deals in which for an investment of *x*% they received *x*% of the income after distribution and talent participation costs and fees; the LLPs on the other hand received at most 54.45% for a 100% investment; and second, the budgets of the films for which the LLPs contracted were increased by the EP fee, so that a higher multiple would be needed (the budgets were also increased by the bond fee, but we think it likely that there may have been a similar charge in relation to the films the BFI considered; likewise, possibly, the Studio overhead).

750. In section 5 above we noted Mr Clayton's reliance on 2.2 x budget as a rule of thumb for profitability. If this was the rule he applied it seems to us that it was unlikely to result in profitability for the LLP. Further Mr Clayton did not indicate that he applied any comparison with known films or attempted any quantitative assessment of how a film would do.

751. In section 4 above: 'Green-lighting' we gave the example of the green-light paper for *Australia*, which permitted a reader to conclude that if Gross Income exceeded 2.85% (= 200%/70%) of budget the LLP would receive more than budgeted cost so that an appraiser only had to decide whether there was a decent chance that Gross Income would exceed 2.85 x budget, and if so by how much.

752. Mr Reid's told us that as good a ready reckoner as you would find was that Gross Receipts would be about 2 x WWBO. Mr Sills assented to the same ratio as a crude measure. Thus the figures appended to the green-lighting paper suggest that the film would be profitable when WWBO > 1.92 x budget. That standard was less stringent than all of: Mr McKenna's 2 x budget, Mr Clayton's 2.2 x budget, the 2.9 x budget for Studio films on which the IFP2 Information Memorandum was based, and the results we obtained by making adjustments to the assumption underlying LS202. If this was the test applied by the committee it would not in our opinion have ensured a reasonable likelihood of profit for the LLP (on the Ingenious basis).

753. It seemed in practice that achieving a box office multiple of 2.2x did not always secure profitability for a film. A spreadsheet prepared by one of Mr Bower's colleagues (which we were told corrected errors in an earlier spreadsheet showing higher multiples) showed that only 6 films out of 22 had achieved multiples of 2.2x or above. Those 6 films were:

(a) *Night at the Museum* (3.4x). This film was not profitable for the LLP, but on the basis of the 2010 Ultimates was projected to be profitable;

(b) *Hot Fuzz* (3.7x). This was profitable for the LLP;

(c) *Die Hard 4* (2.2x). On Mr Forster's evidence this was not profitable nor projected to be profitable (in the LLP's reporting currency);

(d) *Notes on a Scandal* (2.3x). This was neither profitable nor projected to be profitable;

(e) *Shaun of the Dead* (3.6x). Profit of £3m at 5 April 2013, projected Ultimate £8m; budget £5m;

(f) *Closer* (2.5x). No material income at all (due to high P&A expenses and absence of a gross corridor).

Hairspray with a 2.1x multiple was projected to lose £4m.

754. Nor did films which achieved more than 2.2 x budget make substantial profits for the LLP. The June 2013 distribution statement for *Hot Fuzz* shows Theatrical Revenues of $31m. Applying the rule of thumb, that equates to WWBO of the order of $65m or about £43m. The budget for *Hot Fuzz* was according to Mr Forster's table £13m. Thus WWBO was about 3.3 x budget: considerably more than 2.2 x budget.

Mr Forster's table shows that at 5 April 2013 it had made a profit of about £2m but was projected (on the 2010 Ultimate basis) to make £10m. Thus it did not even make a profit equal to its budget. That is compounded by the DVD/home video income for *Hot Fuzz*, which was a much greater multiple of WWBO than the rules of thumb or the IFP2 illustrations allow: being $105m or about 1.6 x WWBO, compared with the 1.26x ratio suggested by the IFP2 calculations and Mr Reid's 50% of WWBO. It thus gave rise to more income than would have been expected by reference to its WWBO.

755. That brings us to our second criticism of Mr McKenna's approach, which is that if the winners are to pay for the losers, the winners must make a lot of money. Mr McKenna recognises the uncertainty of outcome when he says that he imagines whether the film "could" make 2x budget: it acknowledges that in reality there will be a spread of results around an expectation or hope. But if the LLP is to make a profit that distribution must be such that when a film wins it will bring in enough. If the likelihood of 2.5 x budget is remote and that of more than 3.3 x budget (enough to allow *Hot Fuzz* to make a contribution of more than its budget to profit) is even more so, but that of 1.5 x budget is less so, it does not immediately seem to be realistic to hope for an aggregate profit.

756. All this causes us to doubt whether the green-lighting committee (which included Mr McKenna) and those who put films to it (which included Mr Clayton) applied a test which would have enabled them to have a realistic hope that the relevant LLP would make a profit (on the Ingenious basis).

8. The Waterfall

757. The profit illustrations in the Information Memoranda were prepared on the same basis as the LLPs' accounts (we call this the "Ingenious basis") under which it is assumed that the LLP (i) would incur the full budgeted cost of the film (100) rather than 30, and (ii) would earn income, which included amounts which were retained by the CD in reduction of the indebtedness of the CM, and was no more than 54.45% of GDI (rather than 30% of GDI).

758. It is fairly obvious that, if profit was determined on a 30:30 basis, by comparing expenditure of 30 to 30% of GDI (rather than comparing expenditure of 100% of budget to up to 54.45% of GDI), the likelihood of a profit rather than a loss arising (or a lesser loss arising) is greater because such a profit would arise with lower levels of GDI. The following table illustrates this at various levels of GDI and assumes a budget of 100:

GDI	**P/L on Ingenious Basis**	**P&L 30:30 Basis**
40	(78)	(18)
100	(45)	Nil
140	(23)	12
182	Nil	25
200	10	30

759. Put another way, if the CD receives cash of 70% of GDI, it recoups its 70 of expenditure when GDI = budget[23]; if the LLP is regarded as expending 30% for 30% of GDI it too recoups when GDI = budget, but if the LLP is treated as expending 100% of budget and receiving no more than 54.45% of budget (less after GDI has exceeded budget) it does not recoup its cost until GDI is at least 1.83 x budget. That requires Gross Earnings to be almost double. That means that the chance of profitability is less, and may be significantly less (since the film has to do so much better to make money for the LLP).

760. In the same way, in section 1 of this Chapter we noted that the LLPs would be more likely to come into profit in tandem with the Studio, rather than behind it if they regarded themselves as expending 30 for 30 % of GDI. And, as Mr Sills' evidence showed, the performance of the films he looked at did not have to be at the very top of the range for profit on this basis to be realised.

[23] As Mr Reid said: "you would imagine intrinsically that the CD is going to break even – or a little bit more – at that point".

761. We asked ourselves therefore, if profit was to be calculated on the Ingenious basis, whether the revenue allocation to the LLP in the waterfall handicapped the LLPs to such an extent that it was not realistic to hope for them to make a profit on that basis.

762. Mr Milne replies to that suggestion by saying: (i) that Mr Briggs' calculations showed that if the films he had examined had performed in line with comparable films, the films would have delivered profits to the LLPs, (ii) the Appellants conducted an exercise, audited by Mr Briggs, which showed that if *Wimbledon* had performed as well as *Notting Hill*, not only would ITP have made a profit on it, but as a whole ITP would have been profitable, and (iii) Mr Sills accepted the reasonableness of the Ultimates for *Australia* and *Hot Fuzz,* which showed those films as delivering a profit for the LLPs. As a result he says the waterfall works: it is capable of delivering a profit on the Ingenious basis. He does not in this argument rely on these exercises as showing that a profit was foreseeable, but as showing that the model was capable of delivering a profit for the LLP despite the disadvantage conferred on it by the waterfall.

763. Mr Gammie responds: "*Avatar*!". He say that if a substantial participation in the highest-grossing film of all time had not put IFP2 into profit after 5 years, then there was something wrong: the waterfall sent the LLP in to bat on a crooked wicket without a bat, and with the stumps already broken.

764. We therefore turn to consider the evidence of Mr Sills and Mr Briggs, the '*Notting-Hill-for-Wimbledon'* figures, and *Avatar*.

9. The Expert Evidence of Mr Sills, Mr Briggs and Mr Olsberg

765. Our detailed commentary on the evidence of Mr Sills and Mr Briggs is set out in Appendices 2 and 3.

Mr Sills

766. Mr Sills provided reports which exhibited calculations showing what level of gross receipts would have been needed for six sample films (*Australia*, *Avatar*, *Hot Fuzz*, *Happy Go Lucky*, *Wimbledon* and *Blackball*) to generate sufficient income to meet three targets. The targets were:

(a) sufficient cash receipts by the LLP to equal 30% (35%) of the budget of the film. (In the Appendix we call this the joint-venture basis: considering the LLPs as having put in 30% (35%) of the budget and as recovering 30% (35%) of GDI);

(b) when the sum of (i) the payments actually made to the LLP and (ii) the amounts of BDR/BR retained by the CD would equal 100% of the budget. This is the point at which, on the Ingenious basis of calculation of profit, the LLP would break even;

(c) when the total payments of BDR/BR would be equal to the CM loan.

767. Mr Sills then worked back from the relevant levels of gross receipts to estimate the WWBO which would be needed to obtain that level of gross receipts.

768. We discuss Mr Sills' analysis in the Appendix where we reach the following conclusions:

(a) in relation to the 30:30 basis (the joint-venture basis), Mr Sills' evidence suggests a conclusion that, at the time those films were contracted, it would not have been unreasonable to expect the films to have been profitable on this basis;

(b) in relation to the Ingenious basis of profit calculation (the 100%: 54.45% basis) Mr Sills' evidence permits (but does not require) a conclusion that, at a time when the films were contracted, it would have been very optimistic to have expected this target to have been met for more than a small proportion of those films;

(c) Mr Sills' evidence permits a conclusion that, at the time the film was contracted, it would have been unrealistic to expect that the CM loan would be repaid at any time.

769. Mr Sills also reviewed the 2010 Ultimates. Using the most favourable assumptions, he concluded that the 2010 Ultimates for *Australia* and *Hot Fuzz* were reasonable, but he considered that the *Avatar* Ultimate was unreasonable, in particular in its estimation of DVD income at $3.38 billion (as Mr Gammie noted this represented, at say $5 for a DVD, DVDs for 750,000,000 people): Mr Sills had never seen a film make even $1 billion from that source.

Mr Briggs

770. Mr Briggs' gave his expert opinion on two relevant groups of questions. We set out in Appendix 3 the details of his evidence and our commentary on it.

771. The first group of questions asked him to consider what revenues would have arisen to the LLPs from five Sample Films (including *Wimbledon*) if they had performed as well as the average of a group of Benchmark films chosen by the Appellants. As a separate part of this exercise he was asked to opine on the revenue which would have arisen to ITP had *Wimbledon* performed as well as *Notting Hill*. We discuss his evidence in relation to the *Wimbledon*-as-*Notting Hill* exercise in the following section and make reference to some of his evidence in relation to *Avatar* in the section after that.

772. The second subject on which Mr Briggs was asked to opine was the reasonableness of the 2010 Ultimates. On this topic we found that Mr Briggs' evidence provided very little support for those figures but, (leaving aside elements of his discussion of *Avatar* – see section 11 below) nothing to suggest they were unreasonable.

773. In relation to the lifetime projections prepared by reference to the Benchmark films we came to the following conclusions for the reasons explained in the Appendix.

774. If the Sample Films had performed at the Benchmark level, and had made the second-cycle revenues (that is to say revenues which might be expected to accrue more than 10 years after the film's first release) calculated by Mr Briggs, they would have been profitable for the relevant LLP (on the Ingenious basis). There was, however, some real uncertainty about the likelihood of second-cycle revenues and without them the films would not have been profitable.

775. The selected films comprising the Benchmark were comparable with their associated Sample Films in the sense that they had elements in common, but they were selected with a view to showing what the Sample Film was capable of, not as a prediction of how it would perform. Thus his calculations showed what was possible, not what was likely. He did not address whether or not, at the time the contract for the Sample Film was made, the Benchmark result was likely. Thus there might also be another pool of comparable films whose performance would indicate that the Sample Films could have been less profitable or not profitable at all.

776. We concluded that, given Mr Briggs' experience and expertise, his exercise shows that a person receiving a report from him at the time of committing to a film would not be unreasonable if he hoped to make the profit predicted by the exercise. But that was not the same as saying that a person who had not had the benefit of that advice at the time of committing could reasonably come to the same conclusion. If you are told you have a particular cancer you may hope for a cure; if you are told by an oncologist that 70% of those with that cancer are cured, you will have reason for hoping that you will be cured.

777. The Benchmark WWBOs required by Mr Briggs' calculation for the profit he illustrates were such that had the films achieved that WWBO almost all would have been in the top 10 films of 2006. Thus it seemed very unlikely that all or even a majority of the films would perform at that level, but it would not have been unreasonable to hope that one (or perhaps more than one) of the films would perform at that level.

778. Thus in relation to Mr Milne's argument that the waterfall "worked", we accept that Mr Briggs' evidence indicated that it was possible for the LLP to make a profit from a film under the waterfall if a film did sufficiently well, but we conclude that it was unlikely that more than one film would so succeed. Mr Briggs' figures for the profit or loss arising suggest that, even if one film in the slate of the related LLP had performed at the benchmark level, the LLP would not (on the Ingenious basis) have been profitable.

Mr Olsberg

779. We set out details of Mr Olsberg's evidence and our evaluation of it in Appendix 6 together with that of Mr Finney.

780. Mr Olsberg was asked to opine on whether, at the time the relevant LLP had committed to them there was a realistic possibility that three Independent films, *Blackball*, *Girl with a Pearl Earring*, and *Happy Go Lucky*, would have performed at a level which would have ensured that a particular amount was received into the collection account. The amount for each film was set by the LLPs' solicitors and represented their calculation of the amount required for the film to be profitable for the LLP.

781. Mr Olsberg answered each question in the affirmative.

782. We concluded that by reference to the time the films were contracted: (i) it was not realistically possible that all three of the films would achieve the thresholds; (ii) that there was a slight possibility that *Blackball* or *Happy Go Lucky* might achieve the threshold, and (iii) that there was a realistic possibility that *Girl with a Pearl Earring* might achieve the threshold.

783. We understood that achieving the threshold would have meant that the relevant film moved into profit for the LLP on the Ingenious basis.

10. Wimbledon-as-Notting Hill

784. In 2010 Ingenious sent HMRC a calculation showing its estimates of the receipts which would have flowed to ITP if *Wimbledon* had performed as well as *Notting Hill* (the "Wimbledon as Notting Hill Ultimate"). The calculations showed a profit (on the Ingenious basis) of £41m. The calculation was based on assumptions as to the ratios of net theatrical rentals to WWBO, of DVD income to WWBO, of TV income to WWBO, and of DVD costs to DVD income (35%) which were fairly standard, and a fixed amount of $80m for P&A expenses.

785. We should start by saying that we reject the attack made by HMRC on this exercise that, because *Notting Hill* was a different genre of film and had a different setting, the comparison does not achieve its object. That would have been relevant if the exercise had been put forward as an argument that this particular portfolio could have made a profit, but, as we understood Mr Milne, it was put forward by him as an argument that if the LLP had chosen a film like *Notting Hill*, then the waterfall would have worked to provide sufficient profit to put the LLP into profit: it was not that this particular film could have done that (even if the argument had been originally presented in that guise by Ingenious). And of course this leaves unspoken the question as to whether the LLP would or could have chosen a film like *Notting Hill*.

786. Mr Briggs conducted two simulations for *Wimbledon*. The first was by reference to 5 successful films (*Notting Hill*, *My Best Friend's Wedding*, *Bridget Jones' Diary*, *Four Weddings and a Funeral*, and *Sweet Home Alabama*) as 'Benchmark' films. The estimate produced on this basis was called the FTI estimate, and was conducted by Mr Briggs using his normal methodology for calculating income and cost components (see Appendix 4).

787. The second simulation for *Wimbledon* was the "*Notting Hill* Ultimate", this was prepared using *Notting Hill* as the only comparator, and using Mr Briggs' methodology for all the variables except P&A for which he was instructed to use $46m, being the actual P&A expenses incurred for *Wimbledon*.

788. Mr Briggs' FTI ultimate for *Wimbledon* showed a profit (on the Ingenious basis) to the LLP of some $23m (or about £15m), and his *Notting Hill* Ultimate a profit of $52m (or about £33m). We conducted a crude exercise to estimate what result Mr Briggs would have arrived at if he had not capped the P&A costs in the *Notting Hill* Ultimate but used his normal methods; we came up with a profit (on the Ingenious basis) of £36m (or about £21m).

789. The analysis sent by Ingenious to HMRC in 2010 showed a net loss (on the Ingenious basis) for the other six films undertaken by Ingenious by ITP of £27m.

790. Mr Forster's statement (B1/7/31) shows an analysis of ITP film profitability by reference to actual receipts at 5 April 2013 and by reference to the results which would accrue from the Ingenious 2010 Ultimates. Taking the six other films together, and *Wimbledon* separately, they show the following results:

£m	Actual at 5 April 2013	2010 Ultimate Projection
The other 6 Films	(26)	(26)
Wimbledon	(31)	(30)
LLP Profit/(Loss) on Films	(57)	(56)

791. The following table compares the Ultimate which would have arisen to the LLP on the basis of the Ingenious 2010 *Wimbledon as Notting Hill* Ultimate with those results which arise from Mr Briggs' *Notting Hill* Ultimate, the tribunal's crude adjustment to it, and the Briggs FTI Ultimate:

£m	Ingenious 2010 *Wimbledon as Notting Hill*	Briggs *Notting Hill*	Tribunal Crude Adjustment to Briggs *Notting Hill*	Briggs FTI
The 6 Other Films	(26)	(26)	(26)	(26)
Wimbledon	41	33	21	15
ITP Profit/(Loss)	15	7	(5)	(11)

792. We are unable to conclude from these figures that, had *Wimbledon* performed as well as *Notting Hill*, ITP would have (eventually) made a profit (on the Ingenious basis). There is a possibility that it may have done so depending on how *Wimbledon*-as-*Notting Hill*'s DVD and TV income and P&A and DVD costs turned out, but we are not able to say that it was more likely than not. Was, then, the possibility that ITP would make a profit a realistic one? Given that the chance of choosing a hit like *Notting Hill* is small, it would be unlikely that *Wimbledon*-as-*Notting Hill* would be chosen. Taking that measure of chance together with the uncertainly as to whether that film would have caused ITP to move into profit, we were not convinced that the *Wimbledon*-as-*Notting Hill* exercise showed that there was a realistic possibility that ITP would make a profit on the Ingenious basis.

793. We therefore also find that the *Wimbledon*-as-*Notting Hill* exercise did not show that the Waterfall arrangements "worked".

794. If these figures, however, are recast on a 35:35 basis (the equivalent for ITP of 30:30 for IFP2) then the results are markedly different:

(a) first we recast Mr Forster's tables on that basis (working to the nearest £5m):

(b) then we recast the Briggs' *Wimbledon*-as-*Notting Hill*, and the tribunal's crude adjustment thereto on the same basis.

795. The result is:

£m	Forster 2010 Ultimate Adjusted	Briggs *Wimbledon*-as-*Notting Hill* Adjusted	Tribunal's Crude Adjustment Adjusted
The Six Films	(10)	(10)	(10)
Wimbledon	(10)	35	25
ITP Profit/(Loss)	(20)	25	15

796. That suggests that *Wimbledon* did not need to do as well as *Notting Hill* in order for ITP to be profitable, and increases the likelihood of such a result on the 35:35 basis. In our judgment such a result would not be fanciful.

11. Avatar

797. *Avatar* was, at the time of the hearing, the film with the highest box office takings ever (although, once inflation is taken into account, it may well have been solidly eclipsed by *Gone With the Wind*, and a couple of others). It took $2.78bn at the box office; next came *Titanic*, released in 1997 which took $2.2bn, and then the runners up: *Marvels the Avengers*, $1.5bn, *Harry Potter and the Deathly Hallows Part 2*, $1.3bn, and all the rest took less than half what *Avatar* took. Only 18 films had ever gone past $1bn.

798. So *Avatar* was a real hit: it was one of Mr McKenna's hen's teeth.

799. *Avatar* was expensive. Its agreed budget at the time of the Avatar Hedge in 2007 was £182m; but it cost more than that: Mr McKenna said getting on for **$**500m; but we think **$**450m (or about £300m) is nearer: the 2013 Fox distribution statements show that $149m was kept back out of net receipts for the Completion Guarantor's completion costs; adding that to the £182m (or $286m) 2007 agreed budget gives about $450m – to the nearest $50m.

800. IFP2 and IFP were both involved in it. But they did not finance (even with the CM loans) 100% of the budget. The details are explained in the section on the Avatar Hedge in Chapter IV section 4 and Appendix 5, but in outline, of the budget of £182m they contributed £115m, and the rest was provided by a shortfall financier (likely to have been Fox or an affiliate). Thus the eventual cost of the film was met:

(a) By the Completion Guarantor as to $149m, i.e. as to some 40%;

(b) By the Shortfall Financier as to some 37%;

(c) Under the CD Model as to the remaining amounts (70% of which were financed by Fox).

801. The Completion Guarantor was we believe a Fox associate, and we think it likely that the Shortfall Financier was too. Thus quite a bit of the net income would be retained by Fox, but some share would accrue to the IFPs.

802. In fact the LLPs' share – even on the Ingenious basis – was well under 50%. Thus (i) the reader should not assume that because *Avatar* earned so much that the LLP did too: the question is how big was the LLP's margin on *Avatar*, not how much WWBO it made: if an LLP had only 1% of a film which produced a 500% return or 100% of a film which produced a 1% profit, that participation would hardly be expected to cure all the LLP's ills; and (ii) this reminds the reader of our conclusion that being at the heart of production did not mean that in substance, at law, *or in form*, 100% of the budget had to be borne by the LLP.

803. By August 2013 the Fox distribution statements show that $123m (say £100m) had been (preliminarily) allocated to the LLPs under the schedule 7 waterfall, of which $95m was retained by Fox (so as to reduce the CM loan).

804. Now, Mr Forster's exhibit shows that, on the Ingenious basis, by April 2013 the LLPs had together made a loss of some £21m on their interest in *Avatar*. But it appears that Ingenious' accounting for *Avatar* had followed the form of the Avatar Hedge (and not its substance) and treated all the extra money as paid for *Avatar* and none for the additional income stream which flowed from *Die Hard 4* and *Life of Pi*. Mr Milne told us that when this was corrected *Avatar* showed a net profit (still on the Ingenious basis) of some £9m[24]. We accept that result as about right.

805. But that is still not a great profit – as a percentage of the capital laid out – for a blockbuster some 3.5 years after its release. One would surely expect to get a better return. We therefore asked ourselves whether there was anything odd in the income and cost flows – something which would explain why a better percentage return had not been achieved, but:

(a) WWBO ($2.78bn) was more than 2.2 x budget ($286m), and more than 2.2 x or even 2.9 x the eventual cost (being some 6 x the eventual cost);

[24] Because the counterpart to the reduction in Avatar's cost is an increase in the cost of the other two films, this adjustment does not affect the overall loss of the LLP.

(b) Gross income was $2bn by August 2013: that was more than 4 x final cost ($450m); the Information Memorandum states the assumption that IFPs' films will produce gross income on average of 4.2 x budget;

(c) Theatrical net revenue was about 43% of WWBO; LS202 works on an average of 44% of budget;

(d) Home video (DVD) revenue was about 40% of WWBO; LS202 worked on 110%;

(e) Pay TV revenue was about 2% of WWBO; LS202 worked on 16%;

(f) Free TV revenue was 35% of WWBO; LS202 worked on 19%;

(g) Other income was 1% of WWBO; LS202 used 2%;

(h) The ratio of distribution costs to gross income was about 50%; LS202 used ratios which delivered an average of about 40%.

806. So some of the disappointment may be because the August 2013 mix of income does not reflect the mix that might come in over the lifetime of the film. The Information Memorandum indicates that income from home video does not start until about 6 months after release, and that for free TV for 2 to 3 years after release. Thus some lag in the items (d), (e), and (f) might be expected. But also the normal ratios may not apply to *Avatar*, which may well have had special appeal to a cinema audience and so might earn a greater proportion of its income from box office sales than the average film.

807. That is where the Ultimates may help. Perhaps in the long run *Avatar* would contribute more:

(a) Ingenious' 2010 Ultimate indicates an eventual profit of £536m, but that was based on further box office and DVD income which neither Mr Briggs nor Mr Sills could support;

(b) Mr Briggs' *Avatar* Ultimate (on the basis of *Titanic*) gave a lifetime profit of $33m (£22m). If that profit was used to replace the profit derived from the 2010 Ultimates in Mr Forster's report for *Avatar* of £536m, IFP2 would make a projected lifetime loss of £308m;

(c) From Mr Sills' report, if WWBO was $4.16bn, IFP2's receipts on the Ingenious basis from Budget B would have been $72m and if WWBO was $3.6bn, IFP2's receipts from Budget A would have been $154m. Thus to the nearest $50m, if WWBO had been $4bn, IPF2's receipts would have been about $250m or about £150m (to the nearest £50m) which is some £130m more than Mr Briggs' figure. That would therefore reduce the Briggs lifetime loss by £130m. Thus, on the Ingenious basis, even if *Avatar*'s WWBO was $4bn, IFP2's net aggregate result (within similar limits of accuracy) for films would have been a loss of £175m.

808. The Ultimates do not therefore seem to help.

809. There is another element of the *Avatar* waterfall which made it less profitable for IFP2 than might be expected from its box office success. The cost overrun was

financed by the Completion Guarantor, and its costs came out of the waterfall in precedence to the delivery of substantial (non-gross-corridor) income to IFP2. Thus it was not until the guarantor had recouped in full that IFP2 started to earn material amounts.

810. Thus there seem to us to be two types of reason why *Avatar* did not deliver, and is unlikely to deliver, sufficient profit to IFP2 to make it profit making. First, that it was an exceptional film, the mix of whose income elements may not match Ingenious' predictions, and second that the nature of the waterfall was not such as to put the LLP in a position to reap a full share of the profits of success. But *Avatar* was more than 10% of the IFP2 slate by 5 April 2008. If it could not turn a lifetime loss into a profit on the basis that it would perform as well as *Titanic*, then it calls in doubt any conclusion that IFP2 had a realistic chance of profit *on the Ingenious basis.*

811. Finally we recall that in Chapter IV we considered the effects of the Avatar Hedge and concluded that had it not been entered into IFP2 would have realised £20m of additional income. That would not have been enough to secure a profit for IFP2.

812. We therefore find that *Avatar* does not show that "the waterfall worked".

813. But if profits are calculated on the 30:30 basis then we estimate, to the nearest £5m:

(a) Without *Avatar* the projected lifetime profit of IFP2 would be £85m (using the Ultimates adopted in Mr Forster's schedule),

(b) *Avatar*, would yield, on Mr Sills' projection, a profit of £75m[25],

and, as a result, IFP2 would make a profit of £162m. That indicates to our minds a conclusion that on a 30:30 basis a profit would not be an unrealistic hope.

[25] Sills: (i) aggregate LLP receipts $320m (A), being a 47% share of GDI; (ii) production cost $286m (B) after shortfall; (iii) therefore adjusted LLP receipts A x 30/47=$204m; (iv) adjusted production cost B x 30% = $86m; (v) profit = $ 204 – 86 =$118m =~ £75m.

12. The 30:30 Basis for the Determination of Profit

814. The alternative to the 100%:54.45% basis for the determination of profit or loss is the "30:30 basis", namely that the LLP put up 30% (35%) of budget and earned 30% (35%) of GDI.

815. HMRC contended that the arrangements for the films represented "a sharing of film revenues in proportions which reflected the Studio's (CD's) and the LLP's respective contributions to the Approved Production Budget". This we call the 70:30 basis for the determination of takings (acknowledging that it was 65:35 for ITP). This reflected the proportions in which GDI was shared.

816. Mr Milne said:

> (i) that there was no magic in GDI because the same eventual take could be engineered by flexing the Distributor's fee and the Distributor's commission;
>
> (ii) that a 70:30 division did not reflect the shares in Gross Receipts, but of GDI, and
>
> (iii) that although Ingenious personnel used "70:30" in some of their correspondence this was no more than a convenient shorthand for one aspect of a traditional Studio deal.

We have addressed the first two of these points in Chapter III section 2 above. So far as the last point is concerned, it seems to us that 70:30 reflects the economic and commercial substance of the deal: it is not shorthand, but reality.

817. The 30:30 basis does not put an LLP proportionately on exactly the same footing as for example a Studio making the same film. A Studio would bear the direct cost of the film and enjoy all its income. In the case of films made by a PSC the budget of the film included: the EP fee (5%), an allowance for the Studio's overhead, a contingency and a guarantor's fee. The total budget was thus brought to some 130% of the direct costs. Such an increase in costs could be seen as a severe handicap to profitability.

818. However, (i) a Studio would suffer its own overhead costs, and we understood that 10% was a recognised estimate, (ii) the completion guarantor's fee was, we were told, a market rate and would reflect a real liability undertaken by the Studio for which separate compensation was allocable, (iii) we think it likely that the contingency was eaten into in most cases, and in the case of ITP there was a 30:70 sharing of unused contingency. That leaves the EP fee, which was a real extra cost in the budget. That fee might make a 30:30 profit on a film made under the CD model a little less likely than a profit for a Studio making the same film itself, but it does not seem to us materially to affect the chance of a profit on a 30:30 basis.

819. Ingenious personnel knew that the tax relief advertised to investors was dependent on losses being calculated by reference to expenditure of 100; but that was not the same as knowing that the commercial or legal effect was expenditure of 100

and income of 54.45% of GDI. In the same way that the fact that the controlling minds of the LLPs knew that they had to carry on their business with a view of profit does not mean that they had a view of profit, so too the fact that they knew that the advertised tax loss was dependent on determining profit on the Ingenious basis does not mean that they had a view of profit determined on that basis.

820. We note the following as examples which were indicative that Ingenious personnel, and those who dealt with Ingenious, knew that in commercial and economic terms the film deals were deals in which the LLP put up 30% of the cost and received 30% of the net revenue (GDI), and therefore as indicative that they know that any economic profit for the LLP derived from a comparison of those amounts, whatever the formal accounting policies adopted by the LLPs:

(a) In March 2005 Mr Ulman, writing on behalf of Fox to Mr Clayton in relation to an IFP deal had said: "I understand this is essentially to be a 70/30 deal";

(b) Ingenious personnel knew that when a Shortfall Financier was involved it would contribute *x%* of budget and take *x%* of GDI;

(c) At the end of the Approved Budget in the *Hot Fuzz* CDA there are set out the direct costs of the film and their augmentation by the bond fee, the Studio overheads, the executive producer fee and the contingency. It then sets out a Grand total which it divides:

"Ingenious Contribution	30%	$6,621[k]
[CD] Contribution	70%	$15,449[k]"

That indicates that the LLP knew that even the formal documentation evidenced that its contribution to the film was 30% only.

(d) In the Completion Guarantee Agreement clause 8 provides that:

> "subject to the [LLP] not being in default of its obligation to deposit funds in the amount of thirty per cent (30%) of the Approved Budget ... into the production account",

the Guarantor guarantees delivery of the film. The guarantee is not conditional on the CD's 70% being transferred, and in the words above expressly acknowledges the Ingenious contribution as being 30%.

(e) Spreadsheets and figures produced by Nick Crossley in February 2005 for Mr Reid describe "Ingenious' share of GDI" as being 30%, and speaks of Distribution Income being split 70/30 throughout. Three possibilities are discussed for the detail of the gross corridor, and it is noted that one is a better deal for Ingenious (the LLP) since it recoups "more than its pro rata share".

Mr Reid described this as being shorthand: the figures were prepared ahead of a negotiation with the Studio – he said you could use verbose terms and be exact when analysing the situation against the contract, but when you were "going in to deal with the person who is providing the rest of the capital you can go to a

shortcut". That in our view is a shortcut to the commercial and economic effect of the structure.

(f) In his oral evidence in relation to the step variations in Studio Participation and BDR discussed in section 1 of Chapter III, Mr Reid said that Mr McKenna had argued that IFP2 should negotiate with the Studios so that the Studios would get less than 70% of GDI. That indicated an understanding that the economic interest of the LLP was 30% – even though we doubted Mr Reid's particular recollection.

(g) In an e-mail of 7 October 2004 Mr Clayton outlines to a possible partner the principle terms of IFP's business. The first bullet point is:

> "30% equity contribution to budget",

with a recoupment corridor of 35% on all distributable income. Although Mr Clayton said that this was shorthand it clearly reflected the commercial or economic deal he was offering: the legal documents would "conform the underlying economics to the model we are operating." In another e-mail of 20 October 2004 Mr Clayton says that "IFP can offer 30% of a film's gross budget in equity".

(h) The Green-light papers spell out the 70:30 deal. The LLP's share of income as 30% and that of Fox 70%.

(i) Mr Bower said that "some of the spreadsheets talk about "retained by the partnership" because they are talking about the partnership's members being the ordinary members and the CM versus the Studio".

(j) Mr Reid said that at the point when GDI equalled budget: "you would imagine intrinsically that the CD is going to break even – or a little bit more[26] – at that point". If the Studio would break even then (subject to the cost of the EP fee etc. – Mr Reid's "a little bit more") so would the LLP on a 30:30 basis.

821. The Ingenious personnel procured the LLPs to enter into transactions which had that effect. They must have known that this was the result. They must have intended this effect. They must have had a view to the effect those transactions created.

822. For the reasons we give in Chapter X, we consider that GAAP requires the LLPs to account on a basis which recognises the cost of a film as 30 (35) and its income as 30% (35%) of GDI. Whilst that conclusion is drawn for the purposes of technical accounting standards, the principle underlying it of recognising the commercial substance of the transactions is equally applicable to the question of what is profit for the test being considered in this Chapter and, in our view, profit for the purpose of this test should be addressed on that basis.

823. Mr Gammie said that the test of whether or not the business of the LLPs was carried on with a view of profit must be conducted against profits calculated on the

[26] In relation to *Avatar* Mr Reid also said that Fox would have been in profit sooner than IFP2: he mentioned the distribution fees and overhead charge, which gave them other sources of profit, but to our minds the big difference was the division of income.

Ingenious basis. He says that that is the standard against which the Appellants have set themselves and against which they should be judged. There are some difficulties with that view:

(a) HMRC expressly say that Ingenious' view of profit is wrong. In other words it that the figure produced by the Ingenious' basis was not, or would not have been, "profit" within the meaning of that word in the statute. It cannot be right that "profit" is a word of independent meaning, but "a view to profit" carries a subjective personal meaning of profit;

(b) if Mr Gammie is correct then a person who mistakenly thinks that the amount of his turnover is profit (despite expenses) could satisfy, and a person who thinks she is not making a profit because she calculates her profit after deducting capital expenses could fail to satisfy, the subjective test of a view of profit.

824. We prefer the alternative to Mr Gammie's submission, which is that "profit" in section 863 has a meaning independent of the understanding of the person whose subjective view is to be tested.

825. It seems to us that this alternative test is satisfied: the LLPs had the hope and intention of carrying out, and carried out, actions (entering into the film contracts) which would give rise to a realistic possibility of making a profit on the 30:30 basis.

13. Conclusions: With a View to Profit

826. We accept that the LLPs were managed with the intention of securing tax benefits for the investors and in the knowledge that the structure provided substantial benefits for Ingenious. We also agree that the IFP LLPs were managed with an intention of securing income and delivering it to investors, but we do not regard the existence of those objects as meaning that the conduct of the LLPs' business could not also have had a view of profit. That is because the statutory test does not require the view to be the only or the paramount object of the taxpayer.

827. We were not persuaded however that the intention of those managing an LLP was to conduct its business so as to make a profit on the Ingenious basis or that their "view" was that it would be so managed. That is because, bearing in mind the existence of the other objects, the evidence of the controlling minds and of the activity of the green-lighting committee was not strong enough to convince us that they managed the business with a realistic hope of intention of making such a profit. In particular reliance on a 2x or 2.2x multiple, the imposition of the EP fee, the apparent willingness to accept that a Studio would break even first, and above all the imposition of the model which purported to give rise to a 100% investment for less than 55% of GDI, weighed heavily against a conclusion that such was the view they had of the outcome of the conduct of the LLPs' businesses.

828. Thus if the relevant test were simply whether the subjective intentions of the LLPs were to deliver a profit on the Ingenious basis we would find that it was not proved that such was the case.

829. We also concluded that it was unrealistic to hope for profit calculated on the Ingenious basis:

(a) Whilst the Commissioning Distributor Model demonstrated an intention to avoid losses, whether or not it delivered profits for the LLP depended on the terms of the waterfall and the approach to the selection of films. In our view the terms of the waterfall made it unlikely that the LLPs would realise profits on this basis.

(b) Whilst for Independent films it was not fanciful to hope for an outcome of 2 x budget and not fanciful to expect that such an outcome would deliver a recoupment of cost, the effect of the waterfall was that a greater multiple was required for the LLP to make a profit and that was much less likely;

(c) Similarly for Studio films whilst recouping in parallel with a Studio would give a non-fanciful prospect of profit, recouping under waterfall provisions which delivered the LLP a non-proportionate share of income (a maximum of 54.55% of the equivalent for a Studio) meant that the prospect for profit for the LLP on a film on the Ingenious basis was much less likely;

(d) The investigation of the illustrative figures in the Information Memorandum for IFP2 showed that, given realistic assumptions for the variables in the calculation, the levels of box office success required for the films in the slate to achieve an overall profit for the LLP on this basis were very unlikely. We think it likely that a similar result applied for ITP;

(e) The reason for the losses appeared to be the low share of income taken under the waterfalls. *Wimbledon* as *Notting Hill* did not show that the waterfall could work to deliver a profit for the LLP;

(f) Mr Briggs' and Mr Olsberg's evidence satisfied us that it was not fanciful to expect one of the films to make a profit for the LLP, but did not satisfy us that there was a realistic prospect of the LLP as a whole making a profit;

(g) The actual outcomes were losses, which cast no doubt on a conclusion that a profit was not reasonably anticipated, and would have required an explanation, which we are unable to supply, if it had really been the case that profit was a realistic hope.

830. However, we find that an expectation of a profit calculated on the 30:30 basis was realistic and not fanciful. On that basis the LLP was, in relation to Studio Films, roughly in the same position as the Studio in relation to production activity (i.e. setting distribution costs and margin aside). The levels of box office performance required to make a profit on that basis were high but not wholly fanciful.

831. The object of securing the tax benefits carried with it the pretence that profit could be calculated on the Ingenious basis, but the participants knew that the economic effect of the transactions was 30:30 and on that basis a profit was not unrealistic.

832. While there were some features of the way the business was conducted which did not display a wholehearted pursuit of profit for the LLP, for example the 'flex' given to Fox and the need to find films close to 5 April to use the capital raised, the lack of any financial comparisons by the green-lighting committee, and the imposition of the EP fee for the benefit of Ingenious (see Chapter IX: Expenditure), we did not find these so egregious as to preclude a conclusion that on this basis the business was conducted with a view to profit.

833. We find that Ingenious' personnel had a view of the 30:30 result when they procured that the LLP entered into the film contracts. As a result the business conducted by the LLP was conducted with a view to obtaining that result and with the hope of a profit on that basis.

834. We therefore conclude that if profit is properly to be calculated on the 30:30 basis, the LLPs conducted their businesses with a view to such a profit; but if it is calculated on the Ingenious basis, they did not.

CHAPTER IX. EXPENDITURE: Wholly and Exclusively for the Purposes of the Trade

1. The Relevant Legal Principles

835. Section 74 TA 88 provides:

> "74 (1) Subject to the provisions of the Tax Acts, in computing the amount of the profits to be charged under Case I or Case II of Schedule D no sum shall be deducted in respect of –
>
> (a) any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade, profession, or vocation."

836. This provision had effect for income tax purposes until 5 April 2005, and thereafter was replaced for income tax purposes by section 34 ITTOIA 2005, which provided:

> "(1) In calculating the profits of the 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 part or identifiable proportion of the expense which is incurred wholly and exclusively for the purposes of the trade."

837. No suggestion was made that there was any difference in meaning between "laid out or expended" and "incurred".

838. The argument in relation to this provision was divided in two: first, what amount of expenditure was incurred by the LLPs on a film: was it 100 or 30? – for to the extent it had not been incurred it could not have been incurred wholly and exclusively for a trading purpose; second, what were the purpose(s) for which the expenditure was incurred?

839. In relation to the second question, it is well known, and there was no dispute that: (1) by "for the purposes of the trade" is meant for the purposes of enabling a person to carry on the trade and earn profits in it; (2) a dual purpose, where not saved by section 34(2), was not exclusively a trading purpose; as a result an expense incurred both for the purposes of trade and another purpose is not deductible; (3) the purpose referred to is that of the taxpayer subjectively determined; (4) the purpose of the taxpayer must be distinguished from the effect of the expense. Thus a private benefit which is merely a consequence or an incidental effect does not give rise to a dual purpose; (5) although the purpose is to be subjectively determined this does not limit the investigation to the taxpayer's conscious motives; a pinch of salt is necessary – some consequences are so inevitably and inextricably involved in a payment that unless merely incidental they must be taken to be a purpose for which the payment is made.

840. In Chapter X: GAAP we consider the provisions requiring the computation of profit in accordance with GAAP. In this context section 27 ITT0IA provided:

> "(1) In the Income Tax Acts, in the context of the calculation of the profits of a trade, references to receipts and expenses are to any items brought into account as credits or debits in calculating the profits.
>
> (2) There is no implication that an amount has been actually received or paid.
>
> (3) This section is subject to any express provision to the contrary."

841. Almost any payment will, in the books of a trader by, or to whom, it is made, normally give rise to an accounting debit or credit. But the credits and debits with which subsection (1) are concerned are limited to those which are "brought into account in calculating profit".

842. Thus our concern is to determine whether the debits brought into account in the computation of the LLPs' profits and losses in accordance with GAAP were incurred wholly and exclusively for the purposes of their trade.

843. Section 27(2) raised a further issue. If the LLP did not pay or incur the full 70 (65) for a film, but nevertheless brought into account under GAAP a debit representing some part of that 70 (65), did section 34 restrict the allowable debit to that which had been incurred by the LLP?

844. The Appellants say that section 34 is an express provision to the contrary for the purposes of section 27(3) but that whilst that blocks expenses (debits) not incurred wholly and exclusively for trade purposes, it does not introduce an "actually incurred" requirement: so that if GAAP-compliant accounts show expenditure there is no need to ask whether that expenditure was actually incurred.

845. HMRC say that if no expenditure was incurred then section 34 would apply to override section 27(2): the object of section 27 was to make clear that the accruals basis applied rather than the cash basis.

846. It seems to us that the effect of section 27(1) is that we should read section 34 as asking whether a relevant debit was incurred in the prescribed way. Section 27(1) merely says that it is not necessary for an amount to have been paid before a debit can be recognised. The question of whether the debit has been incurred wholly and exclusively for a trading purpose remains. If a debit relates to a claimed expense it seems to us, on a purposive interpretation of the two sections, that the answer to the question of whether the debit satisfies section 34 will generally be the same as the answer to whether the expense would have satisfied that section.

847. Thus we conclude that we must frame our discussion of section 34 in terms of each relevant debit taken into account, or which should have been taken into account, in accordance with GAAP, and address whether that debit was incurred and for what purpose(s) it was incurred. In essence that will require, at least in the circumstances of this appeal, consideration of the same questions in relation to the expense giving rise

to the debit as would be asked in relation to the debit, although the answers may depend on the amount of the debit being considered.

848. The debits in the accounts of the LLP which gave rise to the claimed losses were those which arose from or in the course of the writing down of the 100 cost of the film to an NRV of 20. HMRC's argument is that the 80 debit was not incurred for the purposes of the trade because, since the related cost of 100 was not so incurred, the debit of 80 could not have been.

849. In the case of each argument, however, the proper effect of GAAP is relevant. If GAAP requires a credit of 100 for the cost of the film followed by a debit of 80 on its writing down to NRV, then the argument about what was incurred and why it was incurred must relate to that 80. On the other hand, if the LLP is found not to have applied GAAP correctly and that properly applied GAAP required a credit of 30 (35) to be recognised for the film, a write down to 20% of that figure, i.e. to 6 (7), and the recognition of a debit of 24 (28), then the arguments could have a different complexion.

2. The Parties' Arguments

850. First HMRC say that 100 of expense was not incurred. They put that argument two ways:

(a) that the LLPs did not incur the full 100 of the cost of the film: the legal substance of the obligations was that the LLPs incurred only 30 (35), the balance of 70 (65) being funded by the CD, although documented as if it had been routed through the CM and the LLP. In legal substance there was no loan and there was no capital subscription (for that pre-supposed something which contributed to the asset base of the LLP) and thus no expenditure was incurred in relation to the 70; and

(b) that, even if the LLPs were legally liable to pay 100, the reality of the arrangements was that the LLPs only laid out or incurred 30% (35%) of the expenditure on the production budgets. The question was whether expense had been "incurred". *Ensign* demonstrated that being obliged to pay money did not necessarily mean that expenditure had been "incurred" in the meaning the statute intended for that word. Here the "loan" by the CD to the CM was, as Lord Templeman described the "loan" in *Ensign*, in fact a capital investment by the 'creditor' in return for a participation in profit. The expense had been incurred by the CD, not the LLP.

851. Second they say that, to the extent that the LLPs could be said to have incurred expenditure, whether of 100 or 30, it was incurred for purposes which at least included (a) a tax avoidance purpose, and (b) the purpose of earning fees for Ingenious. Neither purpose was incidental or immaterial. In particular they say that the cost of the Executive Producer Fee was incurred for no purpose other than to provide funds for the Ingenious Group, and the Operator fees were for the generation of capital contributions and were a charge to the individual investors for access to the tax avoidance scheme.

852. Mr Milne says that in *Ensign* Lord Templeman based his decision on a finding that there was no loan: he said "on a true construction of the documents Victory Partnership was not a borrower and expended [25%] only" (273E). By contrast he says the loan to the CM was real and shown as such in the CM's audited accounts, and once that is established it follows that the capital contribution to the LLP is an equally legally valid transaction. He says that the agreements impose an obligation on the LLP to fund the production of the film up to 100, and the payment of 100 by the CD to the PSC causes that obligation to become unconditional and discharges it as to 70. The cash-flow shortcuts affect neither the liability nor the accounting.

853. In relation to the second formulation of HMRC's argument Mr Milne says that it relies on an over-emphasis on cash flows which do not affect the legal or accounting analysis.

3. Relevant Findings

854. In Chapter II section 3 we reached the following conclusions.

(i) Was the LLP Obliged to Pay 100?

855. No. Under the relevant agreements the LLPs were liable to pay only 30 (35) on the making of the agreements.

856. In pursuit of their obligations the LLPs paid 30 (35).

(ii) Recognition of a Capital Contribution: ITP

857. The CM was not obliged to make a capital contribution before the relevant agreements were signed. It had no outstanding obligation. On signing the agreements either:

(a) those agreements did not have the effect that the CM would be treated as having made a capital contribution since nothing was received by the LLP in "money", or

(b) they had the effect that the CM was to be treated as making such a contribution when the CD paid the PSC.

858. Under the Members' Agreement the CM had no indefeasible right to any amount of drawings; on the signing of the agreement it was agreed that (until the loan was repaid) the CM would have no right to drawings in respect of the film.

(iii) Recognition of a Capital Contribution: IFP2 and IG

859. The CM was not obliged to make any capital contribution before the relevant agreements were signed. The parties intended that the CD's payment to the PSC would be treated as a capital contribution by the CM but the payment did not fall within any definition of capital contribution in the Members' Agreement.

860. Under the Members' Agreement the CM had a defeasible right to drawings of 50 of net income. Under the relevant agreements this right was reduced to what it would have been had the LLP been entitled to receive BDR, less BDR until the loan was repaid.

(iv) The Effect of Recognition of a Capital Contribution: Both ITP and IFP2

861. Even if by the relevant agreements the LLP and the CM had effected a change to the Members' Agreement to recognise a capital contribution by the CM in the amount paid by the CD to the PSC, or even if such recognition was a consequence of the Members' Agreement properly understood, the recognition had no effect on the rights of the CM to drawings or on a winding up of the LLP.

4. Discussion

(a) Incurred

862. If the statutory provisions in relation to whether a debit was incurred are construed purposively, are they intended to apply to the transaction, viewed realistically?

863. Mr Gammie says: no loan, no capital contribution and so no expense incurred; Mr Milne says there was a loan so there was a capital contribution and there was an expense incurred.

864. It seems to us that whether or not there was what could be called a loan is not particularly relevant. What matters is whether the LLP incurred an expense, and that depends on the obligations it incurred and discharged under the relevant agreements.

865. In determining the obligations incurred and discharged regard must be had to any which arise by virtue of the recognition of a capital contribution by the CM. But we do not regard the mere recognition of something which is termed a capital contribution enough to say that as a result the LLP acquired the benefit of a sum equal to it and spent it, or that it incurred the amount of the contribution as an expense. It all depends on what the incidents of recognising that contribution were.

866. The parties to the relevant documents characterised the relationship arising between the LLP and the CM as a capital contribution. That they so characterised it does not mean it has characteristics of ordinary share capital. The parties might equally have said that on the PSC's payment the LLP would become the CM's friend. The parties' characterisation does not affect the questions, which are and remain: what obligations did the LLP undertake as a result of the agreed relationship and how were the benefits it received in return applied?

867. It seems to us that the only obligation the LLP acquired as a result of any recognition of a capital subscription by the CM was to make an accounting entry. That to our minds was not the incurring of an expense.

868. Mr Milne suggests that "incur" means "legally obliged to". He relies on *MacNiven v Westmoreland Investments Ltd* [2001] STC 237 in which he says that Lord Nicholls' fundamental point is that "incur" means liable to pay.

869. We do not consider that such a wide meaning accords with the purpose of section 34 (74). A person may be under a legal obligation to pay a sum as a nominee or agent of another but in those circumstances he does not truly incur the expense. To our minds an expense is incurred for these purposes only if the payer suffers or bears its economic burden.

870. *MacNiven* concerned relief for "payments" of interest and in that context Lord Nicholls said that "payment … connotes simply the satisfaction of an obligation to pay". By contrast section 34 (74) is part of the mechanism for determining the profit arising to a person: the economic benefit he reaps from his activity. In that context what he incurs is properly limited to expenses of which he suffers the economic burden. It was in this vein that in *Peterson* Lord Millett said that funding by a non-recourse loan did not alter the fact that the "investor had suffered the economic burden of paying the amount at issue". Likewise in dealing with what cost was incurred for the purposes of capital allowances, Lord Templeman in *Ensign* found that Victory Partnership's obligation was to pay 25%, and the financial consequence of that obligation was that Victory had expended 25% (he implicitly equates expenditure with "incurring"). The financial consequence is the economic effect. It had not incurred expenditure in excess of 25%.

871. We thus consider that an expense is "incurred" in the sense that the legislation had in mind if the taxpayer bears the economic or financial consequences of the expenditure. The reality of the legal obligations incurred by the taxpayer determines the financial consequences.

872. What economic or financial consequences did the LLP suffer as the result of the fruition of the payment obligations under the contract?

873. It became liable to pay 30 (35). It cannot be said that the LLP lost the right to the BDR portion of payment from the CD, because it never had that right. The only other identifiable consequence was that (possibly) it became obliged to treat the CM as having subscribed capital of 70 (not, we emphasise, as no longer owing that amount, because the CM had no such pre-existing liability).

874. We have noted in the case of IFP2 only that if the CM was properly to be treated as having made a capital contribution then IFP2 lost the right to call for an Additional Capital Contribution. But an Additional Capital Contribution made in freely transferable funds carried with it the right to a distribution on the winding up of the LLP, whereas a capital contribution treated as made pursuant to the relevant agreement did not, because it was not so made. Thus the loss of the right to call for an Additional Capital Contribution carried with it the loss of the contingent liability on winding up. As a result the loss of that right did not seem to us to be an economic burden incurred by the LLP.

875. The liability of the LLP towards the CM as a member changed as a result of the relevant agreements, but it changed for the better: until the loan was repaid the LLP was no longer liable to pay drawings at all, in the case of ITP, and liable only in a reduced amount, in the case of IFP2 and IG.

876. The (possible) obligation to treat the CM has having paid up capital 70 did not reflect the assumption of any economic liability by the LLP since it did not increase its liability to pay drawings or affect the CM's rights on a winding up.

877. The only effect was that the LLP might have to make an accounting entry. As we have said, that in our judgement is not what the statute means by incurring an expense.

878. Even if the LLP is to be treated as having incurred the obligation to recognise capital subscribed, and even if that assumption is to be treated as the assumption of a liability by the LLP, what was the consequence? It was matched by the removal of almost all of the LLP's obligation to pay drawings to the CM. Thus in reality that obligation, if it was incurred, did not relate to the business of the LLP, but related to its relationship with its members.

879. The result was that the only economic cost borne by the LLP for the purpose of its business was 30 (35).

880. If GAAP required a debit of 80 to be recognised on the writing down to NRV we find that 70% (65%) of that debit could not have been wholly and exclusively incurred for the trade since that part of it was not incurred at all. On the other hand if GAAP required a debit of 80% x 30 (35) = 24 (28) to be recognised, then that debit would have been incurred and could therefore have been incurred for the purposes of the trade.

881. In relation to the second formulation of HMRC's "incurred" argument, which proceeds on the assumption that we are wrong in our conclusions so far, Mr Gammie says that the question may also be approached by considering what asset the taxpayer acquired and what consideration he gave in doing so. In this exercise he says reality transcends the contractual rights and obligations created and designed to give effect to the arrangements: the mere fact that a person is obliged to spend a sum of money does not mean that expenditure has been incurred by him. In reality the LLP can be seen not to have incurred the expenditure which was funded by the Studio but routed through the LLP: the loans were capital investments by the CD which returned a perpetual share of revenues not interest and capital repayments.

882. It seems to us that the kind of realistic view of the facts which a purposive interpretation of the statute requires is one which, as we have said, recognises that section 34 (74) is set in the context of determining the profit of the taxpayer, and that "profit" is concerned with the commercial and economic consequences of the taxpayer's actions. That is why we view "incurred" as being concerned with whether the taxpayer bore the economic burden of an expense. If the LLP was, contrary to our view, liable to pay 100, then the statutory question is whether realistically it bore the

economic burden of that liability. The realism required by that question is a requirement to look at what real economic burden, what outflow of value, affected the LLP. That requires an answer to the question: "leaving aside the rights to the film, how were the assets and obligations of the LLP different after the liability to pay 100 was satisfied?" The answer to that question we have already given: it had paid out 30 and lost 30 of cash, it had agreed in some way to recognise a capital contribution, and its obligation to pay drawings to the CM had reduced. Of those the payment of cash was a permanent and real economic burden; any recognition of a capital contribution had no economic effect, and the reduction in the drawings liability was not a benefit of its business. The only economic burden it suffered was the outflow of 30. That is all that was incurred.

(b) Wholly and Exclusively: The Purpose for Which Any Expenditure Was Incurred

883. If it can be said that the LLPs incurred the liability of 100 (or expenditure of 100), it seems to us that 70 (65) of that expenditure was not incurred for the purposes of the LLPs' business but for the purpose of providing a benefit to the CD of enabling the CD to reap a share of the benefits from the exploitation of the films.

884. That share included the elements of GDI to be retained by it. The effect of the agreements was to confer the right to retain 70% (65%) of GDI on the CD. That was not an incidental effect. It was an effect which the CD must have stipulated and to which the LLPs agreed (indeed it was an effect which Ingenious personnel stipulated in their requirement that the CD funded 70 (65) and that the deal was subject to the Commissioning Distributor Model). That retention by the CD was such an inevitable and inextricable consequence of the relevant agreements that it must have been the purpose of the parties in entering into them to ensure the retention. If the LLPs incurred 100 then they must have had the purpose of enabling the CD to retain 70% (65%) of GDI.

885. For the same reasons, if the Loan Agreement gave rise to real indebtedness between the CD and the CM, the LLPs must have had the purpose of benefitting the CM (through the application of the retention of BDR by the CD in the reduction of any liability the CM had to the CD).

886. On that basis we would find that, as regards 70 (65) of any 100 incurred by the LLP, the LLP could not have had a trading purpose.

887. The technical issue relates to the debits recognised by the LLP. If the debit on the write down to NRV was 24 (28) then none of that was incurred for this purpose; if the debit was 80, then 70% (65%) of it was incurred otherwise than for a trading purpose.

(c) *A Tax Avoidance Purpose*

888. We have accepted (Chapter VI: Trading section 5 Fiscal Motive) that Ingenious managed the LLPs with a main object of enabling the individual members to obtain loss relief. Mr Gammie says that this object was also a purpose of the expenditure

(whether 100 or 35 (30)) and therefore the entirety of that expenditure had a dual purpose and was (presumably before 2005) not deductible.

889. If the relevant debit is 80, it seems to us that Mr Gammie is right. We accept that the structure of the agreements was designed to deliver tax relief to the investors rather than to advantage the business of the LLPs. We said that we did not regard the advantages of the CD model as requiring that the LLP paid 100 rather than 30. To our minds that feature of the model was added into the contracts in order to deliver an enhanced tax loss to investors.

890. As a result, to the extent 100 was expended under those agreements part of the purpose of that expenditure was to secure the enhanced loss for the investor, and part of the purpose of the debit was the same. That was not a trading purpose; as a result, unless the debit can be severed, none of it is deductible.

891. But if the relevant debit is 24 (28) representing expenditure of 30 (35) the position is different. That is because the question to be asked is: What is the purpose of the debit?

892. We concluded in the preceding Chapter that not only was the legal and economic deal an investment of 30 for 30% of GDI, but that Ingenious personnel (and through them the LLPs) understood that to be the commercial substance of the LLPs' business, and that it was not unrealistic to hope for that activity to yield a profit. That 30 was expended for the purpose of earning profit.

893. The incurring of the liability of 30, and the payment of 30 may have had the effect that the investors would get a tax loss, but that was incidental. It is true that the 30 was spent under an agreement which it was hoped would deliver a loss based on 100. But it was not the obligation to pay 30 which had the tax avoidance purpose but the obligation (assuming there was one) to treat the 70 to be paid by CD to the PSC as an expense incurred by the LLP. The obligation to pay 30 gave rise to the debit. That obligation was matched by rights to 30% of GDI. Its purpose was to secure their benefit.

5. The EP Fee and the Operator's Fee

The EP Fee

894. In section 3 of Chapter III we discussed various items in the Approved Budget for a film. One of these was the EP fee of 5% of the gross budget of the film. This we explained was a fee paid to an Ingenious entity (the "EP") under an agreement with the PSC. Under the agreement the EP agreed to act as Executive Producer. The Deed of Acknowledgement etc. provided for the fee to be paid directly to the EP by the LLP at the time the LLP paid out the 30 - discharging the PSC's contractual obligation to pay and reducing the receipt by the PSC.

895. In section 3(iv) of Chapter III we conclude that the fee was not paid in return for any service rendered to the PSC in the making of the film, and that in the hands of the

EP it could be fairly described as a fee for bringing the financial support of the LLP to the film.

896. HMRC argue that, even if the LLP incurred some expense which was potentially deductible as a result of its payment to the PSC, an amount equal to the EP fee was not incurred wholly and exclusively for the purposes of the LLP's business so that the LLP's deductible expense should be reduced *pro tanto*.

897. The Appellants say that the EP fee was part of the film and budget, that the terms of the deal require the LLP to pay the film budget, and that the LLP does that in order to make the film, that is to say it makes a payment for the purposes of its trade. It is paid, they say, to get the trade going or to keep it going. Even if the fee were not regarded as part of the production budget, the LLP had paid the fee in order to get films going.

Discussion

898. Taking first the arguments that the EP fee was part of the film budget and that the LLP had to pay for that budget (or its share thereof) in order to get the film made, it seems to us to ignore the evidence that it was Ingenious personnel who required that the PSC enter into the EP contract and therein agreed to pay the fee. Various e-mails showed the importance Ingenious personnel attached to Ingenious obtaining the fees it expected. The Operator negotiated the agreements on behalf of the LLP. The correspondence showed that it required the EP contract. The requirement to pay the fee was thus imposed by the LLP through the agency of the Operator. Why did the LLP impose that obligation? It was not to obtain any benefit in the making of the film. We conclude it was not paid for the purposes of making the film.

899. Was it paid in order for the LLP to be able to contract for the film? We are not convinced that it was, for the following reasons:

(a) the terms of the EP contract referred to the rendering of services to the PSC, not the LLP; that might include bringing the LLP to the party, but it does not include bringing the film to the LLP. Regarding the fee payable under that contract as paid for bringing the film to the LLP requires one to treat the contract (which we repeat was imposed by the LLP through the Operator) as not representing what its terms said;

(b) under the Operator's Agreement the LLP acquired the services of the Operator. Those services included the identification of suitable films and the negotiation of agreements. This agreement was in place before the agreements for any film and thus before the EP contract. Any service Ingenious personnel rendered in bringing a film to an LLP or organising for its contract would naturally have been rendered under the Operator's Agreement. Mr Reid accepted that it was the Operator's responsibility to make sure that production was going well. There was no need for the same services to be supplied by another entity; and

(c) there was no indication in the oral evidence, besides perhaps the suggestion that at times Ingenious personnel were wearing two hats, that before the EP agreement was signed the Operator had engaged the services of the EP to organise financing and get the film ready when that was part of the Operator's own role. Indeed it is difficult to see how the Operator could have done that on behalf of the PSC for which it held no agency.

900. We conclude that through the Operator the LLP agreed to the fee for the benefit of the EP and not for arranging the film for the LLP or getting the LLP's business going or keeping it going.

901. We conclude that the obligation to pay the fee was not incurred for the purposes of making the film or arranging for the LLP's contract for the film, but to provide cash for Ingenious. We therefore conclude that it was not incurred for the purposes of the LLP's business.

What Part of the LLP's Expenditure Related to the EP Fee?

902. If we are wrong and the LLP truly incurred 100% of the budget of each film, then 5% of that related to the EP fee. That 5% cost was imposed by the LLP and was not for the purposes of making the film or for the purposes of the LLP's engagement with the film. It was thus not deductible and the LLP's allowable expenditure could be no more than 95% of the budget.

903. If we are correct that the LLP incurred only 30% (35)% of the budget then an issue arises as to whether any disallowance of the expense of the EP fee should reduce the LLP's allowable expenditure to 30% - 5% = 25%, or to 30% - (5% x 30%) = 28.5%.

904. HMRC say that it is the former. The fee, they say, was a separate charge paid directly by the LLP to the EP. The Appellants say that the method by which the fee was paid is irrelevant, what matters is who bore the economic burden of the fee. It was borne by the production budget as a whole including the parts funded by the CD loans. Thus if any disallowance in relation to the fee was required it should be only of that part of it borne by the LLP.

905. It seems to us that there is no doubt that the LLP incurred expenditure of 30. The question is why it incurred it. The answer cannot be simply "because it agreed to incur it".

906. How a payment is used and what a contract says it delivers may illuminate a taxpayer's purpose but cannot determine it. We reject the Appellants' submission that the question of why a sum was paid is determined by who bore the economic burden of a particular component of contractual obligation: in some circumstances that may assist, but it does not determine subjective purpose.

907. In our judgement the LLPs incurred 5 out of 30 for the purpose of rewarding a member of the Ingenious organisation and not for the engagement in a film or in return for introducing it to the film, or even for assisting it in raising capital. It was an

obligation added to the transaction by the Operator for the benefit of the Ingenious group and not for the purposes of the LLP's business; it was not forced upon the LLP by the CD. We conclude that 5 out of the 30 was not incurred wholly and exclusively for the trade of the LLP.

The Operator's Fee

908. Under the Operator agreement the LLP paid a fee of 2.81% of the total recognised capital contributions to the Operator (ITP 4%). In return the Operator agreed to find and negotiate film deals and to administer the LLP. In each LLP's accounts the fee was deducted as an expense in the year paid. IFP2's accounts showed an expense of some £44m for the year ending 5 April 2006 (and £3m in the following year).

909. HMRC say that these fees were in reality scheme fees – fees indirectly charged to the individual members for introducing them to the Ingenious LLPs' tax savings scheme – and not therefore incurred for the LLPs' trade. They also say that the fee related to the capital raised, and, as in *The Vaccine Research Limited Partnership v HMRC* [2013] UKFTT 073, not all that capital was used for trading purpose, so that, as the tribunal found in that case ([89]) the fee could not have been wholly and exclusively for trading purpose.

910. It was clear to us that the LLPs received significant services from Ingenious personnel for the benefit of their businesses. We think it is fair to regard those services as having been provided by the Operator under the agreement. The LLP needed those services to conduct its business. It seems to us that the expense incurred in order to obtain the services provided by the Operator was incurred for the purposes of the LLP's business. We accept that the amount of the fee is linked to the amount of capital raised. On its own we do not see that as necessarily indicating that the fee was paid for raising capital, but it was clear that raising capital was part of the Operator's role and that Ingenious personnel did raise capital for the LLP. We accept that the raising of capital for the business was something done for the purposes of the business. The Appellants accept, however, that 20% of the fee was not deductible because, being attributable to the raising of capital, it was a capital expense.

We conclude that the Operator fee was paid wholly and exclusively for the purposes the LLP's business, although 20% should be disallowed as a capital expense We discuss the accounting for the fee later.

CHAPTER X: GAAP

Introduction

911. The successor to section 42(1) FA 1988, section 25 ITTOIA 2005 provides that:

> "(1) The profits of a trade must be calculated in accordance with generally accepted accounting practice subject to any adjustment required or authorised by law in calculating profits for income tax purposes."

912. We use "GAAP" to refer to generally accepted accounting practice.

913. The format of this Chapter is this:

1. What the LLPs Did – How They Accounted for the Film Transactions
2. The Issues Arising
3. The Rights and Obligations Arising under the Agreements
4. The Accounting Experts' Written and Oral Evidence; Commentary
   - (a) Mr Holgate
   - (b) Mr Steadman
   - (c) Mr Cannon
   - (d) PWC's Letter of 17 June 2004
5. The Tribunal's Three Scenarios
6. Discussion: The Accounting principles to be applied
7. Discussion: Conclusions on the Issues
8. The Operator Fee
9. Summary Conclusions

1. What the LLPs Did – How They Accounted for the Film Transactions

914. In the discussion which follows we assume a film budget of 100 and related ordinary members contributions of 30. This hypothecation of ordinary members' contributions to particular films is of course purely notional and is not required by any of the agreements, but it is generally helpful to illustrate the arguments.

915. We use "Lender" to mean the entity which was the counterparty to the CM under the CM loan agreement, being the CD in the case of Studio films. We use "relevant agreements" to mean the CDA, the PSA, the Loan Agreement, and the Deed of Acknowledgment and Notice of Assignment in relation to a particular film. When we say that BDR (or BR) was paid to the Lender we intend this to include the retention of a sum equal to BDR/BR by the CD in circumstances where the Lender and the CD were the same.

916. The LLPs accounted for the transactions in the following way:

(a) Amounts paid by ordinary members for their membership interest in an LLP were treated as capital of the LLP however they were financed;

(b) The CM was treated as having contributed capital equal to 70% of the budget of each film. To the extent that what had been "contributed" had not been paid by the CD to the PSC the balance was treated as a debtor due from the CM.

(c) On signing the relevant agreements the LLP recognised a liability equal to the amount receivable by the PSC (100) and a corresponding asset, being stock or work in progress ("WIP") of the same amount.

(d) Cash payments made by the LLP to the PSC under the PSA reduced the recorded liability to the PSC.

(e) When the Lender paid amounts to the PSC, the CM's debtor balance to the LLP would be reduced *pro tanto* as would the recorded liability to the PSC[27].

(f) If at the end of an accounting period the film had not been completed the amount carried in the accounts in respect of it as stock/WIP was written down to the value of the "virtually certain income" expected from the film. This gave rise to a corresponding expense in the profit and loss account.

(g) The computation of virtually certain income treated the amount of BDR/BR payable to the Lender as part of the LLP's income.

(h) When the film was completed the balance shown as stock/WIP in respect of the film was effectively transferred to debtors. In terms of discrete accounting entries the figure for stock/WIP was transferred to costs of sale and turnover was recognised equal to a debtor representing the then expected value of virtually certain income, that debtor being generally equal to the cost of sales figure.

(i) When a distribution became receivable under the CDA the full amount of the distribution (i.e. including any amount of BDR/BR which was to be retained by the Lender) was, to the extent it exceeded the debtor in respect of the film, recognised as turnover (and thus profit) with a corresponding increase in the amount of the debtor.

(j) When a distribution was received by the LLP the amount received together with the amount retained by the Lender decreased the debtor balance. The BDR/BR retained by the Lender was, we understood, treated as drawings paid to the CM and debited to the CM's drawings account.

(k) If, at the end of any accounting period, the amount of the future virtually certain income in respect of a film was considered to be less than the amount of

[27] We note that the Approved Cash Flows show payments by LLP before the full 70% has been drawn from the CM. In the accounts of the LLPs large amounts are shown as due from the CM representing unpaid capital

stock or the debtor in respect of that film the carrying value of the stock or debtor was adjusted accordingly, and expense realised. No upward adjustments to the debtor were made.

917. The effect of these accounting practices was that, in the period the relevant documents were signed, the LLP would recognise a loss equal to the difference between the amount receivable by the PSC (the budget of 100) and the value of the virtually certain income; and in succeeding years the LLP would recognise a profit to the extent that the total amount distributable (including BDR/BR retained by the Lender) exceeded the previously recognised virtually certain income.

918. In their accounts the LLPs stated their relevant accounting policies thus:

> "Stocks
>
> Stocks and work in progress, other than long term contracts, are stated at the lower of cost and net realisable value. Cost comprises contractual expenditure in respect of the films being produced on behalf of the commissioning distributor and producer. Net realisable value is based on estimated selling price less all further costs to completion and all relevant marketing, selling and distribution costs.
>
> Long Term Contracts
>
> Long Term Contract balances represent costs incurred on specific contracts net of amounts transferred to sales in respect of work recorded as turnover, less foreseeable losses … Provision is made for the full amount of foreseeable losses on contracts."

2. The Issues Arising

919. The accounting practice adopted by the LLPs gave rise to a number of questions:

> (1) Is it correct (we use "correct" throughout to mean in accordance with GAAP) to recognise the CM's capital contribution as 70 notwithstanding (i) the absence of provisions in the Members' Agreements requiring contribution, and (ii) the obligation under the relevant agreements for its payment directly to the PSC by the Lender and the limited recourse nature of the borrowing?
>
> (2) Is it correct to regard the liability of the LLP for the film as 100 rather than merely the 30 it has to pay in cash? In particular is it correct that, if 70 of CM's capital must be recognised, then 70 must be reflected in the amount of the liability to the PSC for the film (and the corresponding asset)?
>
> (3) Is it correct to treat the relevant agreements as giving rise first to one asset, the rights in respect of the film, and then, on completion of the film, to a second asset, the debtor (the right to payment by the CD)? Alternatively should the relevant agreements be viewed *ab initio* as giving rise only to one asset, namely a right to the receipt of distributions from the CD? Is the asset (a) stock/WIP, or a particular species of stock, a long-term contract, or (b) a fixed intangible asset?

(4) Given that the PSA did not require the payment of the full amount of the budget from the start (requiring only payments at times specified by the agreed cash flow), was it correct to recognise the full 100 liability rather than the amount which had been paid or had become payable by the period end? Indeed was it correct to account for it at all given that no work had been done at that stage?

(5) If the relevant asset is stock or work in progress was it correct to value the amount of the stock as equal to the value of the virtually certain income? If not, what would be the correct valuation basis?

(6) Given that the relevant agreements require part of the distributable income to be retained by the Lender, was it correct to bring into account the full amount appearing in schedule 7 of the CDA (thus including BDR/BR) as income of the LLP rather than only that part of which was actually payable to the LLP?

920. We set out our answers to these questions in section 7. Each of these issues may affect the amount of the profit or loss which it is correct to treat as accruing to the LLP in any period.

921. There was some debate among the experts as to whether, on the assumption that stock should be recognised, it should be classified as a long-term contract. The effect of so classifying it did not affect the resultant profit or loss and as a result we do not address that issue.

3. The Rights and Obligations Arising under the Relevant Agreements

922. Each of the three accounting experts referred to the rights and obligations of, and the effects on, the LLP which arose under the relevant agreements and the Members' Agreement; and to a greater or lesser extent considered that those rights, obligations and effects were relevant in the determination of the economic substance of the transactions. We start therefore by summarising our conclusions in Chapter II in relation to those rights, obligations and effects.

(a) Capital and Membership Rights

923. The CM acquired membership rights in, and obligations to, the LLP on the making of the LLP agreement.

924. On subscribing to the LLP an individual member acquired membership rights under the LLP agreement. The individual's rights depended on the capital contributed.

925. In the case of ITP the CM had no obligation under the Members' Agreements to contribute capital. In the case of IFP2 the CM had an obligation to contribute capital if required to do so by notice from the Operator or on a winding up. No notice was given and there was no winding up.

926. There was no obligation under the relevant agreements for the CM to contribute any more than had been paid at any time by the CD to the PSC.

927. Payments by the CD to the PSC were intended by the parties to the relevant agreements to be treated as some form of capital contributions by the CM to the LLP, although there was some doubt as to whether the Members' Agreements required or permitted such treatment.

928. In the case of ITP any such contribution of capital by the CM as a result of the payment by the CD to the PSC had no effect on the rights of the CM or the liability of the LLP on the winding up of ITP.

929. In the case of IFP2 any amount treated as a contribution of capital to IFP2 as a result of the CD's payment to the PSC conferred no rights on the CM in a winding up of IFP2 because it was not paid in freely available funds to the LLP.

930. Prior to the signing of the relevant agreements the LLP had a contingent obligation to pay drawings to the CM. After they had been signed any such obligation was reduced by the amount of BDR/BR retained by the CD.

(b) Obligations of the LLP to Pay the PSC

931. Under the relevant agreements the LLP was obliged to pay only 30 to the PSC. It was not obliged to procure the payment of 70 by the CD (or by the CM). It was not obliged to treat any asset it held as diminished, or any liability to which it was subject as increased, as a result of entry into the relevant agreements. In particular the recognition of capital contribution by virtue of any payment by the CD to the PSC did not affect the liabilities or obligations of the LLP.

(c) Rights in Relation to the Film

932. The LLP was always devoid of any of the benefits of ownership of the film. It could do nothing with any part of the rights associated with the film at any time during its production. It was bound by iron fetters.

(d) Rights in Relation to Income from the Film

933. The effect of the Deed, the Notice and the CDA was that the only payment right the LLP acquired under the relevant agreements was the right to the payment of the balance of GDI after deducting BDR/BR. Together the agreements conferred no right on the LLP to receive BDR/BR. The LLP could not, after the coming into effect of these documents, compel the payment to it of BDR/BR; and the Lender could compel the payment to it of BDR/BR (or resist any action to prevent it from retaining BDR/BR where it was the CD).

4. The Experts' Evidence

(i) Mr Holgate's Written Report

934. In his report Mr Holgate said:

(a) Capital

GAAP requires the reporting of the entire capital of an entity regardless of its source or the nature of the investor's funding. The LLP's treatment was consistent with that principle. Consideration did not have to be received in cash. It was appropriate to account for capital represented by an outstanding liability.

(b) Expenditure

The LLP's expenditure should be reflected in its accounts. The source of the funds for that expenditure did not affect the amount of the expenditure. In particular he said that he was instructed that the CM's contribution to the film went indirectly to the PSC through actions with three elements: (a) the Lender lends to the CM, (b) the CM invests in the LLP, and (c) the LLP provides funds to the PSC. Each step was a commercial transaction supported by contractual documentation. It did not matter that cash did not move from entity to entity.

(c) The Asset

The first question was the nature of the asset which arose as a result of the expenditure. The LLP contracted for the delivery of a film and agreed to deliver it to the CD. The film should therefore be treated as a current asset because the film was, in the terms of the Companies Acts definition, an 'asset not intended for use on a continuing basis in the company's business'. The proper sub-classification was WIP, a sub-category of stock since: (a) it was, before delivery, a "product … in intermediate stages of production"; and (b) "all copyright to the film whilst it is being produced as well as when production is finished, rests with the LLP until sale to the CD".

Because the film was sold at a single time to the CD, rather than gradually over a period, the Long Term Contract provisions of SSAP9 were not relevant.

(d) Stock/WIP should be carried at Net Realisable Value ("NRV"). Each film should be considered separately. The estimation of NRV as equivalent to the value of virtually certain income complied with GAAP having regard to the guidance in SSAP9 and FRS12.

(e) The LLPs' contracts with the CD and the PSC were executory contracts. A commonly accepted practice is to account for such contracts on the basis of the things which have occurred at the accounting date (a "net" basis) rather than including in the carrying values all future rights and obligations (a "gross" basis). By accounting for the full 100 of the budget the LLPs had adopted a gross basis. In circumstances where the recoverable amount for a film could be much less than the 100 budget, a write down to NRV effectively required the gross amount of the film to be recognised initially; if a net approach were adopted the need to recognise the reduction in stock value could be met only by recognising an onerous contract – a presentation which he did not believe would be informative. Gross accounting was therefore a more suitable basis. In practice it made no difference to the profit or loss for a period.

935. In the joint report of Mr Holgate and Mr Cannon, Mr Holgate explained that he took the view that both the legal form and the economic substance are important in determining correct accounting treatment and that he included in his analysis contractual arrangements put in place by the parties even where they are not reflected

in cash flows. Mr Cannon explained that he did not consider the legal form of the transactions to reflect the commercial substance of the transactions.

(ii) Mr Holgate's Oral Evidence

936. Mr Davey put to Mr Holgate that his analysis of the contractual position did not pay sufficient regard to the requirement of FRS5 that accounts reflect the economic substance of a group of transactions, not just the legal form.

937. Mr Holgate regarded the LLP's position as being analogous to that of a person who needed money to go ahead with a project. If he didn't get the money he could not go ahead. Without the CM's contribution of 70 the LLP could not go ahead with the film. To go ahead with the film the LLP had to find 100 from its own resources; those resources were the capital it raised from its members, and that included the 70 from the CM.

938. Mr Holgate said that he started from the position that the LLP had issued capital and the question was then what were the assets and liabilities it had as a result of the transactions in which it used that capital (assuming therefore in accordance with his instructions that the capital had been used in the acquisition of the film). The FRS5 substance over form requirement permeated that analysis. Recognising 100% of revenue and 100 of stock followed from recognising 100 of capital.

939. Although Mr Holgate said that he would hope to view each contract as within a nexus of other contracts, he did not regard it as correct to view the arrangements as giving rise only to a single asset, being the right against the CD under the CDA, although he acknowledged that the value of the right against the PSC lay in the rights under the CDA. He broke the accounting into two periods – the production period and the exploitation period. In the first period there was an asset (stock) which, when it was finished was delivered to the CD and became a debtor in the accounts. What was key was that there was a production process followed by the sale of the completed item.

Commentary on Mr Holgate's Evidence

940. To some extent Mr Holgate (or those who wrote his instructions) was blinded by the story the draftsman of the relevant agreements wished to tell. Rather than looking at the legal obligations which arose after they had all been executed he considered, and was instructed to consider, how the agreements described the obligations as having arisen. The assumptions he made, and was instructed to make, were thus coloured by this error.

941. Mr Holgate assumes that there was a time when the CM was indebted to the LLP for an amount equal to the payment which the CD had yet to make. We saw no warrant for this assumption in the Members' Agreements.

942. Mr Holgate says that it was appropriate to account for the unpaid capital of the CM "because the LLP can demand contribution of this capital *in cash* either by giving 14 days' notice, or failing that, on a winding up of the LLP." That is the case only for

IFP2. Mr Holgate's reference to payment in cash is, we think, unrealistic: the CM had no substantial assets and any cash it provided came from the CD and could only go directly to the PSC.

943. Mr Holgate says that he was instructed that the CD's contribution to the film went indirectly to the LLP through three elements:

(a) The first was the lending by the CD to the CM:

We accept that on the Lender paying the PSC 70, the CM became in some fashion indebted to it in that amount. Whether or not that payment should be characterised as a loan depends on the context in which "loan" is used.

But this assumes a first transaction in a sequence; that description is not warranted by the relevant agreements.

(b) The second element was the investment by the CM in the LLP:

Again, this impermissibly assumes a sequence of events.

We consider that, even if the CD's payment to the PSC gave rise to a capital contribution, it is misleading to describe the CM as thereby investing in the LLP. Under the single transaction (i) it acquired no material rights in the LLP as a result of that "investment"; (ii) the CM became indebted to the CD, and acquired the benefit that the retention of BDR/BR by the CD would reduce its indebtedness; and (iii) if the LLP incurred an obligation to recognise that capital had been contributed (as to which see later), then at the same time it acquired a reduction in its liability to pay the CM drawings to the extent of BDR/BR.

(c) The third element in Mr Holgate's instructions was that "the LLP provides the funds to the [PSC]".

In our view the LLP was never obliged to pay or procure the payment of 70 to the PSC and there is no reason to treat it as providing those funds to the PSC. There is no warrant for linking the recognition of capital to payment for rights of the LLP in relation to the film. The CD provided the funds, not the LLP.

944. Generally, Mr Holgate's instructions appear to treat the three elements as sequential when the rights and obligations which arise under the agreements afford no reason to do so. There were not three transactions but one combined one.

This approach was particularly evident in a passage of his evidence in which he was talking about the resources of the LLP. He said:

> "What are its own resources? Its own resources are the capital that it raises from its various members. So I think *once* it has raised resources in the form of capital from its members, *then* it will spend them in the contract with the PSC." [our italics]

945. We therefore consider that this part of Mr Holgate's analysis rests on a mixture of false premise and characterisations as to sequence which are not necessary consequences of the agreements.

946. Mr Holgate speaks of taking into account the 'legal form' of the agreements. It seems to us that by this he did not mean the rights and obligations which arose under them but the characterisation of those rights and obligations suggested by the agreements. In other words taking into account the story they tried to tell. We saw no warrant for this in the accounting standards, which are concerned with enforceable rights and obligations not how they are characterised by the parties. Further FRS5 does not direct attention to legal form: the overriding objective of the standard is regard for substance.

947. In his analysis of the nature of the asset which arose as a result of the LLP's expenditure Mr Holgate says that the film was not an asset intended for use on a continuing basis in the company's business, and that all copyright in the film rested with the LLP until sale and that the film was not sold gradually over a period.

These are assumptions as to the legal effects of the agreements which do not in our view reflect the substance of the transactions in accordance with FRS5. Whilst it might be said that the bare right to the copyright (or 95% of it) rested with the LLP until completion of the film, the CD acquired exclusive exploitation rights to the film as they arose. Mr Holgate's analysis is applicable to the bare right to the copyright and ignores the provision of the exclusive licence and the effect of other provisions of the agreements. So far as the bare right to the copyright is concerned it has no value because it could not be exploited by the LLP: if the LLP withheld it from the CD, the CD could continue to exploit the film under the licence, and the exclusivity of the licence prevented the LLP obtaining value from it by providing it to a third party. It was thus not something from which the LLP could secure a benefit; it was therefore not an asset as defined by FRS5 (see later). It cannot therefore be treated as held or sold.

948. That part of Mr Holgate's analysis which starts with the recognition of the CM's capital and the related debtor continues by asking what asset the LLP acquired with that capital. That analysis assumes that the LLP used the capital contributed in its business. We have found that the LLP was not obliged to pay or procure the payment of 70, and that the benefit of the Lender's payment of 70 accrued to the CD (and in some fashion to the CM by the reduction in its indebtedness by the BDR/BR retention by the CD) and not to the LLP.

949. Mr Holgate's assumption that the capital was used in the LLP's business also excludes the possibility that the LLP used the capital to provide a one-off benefit for, or in a transaction which provided such benefit to, the CM, in other words as if it used the capital subscribed to give drawings in the form of an asset to the CM (cr capital; dr drawings). More seriously it fails to consider whether what has been treated as a capital subscription has any effect of any substance on the LLP: that is to say whether it imposes on it any obligation to transfer funds, which it does not.

950. We reject Mr Holgate's analogy between the LLP and a person who had 30 and needed the extra 70 to go ahead with a project. The LLP could in many cases have financed 100% of a film from the ordinary member contributions, although of course that may have reduced the number of films with which it was involved. The fact that

it undertook an obligation to finance only 30% was not a consequence of needing extra money but of a policy that 70% should come from sources other than the ordinary members.

951. In summary we conclude that Mr Holgate's analysis rested on assumptions as to the effects of the relevant agreements and the Members' Agreements which were unjustified. We were therefore unable to accept his conclusion that the LLPs had accounted for the transactions correctly in recognising stock as an asset and treating it as having an initial value of 100.

(ii) Mr Steadman's Written Report

952. There were some aspects of his report in which Mr Steadman's evidence duplicated that of Mr Holgate. We have ignored those parts. We note the following parts of Mr Steadman's report in which his approach or opinions differed from those of, or he covered grounds different from those covered by, Mr Holgate:

(a) Expenditure

Mr Steadman's approach to the recording of the stock and debtors in relation to a film started from a slightly different point from that of Mr Holgate, but reached the same conclusion. He started by saying that GAAP requires the recognition of the liability to deliver the film incurred by the LLP under the CDA. Relying on paras 16-18 FRS5 he says that the measure of that liability is the outflow of value required to satisfy the obligation, and that may be measured as the cost to be incurred under the PSA.

The corresponding debit had to be recognised as an asset. It did not matter whether that asset was the benefit of the PSA or the rights under the CDA. It was a current asset being held for sale. "These contracts", he says, "need to be considered separately and, in accounting terms, it is necessary to consider whether a transaction has taken place and if so to account for the assets and liabilities arising."

(b) Distributions

Mr Steadman regards the LLP's practice in relation to accounting for distributions arising to be correct.

953. In the joint report of Mr Steadman and Mr Cannon, they agree that para 14 FRS5 requires the determination of the "overall commercial effect" that a group of transactions achieves or is intended to achieve.

954. They agree that the determination of the overall commercial effect is ultimately a matter for the tribunal and not for expert evidence, although Mr Cannon thinks an accounting expert may valuably comment on the substance of transactions.

955. In evaluating commercial effect Mr Steadman considers it correct to take into account the activities of the LLP described in the Members' Report in its accounts, in the Information Memorandum, and in the statements made by the witnesses in their

witness statements. He notes that departure from legal form is rare and that the CDA and the PSA were each for the delivery of the whole of a film and not part of one.

(iii) Mr Steadman's Oral Evidence

956. Mr Steadman accepted that financial statements should report the substance of transactions and that greater weight should be given to aspects which had commercial effect. He accepted that a group or series of transactions which achieves, or is intended to achieve, an overall commercial effect should be viewed as a whole (see para 11 FRS5 below).

957. Mr Steadman said that under FRS5 a financial asset includes a contractual right to receive cash or other financial assets, and that whether or not something is a contractual right depends upon whether the payer can avoid delivery. Therefore he said that as soon as capital was introduced by the individual members of IFP2 the LLP had to recognise an asset in the form of the right to receive payment on 14 days notice from the CM. Thus he says that IFP2 correctly accounted for the unpaid capital of the CM. He drew an analogy with the treatment of a limited company's paid and unpaid capital in Companies Acts disclosure. (This analysis could not extend to ITP).

958. In his report and in the initial stages of his oral evidence Mr Steadman said that the CDA and the PSA had to be considered separately: they were separate transactions. The transactions under the CDA between the CD and the LLP, and under the PSA between the LLP and the PSC had to be examined for economic substance and accounted for separately, although if they were part of a whole one had to look at that as a whole as well. It was this latter process which enabled him to value the liability of the LLP under the CDA as being the cost of the film under the PSA: the CDA created an obligation on the LLP to deliver a film – that was a liability whose value was the cost of satisfying it through the PSA. One therefore recognised the cost payable to the PSA of 100 as a liability although as payments were made to the PSC it was reduced.

959. But later Mr Steadman accepted that it was correct to look to the totality of the transactions and account for that totality: linked transactions could change the scope of an asset or liability which might otherwise have been recognised by reference to one transaction alone. Mr Steadman agreed that for the purposes of the LLP's financial statements, since the CDA and the PSA were made in contemplation of each other, one could take them both into account in looking at the overall transaction for FRS5 purposes insofar as so doing affected the assessment of the assets and liabilities of the LLP.

960. Mr Steadman said that he did not regard the asset which was the counterpart to the liability under the CDA as a fixed intangible asset because it was sold on. That opinion assumed that the LLP had an asset in the form of a right against the PSA, rather than the right against the CDA.

961. Whilst Mr Steadman accepted that the effect of Clause 3.1 of the PSA was to make the LLP's liability to pay 30 contingent upon the Lender having paid 70 to the PSC, he did not initially accept that the substance of the LLP's liability was to pay 30 because that omitted consideration of recognition of the CM's capital. The 70 "paid" to the PSC was the application of the CM's capital contribution. The LLP's capital had to be the starting point. The accounting debtor in respect of that capital was satisfied by the payment to the PSC – effectively the CM contributed the benefit of the loan from the Lender.

962. However, later in his evidence Mr Steadman appeared to accept that the capital structure of the LLP was irrelevant to the accounting treatment of the transactions.

963. In the same way Mr Steadman regarded the LLP's entitlement under the distribution arrangements as including BDR paid directly to the Lender. He regarded the LLP as having had an (existing) entitlement, which it had (then) chosen to use in payment to the Lender for the benefit of the CM as (future) drawings[28]. The Payment Instruction, even though executed at the same time as the CDA, did not in his view affect the (earlier) accrual of the entitlement. The documents told a sequential story, although he agreed that it was a difficult situation because all the agreements were executed at the same time.

964. But Mr Steadman said that if the overall commercial effect was to make it appear that the partnership had, say, a 55% entitlement when in fact it had a 30% entitlement, then following FRS5, the financial statements should show that overall commercial effect. The question of what is the overall commercial effect "was the reason we were all [t]here". If ultimately the overall commercial effect of the transactions, taken as a whole, was found to be different from that, then the accounting would follow that finding.

965. In relation to the determination of NRV he regarded the virtually certain income test as a higher threshold than estimated proceeds but regarded it as appropriate in view of the risks involved. Mr Steadman acknowledged that virtually certain income, which he described as certain income minus credit risk, was self evidently different from the SSAP9 terminology of NRV which required making an estimate, but given the material uncertainty and the effect of the FRS18 requirement to take account of material uncertainty in arriving at estimates, thought that the virtually certain test was appropriate.

[28] Mr Steadman acknowledged that in the case of IFP the payment of BDR to the Lender became compulsory under the relevant agreements, and was not a requirement of the LLP Member's Agreement, under Clause 3.1 of which 100% of income could be allocated as drawings to the individual members, but he did not regard this as affecting his analysis. That was the case even though the BDR part of what he regarded as the entitlement of the LLP, being payable only to the Lender, was outside the **control** of the LLP. He accepted that, if the option of the Operator under clause 9.8 to allocate 100% of drawings to the individual members were exercised it could be "difficult" to account for any amounts which had been paid to or retained by the Lender: they could no longer be described as drawings.

Commentary on Mr Steadman's Evidence

966. Mr Steadman starts by saying that GAAP requires the recognition of the liability to deliver the film incurred by the LLP under the CDA. He says that the measure of that liability is the outflow of value required to satisfy the obligation.

967. Although Mr Steadman did not give quite the same reason as Mr Holgate for treating the right to the film as an asset of the LLP which was then sold on, we reject the inherent assumption that that right was properly to be treated as an asset for the purposes of FRS5.

968. If the outflow of value from the LLP is only 30, then that would be the amount of the liability and initially the amount of the corresponding asset. The fact that under the CDA the LLP is required to deliver a complete film which cost 100 does not affect the value of the liability or the initial value of the asset.

969. Given our conclusion that the only liability of the LLP was to pay 30, the value of the liability could be treated as being 100 only if the commercial substance of the transactions so required.

970. Initially Mr Steadman did not regard the substance of the LLP's liability as being 30 because that omitted consideration of the application of the CM's capital in the outflow of value required under the PSA. However, (i) later Mr Steadman agreed that there was no necessary link between the CM's capital and the liability of the LLP to the PSC, and (ii) as we have noted in relation to Mr Holgate's evidence any recognition of such capital did not give rise to a liability of the LLP or increase the value of its obligations in such a way as to require the recognition of a liability under FRS5.

971. We conclude that Mr Steadman's evidence does not support a conclusion that it would have been in accordance with GAAP for the LLP initially to account for an asset of 100 representing its interest as against the PSC for the film.

972. Like some of those of Mr Holgate, Mr Steadman's conclusions that the LLP did not acquire a fixed intangible asset (being the right against the CD under the CDA) and that it should be treated as being entitled to the BDR/BR were dependent on treating the relevant agreements as being made in a stately dance so that there was time for rights and obligations to accrue under one provision before they were changed by the next; and upon treating the words of the agreements as telling a story rather than as creating new rights and obligations which arose at the time they all came into force. That in our view is an impermissible approach to the relevant agreements, which must be read together and as all coming into effect at the same time. As we shall explain later we do not regard such treatment as being in accordance with the economic substance of the transactions. We therefore do not find that his evidence supports a conclusion that the treatment adopted by the LLPs was in accordance with GAAP.

973. Mr Steadman's approach to taking into account the Information Memorandum and Members' Reports to determine the substance of the transactions was not

challenged but was not expressly adopted by the other experts, and we saw no warrant for it in the accounting standards. It seems to us to permit the reporting entity to massage the appreciation of the substance of its transactions.

(iii) Mr Cannon's Written Report

974. In Mr Cannon's report he said:

(a) Capital

He was not instructed to offer an opinion on the correct treatment of the LLP's capital.

(b) Expenditure

Mr Cannon's opinion was that the LLP did not get the benefit of the monies paid to the PSC by the Lender. He regarded the LLP as being liable to pay only 30 since its obligation to make payment was subject to the PSC receiving the funds from the Lender: it did not have to make any transfer of value until the Lender had paid its 70. Thus he regarded the LLP as incurring expenditure of only 30. Even if there could be said to be a legal obligation to transfer 100 he regarded the LLP as not being required to transfer economic benefit of more than 30. This he regarded as consistent with the LLP acquiring an asset – the right under the CDA to payment from the CD – which was limited to 30% of the distributable income.

(c) Mr Cannon considered that the obligation of the LLP to pay 30 gave rise to the corresponding recognition of 30 of stock. His preferred designation would be as a long-term contract but he accepted that it made no difference to the GAAP profit.

(d) Mr Cannon accepted that the stock should be written down to NRV and that it was correct to use an estimation technique for so doing, but he regarded the LLP's practice of taking into account projected future income as insufficiently prudent. He would reduce the turnover and profit (and implicitly also the carrying value of the debtor or stock) accordingly.

(e) Distributions from a Film

Mr Cannon did not consider that the LLP should have recognised that part of the distributable income (BDR/BR) which was required to be paid directly to the Lender – either as part of its turnover or in assessing the NRV of its interest in a film.

Mr Cannon's Oral Evidence

The LLP's expenditure

975. Mr Cannon said that the LLP was only ever obliged to transfer economic benefit of 30. That is all it had to pay. Mr Milne criticised this conclusion. He said that (a) the agreements show that the LLP has an obligation to pay 100, (b) that the commercial substance of the Inside Track model was that the LLP should be at the heart of production – incurring the whole obligation to fund the film, not just lobbing in 30,

(c) that the obligation to deliver a benefit may be satisfied otherwise than by payment of cash, and (d) that Mr Cannon impermissibly limited his view to cash movements.

976. Mr Cannon replied that because the LLP was obliged to make payment only if, and after, 70 had been paid by the Lender to the PSA, it did not have an obligation to deliver 100 of value. He did not regard his concentration on cash flows as being at variance with proper accruals accounting.

977. Mr Cannon was asked whether his analysis would have been different if cash had actually been routed through the CM to the LLP and thence to the PSC. His initial reaction was to say that in those circumstances it would look as if the LLP was incurring 100% of the costs, but when asked to take into account the source of the cash and that the LLP would remain entitled to the same cash payments from the CD, he said it would not change his analysis.

The LLP's Capital

978. Mr Cannon was also asked to venture opinions on the correct accounting treatment for the LLP's capital, something he had not been asked to consider in his report. He considered that if the LLP should recognise the CM's capital and at the same time a debtor for the amount unpaid, the unpaid debtor should be written down if it was regarded as uncollectable. He considered that such a write down should not be regarded as giving rise to a loss made by the partnership but as a diminution of its capital. He questioned whether, in such circumstances, the capital should have been recognised at all even if the CM's interest conferred on it certain rights.

979. This left the question as to whether, if after the CM became obliged to contribute capital, and after capital of 70 and a debtor of 70 had been recognised, the LLP procured, through the relevant agreements, the accrual of the right for the benefit of the CM of the payment of BDR/BR to the Lender so as to reduce the CM's liabilities, this was a transfer of benefits to the CM in the nature of drawings, so that if the debtor was treated as reduced by 70 on the Lender's payment to the PSA, the corresponding credit was to the CM's drawings account rather than to stock.

Commentary on Mr Cannon's Evidence

980. It is true that, in describing the reasons for his conclusions, Mr Cannon focussed on the obligation of the LLP to pay cash and in that respect appeared to pay little attention to any obligation to deliver other forms of economic benefit, but at the heart of his evidence is an assumption that the LLP was not obliged to deliver even 30 to the PSC unless the Lender had paid 70 to the PSC and that the LLP had no obligation to ensure the payment of the 70 to the PSC. On this basis the Lender's payment of 70 did not discharge a liability of the LLP to transfer economic benefit because there was no such liability. Our analysis of the obligation and rights under the relevant agreements gives rise to the same conclusion.

981. Mr Milne criticises Mr Cannon for focussing on cash movements: he says that a fundamental principle of GAAP is accruals accounting. We did not consider that Mr Cannon made the mistake Mr Milne lays at his door. Accruals accounting involves the

recognition of assets and liabilities in the periods in which they arise. Mr Cannon's references to cash were to the obligations to deliver cash – the outflow of economic benefit described in FRS5 and thus the identification of the liability which is the precursor of the recognition of an accrual. What was missing from Mr Cannon's analysis was consideration of the economic burden arising from the recognition of capital contributions, but as we have said, there was none.

982. Mr Cannon's reaction to the question as to whether his view would change had cash actually been routed through the CM and the LLP to the PSC is illuminating. The question assumes that once in possession of the cash the LLP would happily have used it – free of contractual compulsion – to acquire rights to only 54.55% of GDI despite paying 100% of the cost of the film. It exposes therefore the hidden constraint that the sequential transaction painted by the draftsman would in fact have been entered into if the LLP had free use of the money. The true parallel transaction in which cash moved would be one in which the LLP was contractually bound before receipt of the cash to use it in a particular way. That was not the "cash" transaction put to Mr Cannon.

983. Whilst we reject Mr Cannon's assumption that an LLP acquired an asset under the PSA which it later sold to the CD, we accept his evidence as to the proper initial carrying value of the asset which the LLP acquired under the agreements. .

(iv) The PWC Letter of 17 June 2004

984. On 17 June 2004 PWC wrote to the directors of Ingenious with their views on the proper accounting for Inside Films 1 LLP and 2 LLP. These were LLPs for corporate investors but the transaction structure was similar to that relevant to the LLPs, involving a CDA and a PSA for a film.

985. We did not hear from the writers of the letter, but the letter was before us and there was some discussion of it in Mr Holgate's oral evidence.

986. The letter considered how the asset which arose in connection with the PSC's creation of the film should be accounted for. PWC's conclusion was that their "preferred" view was that it should be treated as a fixed intangible asset, but that treatment as stock was acceptable and in accordance with GAAP. There were, in PWC's view, four aspects which indicated treatment as a fixed intangible asset:

(a) The CDA and the PSA were entered into at the same time;

(b) The effect of the contracts was that the film rights never ended up with the LLP;

(c) Once the film was completed and transferred to the CD, the LLP retained a right to a portion of the income generated by the film;

(d) The timing and quantum of the income was uncertain.

987. The amount at which the fixed intangible asset should be recognised in the accounts would have to take into account any impairment in the value of the asset, or a provision would need to be made for the CDA as an onerous contract.

988. Mr Holgate disagreed with PWC's preference for fixed intangible asset treatment because he regarded the relevant asset as being the film, not the right against the CD.

(v) The Accounts and Shipleys LLP's Opinion

989. The accounts of IFP2 recorded the accounting policy for stock as being that it was stated at the lower of cost and net realisable value, and that net realisable value was based on estimated selling price; for long term contracts the accounting policy was to make provision for foreseeable losses on contracts.

990. We should note that Shipleys gave an unqualified opinion on the LLPs' accounts. We infer from this that they concluded that the accounting policies adopted by the LLPs and their implementation were correct. We did not, however, hear from Shipleys and so are unable to record their reasoning.

5. The Tribunal's Three Scenarios

991. Each expert was asked about the correct accounting for the following three transactions:

(a) Under a contract between A and B: A agreed to pay B 100; B agreed to make a film; B agreed to pay A *x*% of the income from the film.

(b) Under a tripartite contract between A, B and C: A agreed to pay B 100; B agreed to make a film; B agreed to transfer the film to C when made; and C agreed to pay A *x*% of the income from the film. A had no right to play, and did not play, any role in the making of the film.

(c) Under a tripartite contract between A, B and C: A agreed to pay B 100; B agreed to make a film; B agreed to transfer the film to C when made; and C agreed to pay A *x*% of the income from the film. A was entitled to interfere in the making of the film.

992. The experts agreed that:

(a) In the first example, A should recognise a fixed intangible asset from which it derives income;

(b) In the second example, A should recognise a fixed intangible financial asset from which it would derive income; and

(c) In the third example, the correct treatment depended on the role taken by A in relation to the making of the film.

993. In the third example Mr Holgate said that the accounting treatment would be different if A had a substantive role in the film-making process; Mr Steadman said that if there was sufficient activity by A then it should recognise a current asset debtor, and Mr Cannon said that if A had sufficient control over the making of the film it should account for the asset as a current asset.

6. Discussion: The Accounting Principles to be applied

994. Before FA 1998 the case law made it clear that profits and losses of a business for tax purposes were those determined on "the correct principles of the prevailing system of commercial accounting" (see Pennycuick V-C in *Odeon Associated Theatres v Jones* 48 TC 257 at 273, and Bingham MR in *Gallagher v Jones* 1990 3S TC 537 at 554).

995. Section 42 FA 1998 required computation of such profits on such a basis as to give a true and fair view. In 2002 section 42 was amended so that it required computation in accordance with generally accepted accounting practice.

996. In this case it seems to us that there will be little or no difference between profits ascertained in accordance with the 2002 standard and that previously applicable. That is because, as we explain later, an LLP's accounts prepared on the principles of generally accepted accounting practice will show a true and fair view.

997. Prior to 1998 there may, however, have been cases where there were two or more ways in which a particular item could properly have been accounted for in accordance with the prevailing system of commercial accounting : in such cases the courts might, before FA 1998, have been able to determine which was the "correct" principle to be applied. But it seems to us that the scope for such interference by the courts is now more restricted. After 2002 if an accounting basis has been used which is in accordance with generally accepted accounting practice such a basis may be thrown out only by an "adjustment required or authorised by law", and such words do not to our minds encompass judicial selection of one of a number of generally accepted bases.

998. Regulation 3 of the Limited Liability Partnership Regulations 2001/1090 applies the provisions of Part VII of the Companies Act 1985 to the accounts of LLPs. Section 226 of that Act requires accounts to show a true and fair view. It was clear to us therefore that GAAP for an LLP must be such accounting practice as will show a true and fair view, because there is no doubt that to be generally accepted the practice must comply with the legislation.

999. Although the requirement that the accounts give a true and fair view involves the application of a legal standard, the courts have been guided as to its content by the expert opinions of accountants as to what the best current accounting practice requires. Thus, in a somewhat circular fashion, GAAP requires a true and fair view, but what is a true and fair view is informed by generally accepted accounting practice.

1000. The experts are in turn guided by authoritative statements of accounting practice issued or adopted by the Accounting Standards Board, which are given statutory recognition by section 256 and paragraph 36A of Schedule 4 of the Companies Act 1985.

1001. These published standards not only guide accountants in the preparation of accounts but also mould the expectations of those who read or use the accounts. Therefore compliance with professional standards is prima facie strong evidence that the accounts present a true and fair view and comply with GAAP, and deviation from

accepted accounting principles (rather than practice) is prima facie evidence that the accounts do not present a true and fair view and do not comply with GAAP.

1002. That is acknowledged by the 1999 Statement of Principles for Financial Reporting: "10. The concept of a true and fair view lies at the heart of financial reporting in the UK and the Republic of Ireland ". That Statement does not define a true and fair view but says at 13 that it is the detailed “legal requirements, accounting standards and in their absence other evidence of generally accepted accounting practice ...that normally determines the content of financial statements".

1003. Before us the evidence of the experts was that the provisions of the accounting standards determined what would be generally accepted accounting treatment. We find that accounts will normally have to comply with the accounting standards and guidance published by the UK Financial Reporting Council in order to show a true and fair view and to qualify as having been prepared in accordance with GAAP.

1004. We found it difficult to regard accounts of an LLP which show a loss arising in period 1, where nothing has been done apart from signing some contracts, and profits arising in later years when anticipated income starts to flow as providing useful information to the readers of those accounts or as fairly representing the true financial state of the LLP. Nevertheless if the LLPs' presentation was required or permitted by accounting standards it seemed to us that it would be in accordance with generally accepted accounting practice. However, whether or not the presentation was in accordance with such standards depends on a proper understanding of the transactions to be accounted for.

1005. The provisions of the following standards were cited by one or more of the experts and are relevant.

Accounting Policies

1006. Para 14 FRS18 requires that an entity should adopt accounting policies that enable the financial statements to give a true and fair view, and that those accounting policies should be consistent with the requirements of accounting standards and companies legislation.

1007. ‘Accounting Policies’ are defined by FRS18 to be the principles and practices applied by an entity that specify how the effects of transactions and events are to be reflected in its financial statements through recognising, selecting bases of measurement for and presenting assets, liabilities, gains, losses and changes to shareholders’ funds.

1008. In practice there will be a very narrow range of situations where the accounting requirements of UK GAAP permit a choice of accounting policies. Where a choice does exist between two policies which both satisfy para 14 of FRS18, para 17 of FRS18 requires that the policy “judged by the entity to be most appropriate to its particular circumstances for the purpose of giving a true and fair view” be selected. Para 30 requires any such judgement to be conducted against the objectives of relevance, reliability, comparability and understandability.

1009. Para 36 FRS18 provides that "appropriate accounting policies will present transactions and other events in a way that reflects their substance", and that a transaction or event is faithfully represented if the way in which it is recognised, measured and presented "corresponds closely to the effect of that transaction or event".

1010. Para 37 of FRS18 provides that prudence requires accounting policies to take account of uncertainty; and paras 50 and 51 that where it is necessary to choose between estimation techniques which are consistent with accounting standards an entity should select whichever technique is most appropriate.

Substance

1011. FRS5 deals with "reporting the substance of transactions". Its object is to ensure that the substance of an entity's transactions is reported in its financial statements. In its summary section it records, at b and c, that its provisions will mainly affect complex transactions whose substance is not readily apparent and whose "commercial effect may not be adequately expressed by their legal form".

1012. Para 12(d) excludes expenditure commitments from the scope of the standard until the earlier of delivery or payment. The standard thus seems to apply once a payment has been made by the LLP under the transaction. None of the experts indicated that FRS5 should not apply from the time the relevant agreements were signed.

1013. It requires that "the commercial effect of the entity's transactions and any resulting assets, liabilities, gains or losses should be faithfully recognised in its financial statements." Where a specific accounting standard applies to a transaction it provides that it "should be applied to the substance of the transaction and not merely to its legal form and for this purpose the general principles set out in FRS5 will be relevant" (para 43). (Para 11 defines 'transaction' to include a group of transactions designed to achieve an overall commercial effect.)

1014. Para 14 of FRS5 says that "in determining the substance of a transaction all its aspects and implications should be identified and greater weight given to those more likely to have a commercial effect in practice. A group or series of transactions that achieve or are designed to achieve an overall commercial effect should be viewed as a whole". Paras 51 and 52 indicate that in assessing the commercial effect of a transaction it will be important to consider the position and motives of other parties to it.

1015. Para 17 says "to determine the substance of a transaction it is necessary to identify whether the transaction has given rise to new assets or liabilities for the reporting entity and whether it has changed the reporting entity's existing assets and liabilities".

1016. FRS5 defines assets and liabilities. "Assets are rights or other access to future economic benefits <u>controlled by an entity</u> as a result of past transactions or events." Control in this context means the ability to obtain future economic benefits and to

restrict the access of others to those benefits. Para 54 explains that "control" is "the means by which an entity ensures that the benefits accrue to itself and not others".

1017. "Liabilities" are defined as an entity's obligations to transfer economic benefits as the result of past transactions or events.

1018. Paras 17 and 18 FRS5 provide that there is evidence that an entity has a right or other access to benefits (and if controlled by the entity thus an asset) if the entity is exposed to the risks inherent in the benefits, taking into account the likelihood of those risks having a commercial effect in practice. Evidence that an entity has an obligation to transfer benefit (and hence a liability) is given if there is some circumstance in which the entity is unable to avoid, legally or commercially, an outflow of benefits.

1019. Lastly, in relation to substance, the Statement of Principles records, at 3.13, that "although the effects of the legal characteristics of a transaction … are part of its substance, they have to be considered in the context of the transaction as a whole including related transactions"; and para 46 of FRS5 provides that, particularly for complex transactions, it will not be sufficient merely to record the transaction's legal form, as to do so may not adequately express the commercial effect of the arrangements. That paragraph continues to say that notwithstanding this the FRS "is not intended to affect the legal characterisation of the transactions or to change the situation in law achieved by the parties". We do not read this last sentence as having any particular effect in this appeal; as we see it, it is the duty and the joy of the tribunal to determine on normal legal principles the incidents arising from the transactions, and then to ask what accounting practice should have been applied to them.

1020. In summary, it seems to us that these provisions require that the assets and liabilities arising to an entity from a group of transactions intended to achieve an overall commercial effect must be determined by considering what legal rights and obligations arise from those transactions, and therefore what economic benefits can be controlled or suffered by the entity by recourse to law, and then considering those as a whole *together* with any other features of the transactions or the setting in which they take place (including the position of third parties if relevant) to determine what is the commercial or economic substance of the economic benefits and obligations of the entity.

Stock and Work in Progress

1021. SSAP9 is a long-standing accounting standard dealing with accounting for stocks, work in progress and long-term contracts. Paragraph 1 of Part 1 explains that the matching of costs and revenues of a given period means that the cost of unsold stock at the end of an accounting period must be carried forward to be matched with sale revenue when it arises, but:

> "[i]f there is no reasonable expectation of sufficient future revenue to cover the cost incurred … the irrecoverable cost should be charged to revenue in the year under review",

and thus that stock should normally be stated at the lower of cost and net realisable value.

Paragraph 2, which echoes the requirements of para 14 Sch 4 Companies Act 1985, requires that this comparison needs to be made in relation to each item of stock separately, although where this is impossible similar groups or categories of stock may be taken together. But it says that to compare total realisable value with total cost would result in setting off foreseeable losses against unrealised profits.

1022. Net realisable value is there defined as the actual or estimated proceeds from the sale of such items less costs to completion and marketing and selling costs.

1023. The standard contains similar provision in relation to long term contracts "if it is expected that there will be a loss on the contract as a whole" all of that loss should be recognised as soon as it is foreseen, and initially deducted from the WIP figure for the contract "thus reducing its net realisable value".

1024. In summary, if an asset is identified which is properly classed as stock or work in progress, it must be stated at the lower of cost or net realisable value, and net realisable value is determined by reasonable expectation.

1025. We have recorded the accounting policies of the LLPs as stated in their accounts. As they are stated there is no question that those for stock and WIP comply with accounting standards. A question is whether the virtually certain income approach of the LLPs complied with those policies.

FRS12: Provisions, Contingent Assets and Liabilities (and Onerous Contracts)

1026. FRS12 relates to provisions, contingent liabilities and contingent assets. It defines a contingent asset as "a possible asset that arises from past events and whose existence will only be confirmed by the occurrence of one or more uncertain future events not wholly within the entity's control". The standard states that contingent assets should not be recognised, but "when the realisation of the profit is *virtually certain*, the related asset is not a contingent asset and its recognition is appropriate." (para 33).

1027. The provisions of FRS12 were not directly relevant to the LLPs' accounts but the concept of "virtually certain" income was used by the LLPs in estimating net realisable value, and, as we shall recount, was relied on by Mr Holgate in his support of the LLPs' formulation of net realisable value.

1028. FRS12 also deals with onerous contracts; it defines an onerous contract as "a contract in which the unavoidable costs of meeting the obligation under it exceed the benefits expected to be received under it".

7. Discussion: Our Conclusions on the Issues

The Substance of the Transactions

1029. Mr Cannon and Mr Steadman agreed that it was for the tribunal to determine the commercial substance of the transactions. It is to that substance that the relevant accounting standards must be applied.

1030. Having regard to the provisions of FRS5 cited above, we find that that substance of the transactions was the following:

(a) The LLP became liable to pay 30 to the PSC only after the CD had paid 70: 30 was the extent of its unavoidable obligation;

(b) The LLP had no other obligation to make or procure the making of any payment to the PSC.

(c) To the extent that a payment by the CD to the PSC was properly to be treated as a capital contribution by the CM, such a contribution was made when the payment was made by the CD.

(d) That contribution gave rise to no unavoidable obligation on the part of the LLP to transfer economic benefits to the CM and was not used by the LLP to pay for any rights in relation to the film which accrued to it.

(e) Any obligation of the LLP to pay drawings to the CM was removed to the extent of BDR/BR.

(f) Even if the agreement that the CD should retain BDR/BR in repayment of the loan was a benefit supplied by the LLP to the CM under the agreements, it was the counterpart of the satisfaction of any capital contribution recognised by the LLP.

(g) The film therefore 'cost' the LLP only 30.

(h) The PSC was obliged to make the film.

(i) During the making of the film the LLP had none of the benefits of ownership of the film other than such rights as would be held by a constructive trustee.

(j) On the completion of the film the LLP transferred nothing of substance – no economic asset which it controlled – to the CD.

(k) When the film had been made the LLP became entitled to amounts determined by deducting BDR/BR from the schedule 7 computation. This was the only economic benefit it controlled.

(l) The CD retained a 70% interest in GDI representing its 70% contribution to the cost of the film.

1031. To the extent that it is correct (in accordance with paras 51 and 52 of FRS5) to have regard to the position of other parties in assessing the substance of the LLP's assets and liabilities: (i) the making of the CM loan made no economic difference to the CM: it lost no right to economic benefit it controlled beforehand and acquired

none (other than the 5% net of tax share of GDI in the case of the IFP and IFP2 CM); (ii) the CD was indifferent to whether it retained the income from a film as loan repayment or as income from the film (see e.g. the Tap, and the likelihood of loan repayment in Mr Sills' computations); (iii) the tight drawing of the relevant agreements shows that the Studio would never have made an unfettered multi-million pound loan to a shell company (the CM) it did not control which did not deliver to it the right to control 70% of the income from the film; (iv) the economic reality was that the CM had nothing of value to contribute to the LLP. Nothing of substance (other than the accrual to the CM of the 5% share of GDI) could happen on its signing the relevant agreements.

1032. We now turn to the 6 issues identified in section 2 of this Chapter

(1) The CM's Capital

(i) ITP

1033. To the extent that the experts relied upon the CM having incurred an obligation to contribute capital prior to the signing of the agreements, we found no warrant for that conclusion in the ITP Members' Agreement. ITP did not control any access to future economic benefit in relation to any possible future contribution by the CM. For the purpose of FRS5 it did not therefore have an asset representing unpaid capital.

1034. If by virtue of the relevant agreements the CM is to be treated as having made some form of capital contribution to ITP when the CD paid the PSC, it seems to us that for FRS5 purposes that contribution has no substance and should therefore not be reflected in ITP's accounts. That is because it reflects no liability of ITP to transfer economic benefit to the CM.

(ii) IFP2

1035. In the IFP2 Members' Agreement the CM had an obligation to make an Additional Corporate Member's Contribution (which we abbreviate to Additional Capital Contribution) if called upon to do so by the Operator. The LLP therefore had a right to future economic benefit which it controlled. That right was therefore an asset within the definition in FRS5 and would reduce when such an Additional Capital Contribution was actually made. The "other side" of the recognition of such an asset would be the recognition of Members' capital as a form of liability of the LLP.

1036. What then was the effect of a payment by the CD to the PSC? In section 3(a)(ii) and (iv) of Chapter II we addressed the effect of such a payment in relation to IFP2:

(a) Our preferred analysis was that such a payment to the PSC was not a capital contribution for the purposes of the Members' Agreement. On that basis the asset reflecting the right to Additional Capital Contribution was unaffected by the payment (as would be the amount of any recorded members' capital). It did not reduce on the making of such a payment. There would be no reduction in one asset which would require the recognition of another asset (a greater interest in the film);

(b) If our preferred analysis is wrong, such a payment by the CD to the PSC would be a Capital Contribution for the purposes of the Members' Agreement, and the making of the payment would reduce the amount of Additional Contributions which the LLP could claim, and thus reduce the asset recorded as the right to the Additional Capital Payment by the amount of the payment. But, because clause 22.2 limited the liability of the LLP in relation to the eventual repayment of contributed capital to the liability which represented amounts which had been received by the LLP in freely transferable funds (which the CD's payment to the PSC was not), the reduction in the amount of debtor for the Additional Capital Contribution brought with it a reduction in the liability representing the right of the CM in respect of capital. Thus, to the extent that an asset (the right to payment for members' capital) and a corresponding liability (members' capital) had initially been recognised in respect of the LLP's right to call for the payment up of unpaid Additional Capital Contribution, both those balances had to be reduced when the capital contribution was recognised. Therefore as a matter of bookkeeping mechanics there was not room for the recognition of another asset (a greater interest in the film) by virtue of the CD's payment.

1037. Thus in either case there was no room for the recognition of a corresponding asset in the shape of the film as a result of any recognition of capital.

(iii) Conclusion

1038. The provisions of the Members' Agreement which have the effect that the recognition of a capital contribution by the LLP gave rise neither to an obligation to pay drawings nor to any obligation to make payment on the liquidation of the LLP – so that no future obligation to transfer economic benefit arose by virtue of such recognition – were neither put to Messrs Holgate, Steadman and Cannon nor referred to by them. Implicit in their analysis (or at least that of Messrs Holgate and Steadman) was that the capital subscribed partook of the nature of a liability which was to be balanced by an asset (which was the cost of the film). In the light of the provisions of the Members' Agreements we cannot accept their evidence as to the proper treatment of any capital treated as contributed by the CM as a result of the relevant agreements; in our view GAAP did not permit the LLP to accord to such capital the nature of a liability, and there was no reason to treat the recognition of any contribution as giving rise to the recognition of an asset, being the interest in the film, of the same amount as the contribution. The accounting entries made did not represent the substance of the transactions.

(2) The Liability of the LLP to Pay, and the CM's Capital

1039. The relevant agreements were designed to achieve a single composite objective and, by para 14 FRS5 should be viewed as a whole.

1040. We have concluded that in substance and in legal form the LLP had an obligation under the PSA to pay or procure the payment of only 30. That obligation was contingent on the Lender advancing 70 to the PSC.

1041. For accounting purposes we ask what obligation the LLP had to transfer economic benefits as a result of the agreements. It was clear that as regards the 30 the LLP would be unable to avoid its obligation to make payment when the conditions were satisfied. The conditions were satisfied when the Lender made payment. Thus at that time the LLP had a liability of 30.

1042. The definition of liabilities in FRS5 Speaks of an obligation to "transfer" economic benefits. If the LLP had an obligation to procure the payment of 70 by the Lender, then it was likely that failure to do so would result in a claim to damages, which the LLP could not avoid. But we do not consider that any such obligation was incurred by the LLP. Nor were there other commercial circumstances which would compel or enable the LLP to procure such payment[29]. If it had not been made, the LLP might seek to persuade the CD to make the payment but it was inconceivable that the LLP would itself make the payment. As a result we conclude that in substance the LLP did not have a liability for accounting purposes on that basis.

1043. We asked ourselves whether there were any commercial effects which could indicate that the substance of the matter was that the LLP's liability was 100 rather than 30. In this context we considered the professed objective of the LLP to be at the heart of production. That objective it seemed to us was achieved by its participation in the making of the film (mainly before the contracts were signed). It did not seem to us that incurring a liability of 100 rather than 30 affected those objects.

1044. In this context we noted our previous conclusions in relation to (a) the shortfall mechanism in some of the transactions with Fox and (b) the participation of IFP3 together with IFP2 in *Avatar* and (c) the Avatar Hedge. These indicated that being at the heart of production did not involve incurring all the liability for a film's budget.

1045. We asked whether the LLP's rights to receipts affected the substance. If it was entitled to the receipts, which in broad terms could be said to flow from a 100 contribution, that would indicate that the substance might be a liability of 100. But our conclusion was that the LLP was never entitled to the BDR portion of the Receipts – it never had a right to control them (in the sense of para 54 FRS5) and was never affected by the uncertainties in their amount or payment – so we concluded that there was no commercial effect from this source which dictated a different substantive result.

1046. Mr Holgate (and initially Mr Steadman) regarded the recognition of the CM's capital as the starting point for the valuation of the LLP's liability.

1047. We do not, however, believe that the recognition of the CM's capital must be treated as a liability of the LLP incurred on the films. That is for three reasons: (i) the effect of any recognition of the CM's capital contribution did not give rise to a "liability" on the part of the LLP because it gave rise to no obligation to transfer economic benefit, (ii) the reasons given in relation to issue *(1)* above in relation to the

[29] Even if the CDA imposed an obligation on the CDA it had no liability for any default if the default arose from the failure of the CD to pay the PSC

mechanical accounting, and (iii) any obligation to recognise such capital was part of a composite agreement under which the LLP consented to BDR/BR being retained by the CD for the benefit of the CD and the CM agreed to reduced drawings.

1048. This analysis does not suggest that in substance the LLP became liable to transfer other economic benefits for the film, and accordingly that it had any liability of 70 in respect of the film or its delivery to the CD.

1049. Finally para 51 of FRS5 permits regard to be had to the commercial logic of the transaction for other parties to it. The CD is a party to the relevant agreements. It provides 70 (65) for the film and receives 70% (65%) of GDI. Treating its interest as merely a loan to the CM (together with a further interest in income from the film) does not adequately describe its commercial position. The CM is economically a conduit for the CD's interest in the proceeds of distribution of the film.

1050. We conclude that in commercial and economic substance the liability of the LLP in relation to the CDA and the PSA was 30.

(3) Was the Film 'Sold' to the CD: One Right or Two?: The Nature of the Asset

1051. Mr Holgate and Mr Steadman considered that the LLP should be treated as acquiring a film as stock which it held until it was transferred to the CD, when it should recognise a debtor. Mr Cannon's report was prepared on the basis that the LLPs operated a film production business, producing, completing and delivering films. He did not dissent from the approach of Mr Holgate and Mr Steadman.

1052. A contrary preference is expressed in PWC's letter. They prefer treatment under which the LLP recognises a single fixed intangible asset, namely the right against the CD to payment.

1053. Mr Holgate's rejection of the fixed intangible presentation rested on his conclusion that the film was an asset of the LLP which it held, and then transferred to the CD. We have noted that Mr Holgate's description of the transactions fails to take into account the fetters on the LLP's right in the film imposed by the licence and the agreements. It seems to us that treating an event under which there is no substantial economic change in the rights of the CD to exploit the film, and no substantial change in the rights the LLP controls to receive economic benefits from the film or otherwise as being of commercial significance does not accord with the substance of the transaction. Further the circumstances of the Avatar Hedge (Chapter IV) indicate that it was not essential to an LLP's business that a completed film should be delivered to it for onward delivery.

1054. Further the analysis treats the copyright in the film as being an asset of the LLP. FRS5 defines an asset as the right or access to future economic benefits *controlled by the entity*. But in the light of the fetters on its use of the film, it seems to us that the LLP has no right to control the benefits of the film rights (i.e. to ensure that those benefits accrue to itself and not others): although it was entitled to payments from the CD in respect of the CD's use of the film, its control was over the rights to payment against the CD, not over the film. Accordingly we view the right as against the PSC to

the film as it was being made as having no commercial substance and as not being able to give rise to economic benefit controlled by the LLP. As a result it does not fall within the definition of an asset in the standards.

1055. Moreover, the rights and obligations of the LLP under the CDA and the PSA are no different from those which would arise under a tripartite agreement incorporating the terms of those agreements. Save in relation to the fact that there is a formal assignment of the copyright to the CD and the provision of the licence, such an agreement would be similar to that in our Scenario 3. In that example all three experts agree that unless A (the LLP) has a substantial role ("altering the product, adding value, decision making") in the making of the film it should be treated as having one intangible fixed asset, namely the right against the CD. As we explain elsewhere we do not regard the LLP's role in the making of the film as substantial although we accept that prior to contract Ingenious may have had some input.

1056. The difference between our Scenario 3 and the contracts of the LLP is that the PSA and CDA provide for the accrual of the copyright in the film (or 95% of it) to the LLP and the later transfer of 100% of it to the CD (the 5% passing in much the same way as the film on Scenario 3). But in the light of our conclusions as to the commercial substance of the rights in the film held by the LLP, this cannot make any difference to the correct accounting treatment.

1057. In our view, there was in substance no sale of rights in the film by the LLP to the CD: for FRS5 purposes the LLP only ever had one asset of substance, namely its rights against the CD. That right was held "for use on a continuing basis in the …business". It was therefore not a current asset.

1058. . We conclude that intangible asset treatment is correct, and that the recognition of the film (the right against the PSC) as stock or WIP is not permitted by GAAP since it does not reflect the substance of the transactions.

1059. In their letter PWC say that the recognition of such an asset should take account of any impairment in value, or a provision should be made for an onerous contract.

1060. Mr Holgate told us that venture capital funds recognise long term impairments and in making that determination "you are given in practice a little bit of time to see how a new venture goes. You don't have any real information until some time has passed. But when you start to get some information then you will get a sense of whether there is an impairment…" On this basis it seems that it would generally be accepted that no impairment should be recognised in the first period.

1061. But Mr Cannon ventured that the impairment of such an asset would be on the same basis as the writing down of stock to the estimated expected income. If that is right then impairments in the value of that asset would be recognised as losses or expenses.

1062. If the combined agreements for a film are properly described as an onerous contract, it seems to us that the effect on the profit and loss account for period 1 will be the same as if the relevant asset were treated as stock. In either case there will be a

provision equal to the difference between the initial value (30) and estimated proceeds. On the other hand, if onerous contract treatment is not correct then we would prefer Mr Holgate's view that impairment need not be recognised in period 1. Whether or not the contracts were onerous is discussed in the next section.

(4) Accounting for the Full Cost ab Initio; Onerous Contracts

1063. The LLP's obligation to pay the PSC is to pay in accordance with the Approved Cash Flow. That phased payments over the period of making of the film. But the LLP accounted for the whole of the payments (and recognised a write down of the whole sum to NRV) from the start. Was that correct?

1064. This question arises both if we are right and the LLP's legal or commercial liability was only to pay 30, and if we are wrong and the substance of its liability was to pay or procure the payment of 100. In either case the question is whether the liability should instead have been recognised only as the payments became due under the agreed cash flow.

1065. Mr Holgate explained that an alternative to the treatment adopted by the LLPs would be that recommended by the non-mandatory Statement of Principles in relation to executory contracts. That alternative practice, he said, was also common practice for executory contracts.

1066. The Statement, in a section of a chapter concerning the elements of financial statements dealing with offsetting rights and obligations, says that where an entity enters into an agreement but no act of performance has taken place, then it does not have control of future economic benefits or obligations to transfer them, but has a net position. In such a case "the rights and obligations arising …together represent a single asset or liability". In other words the accounts should state the net position.

1067. Although Mr Holgate acknowledged that the LLPs' practice was not common practice, in his view the treatment they adopted was correct (Mr Cannon did not comment on this issue). This was for two reasons: (i) it showed a more complete picture of the LLP's liabilities, and (ii) it focussed attention in the right place: namely the asset and its writing down in accordance with SSAP9; the net approach would "wrongly focus attention on the provision [for] onerous contracts". If only 40 of 100 had been paid but a reduction in value of 75 had to be recognised, that could be done either (a) by recognising stock of 100 and writing it down to 25, or (ii) recognising stock of 40 and writing it down to nil and making a provision for an onerous contract of 35. Mr Holgate did not regard the contract as onerous, and making provision for an onerous contract did not capture commercial sense. As a result in his view the gross basis was better.

1068. FRS12 defines an onerous contract as: "a contract in which the unavoidable cost of meeting the obligations under the contract exceed the economic benefit expected to be received under it." If the expected income from a film was the NRV as calculated by Ingenious, these words would be satisfied since the costs would exceed the expected economic benefit.

1069. But Mr Holgate suggested that the contract was not onerous because it had been entered into freely, in effect he regarded an onerous contract as one which *became such* after it had been entered into. But he accepted that it was a fine point.

1070. In their letter PwC regarded the contract as onerous.

1071. On this issue we have the misfortune to differ. Mr Stafford considers that GAAP requires net presentation and that the film contracts cannot be considered as onerous. As a result he concludes that no provision should have been made. Mr Hellier considers that whichever presentation is adopted a provision is required by GAAP equal to the difference between the amount initially recognised for the asset and its NRV. In more detail our respective reasoning is as follows.

1072. Mr Stafford regards Mr Holgate's view as putting the cart before the horse: he considers that first one should ask whether the contract is onerous and then, only if it is, make a provision, rather than assuming an immediate provision is needed.

1073. It seems to Mr Stafford that the contracts entered into by the LLPs, until such time as work was done on the films, clearly constitute executory contracts according to the wording of the Statement of Principles (which in his view forms part of GAAP being "other guidance published by the UK's Financial Reporting Council"). In his view therefore, the contracts entered into by the LLPs were executory contracts and should be accounted for on the net basis until some work is performed under the contract.

1074. Further, in his view, it seems inconceivable that experienced business people such as those at Ingenious would routinely enter into contracts which were onerous *ab initio*. It is of course possible that contracts can become onerous due to circumstances arising after the contract date. It therefore seems illogical, in view of the requirement to make a provision only if the expected benefit is less than cost, to regard the contracts as onerous, particularly considering the overall professed view of profit and the concept of expected value discussed later.

1075. Mr Hellier considers that if a gross presentation is in accordance with GAAP a write down of the asset to NRV is required, and that if net presentation is required then a provision should be made of the difference between NRV and cost; and that, taking NRV to mean expected value, the effect on the profit for a year would, as Mr Holgate said in his report, be the same. He considers that if net presentation is required, the contract is onerous within the definition in the Statement and that there is nothing in the definition which prevents a contract from being onerous ab initio or because it is entered into freely. He considers that the proper question is not "would these experienced people have entered into contracts with an expected value less than cost?" but "did they enter into such contracts?": what is required is the determination of what is expected. He considers that Mr Holgate's fine point about contracts entered into freely is properly resolved by considering a contract entered into foolishly but freely, where the state of the reporting entity would not be properly reported if the effect of the foolishness were not reflected in the accounts. In relation to the assessment of the expected value (the NRV), he considers that it is possible to hope

for a profit from a portfolio of films at the same time as recognising that each individual film may not be expected to yield income exceeding its cost. (Whether or not such a hope was a view of profit may depend on the likelihood of its realisation.)

1076. Where a tribunal consisting of two members is not unanimous, regulation 8 of the First tier Tribunal and Upper Tribunal (Composition of Tribunal) Order 2008 SI 2008/2835 gives a casting vote to the presiding member. Mr Hellier exercised that vote in favour of his view (see further para [1087] below).

(5) Estimation of NRV: Virtually Certain Income

1077. The issue we address in this section is whether, by applying the virtually certain income method of estimation, the LLPs in fact pursued an accounting policy for stock and WIP different from that stated in their accounts and one which was not correct. We also address the amount of any provision which should have been made if the CDA and the PSC were together regarded as giving rise to a fixed intangible asset and an onerous contract.

1078. Mr Cannon's view was that in its recognition of possible future income in the calculation of revenues (and implicitly of the NRV of the stock or debtor), the LLP was insufficiently prudent and to that extent overstated the value of the asset.

1079. Both Mr Cannon and Mr Holgate said that an estimation technique complying with FRS18 para 51 should be used to determine net realisable value. SSAP9 Appendix 1 indicates that such estimation may be based on a formula using pre-determined criteria.

1080. Mr Holgate regarded the approach adopted as an estimation technique which complied with the requirements of GAAP.

1081. SSAP9 defines net realisable value to be determined by reference to the estimated selling price: "virtually certain" does not appear in the standard.

1082. Mr Holgate explained that the policy of writing down to virtually certain income had support in the requirements of FRS12 to recognise contingent assets only if realisation was "virtually certain". He noted that the definition of contingent asset could apply to the LLP's stock: there was a "possible" asset – the possibility that the LLP might receive income; it arose from past events; its existence (the flow of money) would be confirmed only by uncertain future events – the success of the film; and those events were not within the LLP's control. But he accepted that such assets usually arise from unexplained and unexpected circumstances, and that stock was not normally accounted for in this way. Nevertheless he regarded the "virtually certain" test as sensible because otherwise there would not be prudent income recognition. He found additional support for the policy in the requirement to deduct "foreseeable losses" in SSAP9.

1083. It seems to us that there is a difference between what is virtually certain and what may be expected, and between a loss in the value of an asset which may be foreseen and a reduction in value to what is virtually certain. In his oral evidence Mr

Holgate described the SSAP9 requirement in relation to stock thus: "you say, well, what are you likely to get from selling this. What are your likely proceeds?" Again it seems to us that there is a difference between what is likely and what is virtually certain.

1084. Though both sides agreed that long-term contract treatment was not appropriate for films, the standard talks about providing for foreseeable losses on long-term contracts. Again, this wording implies a degree of certainty regarding the losses.

1085. The first paragraph of the explanatory note to SSAP 9 explains that accounting for stock by carrying unconsumed stock forward to set against future sales is required by the matching concept, but if there is "no reasonable expectation of sufficient future revenue to cover the cost incurred" the stock should be written down. The qualifying of "expectation" by "reasonable" in that explanation emphasises to our minds that this does not require a worst-case estimation.

1086. Also, Appendix 1 of SSAP9 provides further commentary on net realisable value. Although for guidance only and not part of the standard this appendix should be given due weight. The guidance envisages that the main situations where NRV will be less than cost are where there has been an increase in costs or a fall in the selling price, physical deterioration, obsolescence, a loss-leading policy or production or purchasing errors. Clearly none of these apply to the LLPs. Apart from the last two factors, there is a clear implication that NRV would normally be affected by events in the future rather than events pertaining at the date of acquisition of the stock or date of commitment to expenditure.

1087. Moreover the standards implicitly recognise the concept of "expected value" which deals with a number of possible scenarios by adding together the various income levels multiplied by the respective likelihood that they will arise, and it seems to us that if the LLPs truly expected profits then the mathematical expected value of the outcomes would be at least 100% of cost: such an expectation would recognise the high probability of virtually certain income but also the low probability of a real winner. That would not anticipate a profit because it is the value of the asset which is being ascertained, not the future income.

1088. Mr Stafford in particular felt that it flew in the face of common sense that a loss of £80 can be generated on a cost of £100 merely by signing a piece of paper. And considered that no write-down of stock would be appropriate until such time as evidence came to light casting doubt on the likely commercial success of the film concerned. Nevertheless Mr Hellier considered that, if the experts based their conclusions on sound assumptions as to the facts and if there was no internal contradiction in their reasoning, the tribunal should accept their appreciation of what was generally accepted practice. He regarded their evidence as indicating that it was accepted practice that the net realisable value of an asset could be less than its cost immediately after its acquisition.

1089. Mr Stafford was content for Mr Hellier to exercise his casting vote (see [1074] above) in respect of both the executory/onerous contract and the NRV issues (which

Mr Hellier did) and merely wished his views to be recorded. On the basis of Mr Hellier's view that, in either making a provision for an onerous contract (the combined effect of the CDA and the PSA) or in determining NRV, it was possible that NRV would be less than cost, we came to the following conclusions about NRV:

1090. We concluded that because the experts had focussed on the film – the right as against the PSC - as the asset, they had not fully considered the principles to be applied to the valuation of the asset of substance which arises under the relevant agreements, namely the rights against the CD under the CDA.

1091. The standard requires a reasonable estimate of the realisable value of the relevant asset. Ingenious' valuation method assumes that the only way in which its rights were realisable was through the effluxion of time as income arose under the CDA. But that ignored the possibility of selling those rights to the Studio.

1092. This possibility was not canvassed with the experts but follows from the provisions so the standards, and the tenor of their evidence. As Mr Holgate said, "you say, well, what are you likely to get from selling this. What are your likely proceeds?"

1093. We accept that in the case of Independent films such a sale would not be reasonably possible. For such films there would be no obvious buyer for the LLP's asset. For such films we can see no alternative way reasonably to estimate their value other than by reference to expected income. For such films the consistent application of a policy of estimation of virtually certain appeared to be generally accepted practice despite the indications we have noted above in the standards to the contrary.

1094. But for Studio films the position was different. Fox afforded two facilities to Ingenious which are relevant in this context. First: it permitted Shortfall funding - effectively taking over what would otherwise have been liabilities of the LLP; that shows to our minds that Fox would not have ruled out of court an approach by an LLP to sell its interest in a film back to Fox. Second, it went further than that. So that for example both *Notes on a Scandal* and *A Good Year* closed in August 2005, but were the subject of an unwind letter. It seems to us that it is likely that a Studio would be a potential purchaser of the LLP's rights under the relevant agreements. .

1095. It cannot be said that a Studio would cavil at buying back all the films because the exercise required by SSAP 9 is on an asset by asset basis, and the standards indicate the same approach to an onerous contract. The only question is what would the Studio pay for the LLP's interest in a particular film. Of course one would not expect the Studio to buy the LLP's rights at the 30 put into the deal by the LLP: for a start it would not want to give Ingenious the 5 EP fee; it would also wish to retain some of the benefit of the LLP's contribution to its overheads, the contingency and the margin incorporated into the development costs charged to the PSC. It would also wish to keep obtain some further financial benefit. But, given the unwind letters, there would have been a reasonable expectation that for 30 put into the film by an LLP a Studio would pay at least 20 to buy out the LLP's rights to payment under the relevant agreements.

1096. As a result we do not consider that it would be in accordance with GAAP to make a provision for more than 33% of the carrying value of a Studio Film.

In this analysis we treat the relevant asset as the rights to payment the LLP has under the relevant agreements, not as the right against the PSC to the film. If that asset is, as we conclude above, a fixed intangible asset, then either an impairment or a provision for an onerous contract should be recognised equal to the difference between the initial carrying value and the NRV as determined above. If, contrary to our view, that asset is stock it should be recognised at such NRV.

The Calculation of NRV

1097. In Appendix 9 we explain how in practice NRV was computed and set out the conclusions we derived from that process:

(a) Minimum income or virtually certain income was understated by the effect of:

(i) the reduction of 50% applied to sales' agents low estimates;

(ii) the discount for the time value of money applied in the ITP estimates for Independent films and in the IFP2 estimates for Studio films;

(iii) the application of a ratio of P&A expenditure to net theatrical receipts exceeding 60%.

(b) Neither ITP nor IFP2 operated a policy of determining NRVs at about 20% of budget, but in practice the decisions taken by both entities were biased in favour of elements of the calculations which would deliver NRV closer to 20%.

(c) This practice resulted in the understatement of NRVs when measured against a policy of calculating NRV as minimum income or virtually certain income

(7) The Recognition of Income

1098. We have said that the agreements provide a right for the LLP to receive receipts less BDR, and that the LLP never acquired a right to payments representing BDR.

1099. Mr Steadman agreed that only value which was in the control of the LLP was relevant (see definition 3 FRS5).

1100. In our judgement the provision in the agreements that BDR be paid to the Lender means that the LLP had no right to control the benefits of that income flow. Nor was the LLP exposed to any risks associated with the benefit of BDR: variation in its amounts or the effects of non-payment had no economic effect on the LLP. Thus when the payments were made the LLP could not treat them as its assets. It could not therefore treat them as its income.

1101. Accordingly when accounting for the value of the stock or debtor the LLP was incorrect to include BDR/BR in the calculation.

8. The Operator's Fee

1102. Under the IFP2 Operator's agreement the LLP agreed to pay the Operator a one-off fee of 2.81% of the capital contributions recognised. The accounts of IFP2 for its first period showed a deduction of £44m for this fee. There was a further deduction in the following year of £3m which we understand to be calculated by reference to additional capital subscriptions in that year.

1103. The services to be provided by the Operator were not limited to those which would have been received in the first period: they included administrative and management services which could extend over the life of the LLP, or at least for the five years of operation illustrated in the Information Memorandum.

1104. Mr Holgate considered that the correct accounting treatment for this expense was not to account for it at all as an expense of the first year. He considered that it should be spread over perhaps three years but front-loaded to reflect the additional work in that period of arranging the initial slate. On the basis that the LLP would last for between three and seven years he thought the something like 50:25:25 over 3 years would be right.

1105. Mr Milne accepted this result. We find that it would have been required by GAAP.

9. Summary Conclusions

1106. The accounts of the LLPs do not comply with GAAP. The following changes are required in order to produce profits or losses computed in accordance with GAAP, and thus, subject to other required adjustments, to produce profits and losses for the purposes of income tax:

(a) whilst an LLP may be taken to have agreed to treat the CM as making a capital contribution equal to 70, the nature of that contribution cannot be shown as a liability in the LLP's accounts as it has no substance: representing no obligation of the LLP to transfer economic benefit, at the time of recognition or at any other future time;

(b) in relation to ITP no debtor should be recognised in the accounts for any liability of the CM to contribute capital; in the case of IFP2 a debtor should be recognised together with the corresponding Additional Capital Contribution before the signing of a relevant agreement. On any recognition of capital as a result of signing the agreements both the debtor and the Additional Capital Contribution should be reduced and no liability should be recognised in respect of the contribution;

(c) on signing the relevant agreements the LLP should recognise the liability of 30 (to the PSC), not 100, and a corresponding asset initially of the same amount;

(d) the LLP should not treat itself as having an asset in the form of the rights in the film. It should treat itself as acquiring under the relevant agreements only the rights to payment from the CD;

(e) cash payments made by the LLP to the PSC (as they did) should reduce the recorded liability of the LLP, but payments made by the CD to the PSC should not affect that liability;

(f) the asset acquired under the relevant agreements should be treated as a fixed intangible asset; that asset should be accounted for at cost (30) less any permanent impairment, and if necessary a provision for an onerous contract should be recognised.

(g) the LLP should recognise any receipts comprising the schedule 7 amounts as reduced by BDR/BR;

(h) in setting the NRV of its rights in relation to each film the LLP should make the adjustments set out in 6(5) and 7 above, in particular the limitation on the NRV of a Studio film to 66% of cost. If contrary to our view, the LLP should be regarded as having the film as a current asset, it should be valued at NRV so calculated. If we are right and the correct treatment is as a fixed intangible asset, then the combined effect of impairment and onerous contract provision would give rise to the same profit and loss account effect.

(i) the adjustments in respect of the deduction for the Operator's fee described above should be made.

CHAPTER XI: PARTNERSHIP

1. Introduction

1107. We raised with the parties the question of whether the nature of the arrangements in relation to a film between an LLP and a Studio was that of partnership. It is fair to say that neither of the parties warmed to the idea.

1108. In the House of Lords in *Tower McCashback* [2011] UKSC 19 Lord Walker said that:

> "The Special Commissioner reached a conclusion which had not been contended for by either side, which is an adventurous course to take in a complex tax case (see *Billingham v Cooper* [2001] EWCA Civ 1041, [2001] STC 1177, para 31).

The reference to *Billingham* was to his judgement in that case where he said:

> "But I am conscious of the dangers of judicial predilection for one's own ideas."

1109. It is thus with some diffidence that we pursue this analysis when it was suggested by neither party and fairly hotly contested by both when we suggested it, although it owes something to the submissions of both parties as to the nature of the relationship between a Studio and the LLP in relation to a film.

1110. The analysis might be said to start with Mr Gammie's submissions that the arrangements involved "a sharing of the film revenues in proportions that reflected the Studio's and the LLP's respective contributions to the Approved Film Budget". That is in effect a sharing of profit or loss once those contributions are taken into account, and the presence of the Studio indicates a view of profit. The analysis also owes something to the Appellants' submissions that the LLPs were involved in, or were "at the heart of", the production of the films.

1111. A partnership is that "relation which subsists between two persons carrying on a business with a view of profit" (section 1 Partnership Act 1890).

1112. Section 2 of that Act provides that the receipt by a person of a share of the profits of a business is *prima facie* evidence that he is a partner in the business.

1113. One view of the arrangement between an LLP and a Studio is that they agree together that a film will be made and distributed, and that they will share the income from distribution and in the cost of making and distributing the film; on this view they give effect to the arrangement by entering into the relevant agreements which: (i) provide for the film to be made by the PSC, (ii) provide for each of them to pay the PSC a portion of the 100 to make the film, (iii) allow for them both to have some say in the making of the film, and (iv) provide that the income from the film, after deducting distribution expenses, will be divided up between them.

1114. On this view the business which they carry on is the arrangement to make and exploit the film, they carry it on together because they each have a hand in the making of the film, and the profit (or loss) which they share is the distribution proceeds less the costs of the film less the costs of distribution. The sharing of the profit or loss is not by a simple ratio: the Studio, for example, gets a priority share of 15% of the income which increases its profit or reduces its loss, and the LLP's distribution corridor affects the burden of the distribution costs in the sharing of profit and loss, but nevertheless they share the overall profit or loss from the film.

1115. On this basis what is the nature of the business they carry on together? It is the speculative venture of getting a film made and exploiting it. That is fairly clearly a trade.

1116. If the film had been made by the Studio alone without the involvement of the LLP it would have paid 100% of the cost of the film and received 100% of GDI. It seems to us that such a venture by a Studio would be likely have been conducted with a view of profit: if Studios did not realistically hope to make a profit from their films there would be few left. If the effect of the arrangement with the LLP was that the Studio kept 70% of the net profit or loss and the LLP kept 30% then the consequence would be that each could be said to conduct the venture with a realistic view of profit.

1117. If it is the case that the LLP and the Studio were in partnership in relation to each film they undertook together, then through each of those partnerships the LLPs were conducting a trade with a view to profit. If the only, or substantially the only, activity of an LLP consisted of such partnerships, and its other expenses were not such as to deprive it of the prospect of an overall profit, it would be carrying on trades with a view to profit. That would answer in the affirmative the first two questions before the tribunal.

1118. That would leave the computation of the profits of the LLP. They would be determined by aggregating the share of the profits or losses of each of the partnerships. The taxable profit or loss of each separate film partnership would be computed and then attributed to the partners in the proportions they shared the profit or loss of the film partnership. In computing the profits of the partnerships GAAP would be applied but the complications occasioned could be less.

2. The Evidence

1119. There were a number of items in the evidence which tended to support the view that arranging for the making of a film and its exploitation was a business carried on in common by a Studio and the LLP which displayed some at least of the indications of partnership.

1120. Mr McKenna said:

> "They [the Studios] don't have a crystal ball either and they are expending large sums of money, which is actually why they welcome partners, because they cannot afford to finance their own films."

> "Because the Studio will have a range of projects, some of which they will do on their own, others they will involve partners in making these films."
>
> "... I could ... imagine a conversation between the senior executives of Fox ... shall we lay off some of that risk? ... shall we take a partner?"
>
> "... the fact that they [the Studios] wanted to partner meant that they were considering whether they would ever have produced the film on their own."

1121. Mr Clayton said:

> "We wanted to make sure we believed in our partners. We have found partners [distribution] who we believe in and we are backing their judgement."

1122. When asked what he meant by "partners" Mr Clayton said that he meant it in a colloquial fashion. He continued: "film making is a collaborative process and the best films emerge from teamwork".

1123. Mr Reid said:

> "When you have a film like *Avatar* ... it won't go further unless you get someone like us to partner with them."
>
> "That is one of the reasons Fox takes on partners. The use of them is to mitigate downside risk. The other [is Finance]."

1124. And in response to criticism that the CDA left the CD in control of marketing expenditure, Ingenious' witnesses pointed to the common interest of the parties in the success of the film and the maximisation of net revenue.

1125. In an e-mail Miss Rossellini of Fox said:

> "... we would prefer Ingenious to partnering with other distributors or partners."

1126. These descriptions of the relationship as being that of partnership are of course by no means conclusive that there was a partnership. But they suggest that the makers' unguarded understanding of the business relationship between the two entities was that they were working alongside each other and not in opposition and had a common goal – as partners would. There was an alignment of interest and a degree of trust.

1127. The relevant agreements also contained undertakings by the parties which were consistent with a partnership:

(a) creative control over the making of the film was to be exercised by the LLP in consultation with the Studio but subject to the strict constraints of the CDA;

(b) the CD undertakes to exploit the film on a good faith non-discriminatory basis with the intention of maximising profits from the exploitation of the film;

(c) the LLP agrees to use best efforts to provide the CD with advertising and print materials;

(d) the Studio agrees to act in good faith in calculating GDI.

1128. These factors indicate a common interest in the production and exploitation of the film and the exercise of the good faith customarily implicit in partnership dealings.

3. The Parties' Responses.

1129. HMRC make five points.

1130. First they say that the parties were not carrying on a business in common: the Studio's undertaking to pay the LLP was part of its larger business.

1131. It seems to us that the Studio undoubtedly had a large business in which it conducted activities similar to those conducted in relation to the film on which it may have "partnered" the LLP. But a builder may, as *Walker West* (see below) shows, be a partner in a business in which his activity as a partner is part of its normal business. What matters is whether there is a business carried on in common, not whether what is carried on is similar to other activities of one of the partners.

1132. Second, they say that it seems highly unlikely that the activities for which the Studio was specifically remunerated under schedule 7 – the distribution fee – should be regarded as its own business, yet the payment of a share of GDI should be regarded as part of a partnership business.

1133. It seems to us that this argument relies upon treating GDI as the income which is to be shared, rather than regarding the process as giving rise to the sharing of net revenue i.e. receipts less distribution costs less the cost of the film, and giving the CD something akin to a priority profit share equal to the distribution commission as a contribution to its costs.

1134. Third they say that the tribunal would not be justified in concluding that a party who was not before it (the CD) was in partnership with the LLP.

1135. This seems to be plainly wrong. Tax appeals are generally made by one party against the Revenue. If this argument were right the tribunal could never find there to be a partnership on an appeal unless an appeal by the other "partner" were joined (and that would be impossible if the other party did not want to appeal). Further any such decision of the tribunal on an appeal that A was in partnership with B would not be *res judicata* against B.

1136. Fourth, they say that it would be difficult to compute the taxable profits of partnership – there would be issues for example about obtaining details of expenses, and the place of trade (where the Studio was non-UK resident).

1137. It seems to us that because something is difficult that does not make it wrong. There is plenty of difficulty in the Taxes Acts.

1138. Fifth, they say that, while it is perfectly possible for a partner to be a sleeping partner, an equity investor such as the LLP does not participate in another's business simply by agreeing to invest money in it.

1139. That argument is predicated on the interest being an investment "in the other's business".

1140. The Appellants do not accept that the legal form or commercial substance of the arrangement can be characterised as a 70:30 (65:35) joint venture.

1141. First, they point to the express denial of a partnership in the CDA.

1142. However the authorities show that this is not conclusive, although it may be persuasive if the position is not clear.

1143. Second, they say that after the CDA was signed the CD could only exercise rights in relation to the film by doing so as against the LLP not by direct instruction to the PSC.

1144. The evidence was that in fact the Studios were often more aware of the activities of the PSC (often an associate of the CD) than was the LLP. Further the limitations on the LLP's right to control the creation of the film save with the advice or consent of the CD was in effect a right and obligation of the LLP to consult with the CD. It was a common activity in which the CD had the upper hand.

1145. Third, they say there is no warrant for inferring the sharing of losses.

1146. It seems to us, however, that the sharing of losses results from the terms of the agreements. The film receipts less distribution costs (as defined in the CDA) less the cost of production is the amount shared between the parties, and that sharing flows from the express terms of the relevant agreements. That is a direct consequence of those agreements if the LLP is regarded as contributing 30 and the CD 70.

1147. Fourth, they say that a 70:30 deal is not what the LLP wanted from the Commissioning Distributor Model: it wanted influence and control over the project.

1148. A partnership analysis does not deny the LLP such influence as the agreements confer upon it.

1149. Fifth, they say that 70:30 is not appropriate mathematically since it ignores the prior deduction of some expenses, and ignores the flexibility of the distribution fee.

1150. We have addressed this aspect in section 2 of Chapter II where we rejected it for the reasons given there.

1151. Sixth, they say that a 70:30 analysis is inconsistent with the accounting treatment represented by the experts.

1152. The experts were not asked to opine on the treatment of a partnership, but on the treatment of the LLPs in relation to a transaction which was not described to them as a partnership in relation to a single film.

1153. Seventh, they say that the terms of the CDA, especially schedule 7, cannot be overridden to create a 70:30 profit share.

1154. The argument for a partnership is that the way in which the common business was agreed to be conducted was that if the CD paid 70 to the PSC the LLP would pay 30, and that the income and distribution expense would be dealt with as required by schedule 7 and the Deed. This approach ignores the characterisation of the payments made by the parties. It regards one legal effect of the agreements, namely that the CM became indebted to the CD as irrelevant because it does not affect the nature of the common business of the LLP and the CM or the payments to and by them which had to be made. It regards the other possible legal effect of the agreements – the possibility that the CM subscribed capital to the CD – as also irrelevant as it did not affect what the LLP had to pay or what it was entitled to be paid. This is not rewriting the parties' agreement but recognising that certain provisions are irrelevant in this context. It does not involve re-characterising but regarding those provisions as having no consequence in relation to the question.

1155. Mr Banks drew our attention to *Walker West Developments Ltd v FJ Emmett* 1979 EGLR 118 in which the Court of Appeal had held that there was a partnership, and contrasted it with *Spree Engineering and Testing Ltd v O'Rourke Civil and Structural Engineering Co* (unreported 18 May 1999) in which the High Court had found that there was no partnership.

1156. In *Walker West*, there was an agreement, in which no mention was made of partnership, between WW and E under which land which had been sold by E to WW was to be developed. Under the agreement E, a building company, was to construct roads and services in places on the land specified by WW and to construct houses as agreed between them. WW was to pay E the prime costs of construction together with a "contribution" to E's overheads. The houses so built were then to be sold (conveyed by WW) through agents agreed by the parties, and the net profits would be divided between them equally.

1157. The only evidence of the relationship between the parties was the agreement. Everleigh LJ said that the contract revealed that there was land to be developed, houses to be built and sold and profit shared. E was to do the construction and there was consultation on the site works: WW had control of housing specification and there was consultation as regards estate agents. The project was advertised as a joint one. He regarded those provisions as pointing very strongly – conclusively – to a development business in common. The provision in relation to payment – the reimbursement of prime cost and contribution to overhead made by WW envisaged a situation in which each side was making a contribution. The profit sharing requirement of the definition of partnership was in the contract "in so many words".

1158. In *Spree*, A and B entered into a single agreement with C in relation to a gas pipeline under which A and B were jointly and severally liable for performance and owed each other a duty to perform. They also entered into a joint venture agreement under which: A was to do the electrical and B the civil construction work, the joint venture was given a name (which the judge regarded as artificial), the relationship was declared not to be a partnership, there was to be a joint committee (but the judge found that they carried on their work independently of each other), and there was a joint bank account (the judge finding that sums due for the work of each of them were paid into the account and then paid separately and in full to the one who performed the work for which the payment was made). There were some shared expenses such as secretarial costs and the cost of a performance bond.

1159. The judge regarded A and B as sharing gross returns rather than profit and not in partnership despite the acceptance of joint liability, the joint committee and the expense sharing. He regarded the venture as a non-integrated joint venture where the work of the venture was divided into segments undertaken severally by the participants and the inflowing funds divided so that the profit was taken severally by the participants.

1160. Those cases display features in common with the current appeals and highlight how fact-specific the question is. If the relationship between the Studios and the LLP were that of a non-integrated joint venture it would point away from partnership.

1161. Mr Banks argued that whilst it might be said that under the CDA there was some sharing of the proceeds of distribution less the costs of distribution, one could not ignore either the contribution by the LLP of 100% of the costs of making the films or the provision of the CDA under which the LLP became entitled to more than 30% (35%) of GDI. One could not re-write what the parties had agreed.

4. Discussion

(a) Profit Sharing

1162. We have already cited the provisions of section 2 of the Partnership Act.

1163. It does not seem to us to be a necessary condition of partnership, or for a conclusion that profits are shared or that a share of profits is received, that the arrangement expressly determines the amount of a profit or loss. An agreement under which X and Y agree to bear and pay every expense of a common business equally, and to divide the gross income between them equally is an agreement to share profits and to receive shares of profits whether or not that consequence is made express. Section 2 does not require express terms which use or define the word profit. If profit is shared that is evidence of a partnership.

1164. In *Brostoff v Clark Kenneth Leventhal (11 March 1996*) Dyson J said that it was a necessary condition of partnership that the business of the partnership – the common business – had to be carried on with a view of profit. Likewise in our judgement section 2 applies only if the profit which is shared is that of the common business of the partnership.

1165. That requires the identification of a common business. It seems to us that the only business which could be said to be carried on in common is that of arranging the production and exploitation of a film which had already been made "oven ready" (as one of Ingenious' witnesses described it) by the Studio.

1166. To our minds the costs of that business were the costs of making the film and the agreed specified costs of distributing it. The income was the amount received from its distribution. The profit was the difference.

1167. For reasons explained in Chapter II we consider that the legal effect of the agreements taken together was that the LLP did not have a right to any more than 30% of GDI. The fact that the parties chose to describe this right as a greater schedule 7 right reduced by a reduction in the right under the Deed of Acknowledgement etc. does not mean that the arrangement between them can be characterised as one under which the LLP was entitled to more than 30%, and the Studio to less than 70%. We reject Mr Banks' argument to the contrary.

1168. To our minds the cost of making the film was not only paid but, under the arrangement, also borne by the LLP and the Studio in the ratio 30:70 (35:65). Even if the arrangement between the Studio and the LLP involved the LLP recognising that the CM had subscribed capital of 70 in the LLP as a consequence of the Studio's payment of 70 to the PSC, that does not require the LLP to be treated as having paid or borne more than 30 of the joint venture's cost of the film. And the arrangement between the Studio and the LLP was that the Studio would be rewarded for that payment by a right to retain part of the proceeds of distribution.

1169. The effect of the relevant agreements was that, ignoring for simplicity the distribution corridor and taking production costs as C, distribution costs as D, and gross receipts as G:

(a) If G <= D the loss was G - D - C and would be shared:

(a) Studio 70%C + D - G

(b) LLP: 30%C

(b) If D < G <= 15%G + D < D+C, the loss would have been G - D - C and would be shared:

(a) Studio: 70%C + D - G

(b) LLP: 30%C

(c) If 15%G + D <= G but G <= D + C the loss would have been G - D - C and would be shared:

(a) Studio: 70%C - 15%G - 70%(G - D - 15%G)

(b) LLP: 30%C - 30%(G - D - 15%G)

(d) If 15%G + D <= G and G > D + C, there would be a profit which would be shared:

(a) Studio: 15%G + 70%(G - D - 15%G) - 70%C

(b) LLP: 30%(G - D - 15%G) - 30%C.

1170. The sharing was complex but nevertheless a sharing of profit and loss. This computation does not take into account the actual expenses of the Studio in distribution other than those defined in the relevant agreements. In effect the 15% is taken as a contribution to the Studio's distribution overheads (rather like the contribution in *Walker West).*

1171. The sharing of losses was said in *Walker v Hirsh* 1884 27 ChD 460 to make the presumption of partnership stronger but not conclusive. The profit sharing arrangements outlined above also give rise to the sharing of losses.

1172. In *Walker West* Everleigh LJ, citing *David v Davis* 1844 1 CH 393, said that although the sharing of profits is *prima facie* evidence of partnership and if the matter stops there that is evidence on which the court will act, if there are other circumstances to be considered they must all be considered together, not holding that a partnership is proved by such a receipt unless rebutted, but taking all the circumstances together not attaching undue weight to them but drawing an inference from the whole. We have concluded that there was the receipt of a share of profits and losses of the venture. We therefore turn to other factors.

(b) Symptoms of Partnership

1173. In *Walker West*, Everleigh LJ said that the nature of the relevant relationship had to be determined from the evidence and all the admissible surrounding circumstances. In the current appeal we have evidence of what the parties thought and did as well as the agreements. That other evidence indicates some of the symptoms of partnership: good faith and common interest. Conditions of mutual trust and understanding are symptoms of partnership *(Jesner v Jarrad Properties Ltd* 1992 BCC 807).

1174. The, albeit substantially limited, provision for consultation over the making of the film is not inconsistent with partnership, but its limitation makes it a weak indicator.

1175. The fact that the property of the business, the film rights, are owned only by the Studio when being exploited (and while in production the only right to exploit them lies with the Studio) does not point away from partnership (see *Walker West* and *Fromont v Coupland* 1824 2 Bing 170 – the stagecoach case discussed in argument with Mr Banks).

1176. The agreements display no intention that the parties act as agents of one another. Such agency is a result of partnership and not a condition for partnership. Nevertheless the absence of such an intention lightens the weight in favour of partnership.

1177. The agreements expressly provide that the relationship shall not be one of partnership. Such a provision is not conclusive, but may be of particular significance if the nature of the relationship is not clear (*Brostoff* citing *Weiner v Harris* 1910 1 KB 285, 290 292/3).

(c) A Common Business

1178. It is a necessary condition of partnership that the business be carried on in common – that is to say that there must be a single business carried on by the partners. (see *Brostoff* and *Spree)*. On the other hand it is well established that there can be a partnership with a sleeping partner who plays no part in the business (*Pooley v Driver)*.

1179. The agreements provided that the distribution and exploitation of the film was to be carried out only by the Studio. The LLP had no right to be consulted as to the manner of distribution. There was no evidence that in fact there had been consultation or participation in this process. (Although for Independent films there was some evidence that before contracts were made the LLP had some input into sales agents' activity and approved certain agents.) Thus there was no common participation in this aspect of the business. It is true that in *Walker West* the builder got on and built the houses and there was no evidence of supervision or involvement by WW in its work, and that a sleeping partner may play no part in a business, but in this case distribution was to be the exclusive province of the Studio.

1180. The agreements do not take any account of the actual overhead costs of the Studio in distribution. The 15% distribution fee is a proxy either for them or for them and as some form of priority profit share. That emphasises that the distribution remains under the control of the Studio and that it may be regarded as not being part of the common business.

1181. It does not seem to us that the common business could be taken to be just the making of the film, for there would be none of the money-making exploitation which is characteristic of a business.

1182. If A can make widgets but does not know how to sell them, and B can sell them but cannot make them, then an agreement that A makes and B sells and neither trespasses on the other's activity may be the carrying on of a business in common, particularly where there is some right of consultation. The absence of any involvement of the LLP in the distribution tells strongly against the business being one conducted in common, and, given our diffidence in this matter, we conclude that the business was not so conducted.

5. Conclusion

1183. We therefore conclude that the Studios and the LLPs were not in partnership in relation to each film.

CHAPTER XII: INGENIOUS GAMES: Differences and similarities

1. Background

1184. The following is drawn from the evidence of Mr Scheurer and Mr Divnich.

1185. Electronic, or video, games are played on mobile phones and other mobile devices, on PCs and on consoles. A console is a game-playing device attached to a television: PlayStation (made by Sony), Xbox (made by Microsoft) and Wii and GameCube (made by Nintendo) are examples of consoles.

1186. In 2006 most games were bought on a CD or equivalent device from a retail shop. These CDs were made, distributed and marketed by a "publisher" which would control the rights to the property in the game.

1187. The publisher would normally either develop programming for the game in-house or commission its development by an independent programme developer. Where the software was written by a developer the publisher would commonly pay the developer a fee equal to its costs (plus perhaps a small margin) together with a royalty if the game were successful. Where royalties were paid the initial fee was often treated as an advance payment to be recouped before royalties started flowing.

1188. A game could take a couple of years to develop and once in the shops about 50% of the total sales income would be generated in the first few weeks of sales, and very little more than two years thereafter. Therefore initial performance was crucial. Marketing expenditure was thus large and could often be of a similar size to development costs. There was a high degree of correlation between marketing spend and sales income.

1189. Some games permitted the publisher to develop a series of games in a "franchise". The owner of the rights in the series could bring new games in the series to market at intervals, capitalising on the popularity of the franchise.

1190. The makers of consoles periodically brought out new versions of their consoles. In November 2005 the seventh generation of consoles began with the release of the Xbox 360; PlayStation 3 was released in the US in November 2006 and in March 2007 in the EU and Australasia. The release of new consoles presented opportunities for new games and pitfalls for those whose programming did not suit the new platforms.

1191. There are various genres of video games. These include simulation racing games with varying degrees of realism, and "shooters" whose name speaks for itself.

2. The Structure and Activities of IG

1192. The legal structures and activities of IG shared much in common with those of IFP2:

(a) the Members' Agreement was in substantially the same form and contained the same profits, drawings and capital clauses;

(b) each raised funds from individual members in 2005/6;

(c) in each case the individual members' subscriptions were financed in part from their own resources, and in part by Tranche A and Tranche B loans from Ingenious entities;

(d) each had a CM (which was a member of the Ingenious group) which entered into loan agreements with the games' publishers (the equivalents of the film Studios) under which the CM's indebtedness was repayable only from BDR (unless it chose to repay earlier);

(e) each was managed by an Operator, an Ingenious company, in return for a fee of 2.81% of the capital raised from all members;

(f) each was marketed to prospective investors on the back of an Information Memorandum which set out illustrations of profit and loss over a five-year period;

(g) the activities were accounted for in the same way – treating the game while in development as stock and writing it down to virtually certain income in the first relevant period.

1193. IG's involvement in games was documented by agreements which paralleled those entered into in relation to films by IFP2:

(a) the PSA had its parallel in a Development Services Agreement (a "DSA") under which a development services company (the "DSC") undertook to develop the game in accordance with an agreed specification and IG agreed to pay an agreed budgeted price so long as the publisher made its loan agreement advance to the DSC of 70%;

(b) the CDA had its parallel in a Commissioning and Publication Agreement (a "CPA") under which the LLP agreed to transfer the rights in the game (made according to the same specification as in the DSA) to the publisher, and the publisher undertook to make payments under a schedule 7 waterfall (with a distribution costs corridor) similar to that in a CDA; distribution and marketing costs were the parallel with the film agreements' P&A costs, and likewise were in the sole control of the publisher;

(c) under an Assignment and Irrevocable Payment Instruction and a Deed of Acknowledgement and Confirmation the LLP, the publisher, and DSC and the Operator agreed, in terms identical to those in the IFP2 Deed of Acknowledgement etc., that the publisher's payments under the loan agreement would be made directly to the DSC, and an amount equal to the BDR would be retained by the publisher rather than being paid to the LLP;

(d) an Ingenious entity was appointed Independent Producer on terms which paralleled the Executive Producer Agreements;

(e) there was a security charge under which the CM charged its interest in the LLP in favour of the publisher;

(f) there were licences of the publisher's existing rights in the relevant game to the LLP for the purposes of developing the game (and on-license to the DSC); and

(g) in at least one case Shortfall provisions were included in the arrangements with similar effect to those used by IFP2.

1194. Differences included that there was no equivalent of the Laboratory agreement under which the film master negative was held by the laboratory for the benefit of the CD, and, at least in the case of *Colin McRae*, that there was a deed under which the LLP and the Operator agreed that the provisions of the Members' Agreement would have an effect so that the CM's share of drawings was fixed at 50% until the indebtedness under the loan agreement had been paid off.

1195. Under clause 4.3 of the CPA creative control over the game was to be exercised by the LLP in consultation with the publisher, but all decisions had to be consistent with the specification, and the clause set out the responsibilities of the publisher for, *inter alia*, the supervising programmer. Clause 4.1 required the LLP to comply with directions and requests from the publisher relating to the game under the agreement, clause 3.7 prevented the LLP terminating the DSA without the publisher's consent, and clause 10 gave the publisher a right to require amendments to the final game. Generally little discretion was left to the LLP.

1196. As with the film agreements, the LLP was absolved from any liability for defaults under the CPA if the default arose as a result of a default by the DSC. As with the film LLPs the DSCs appeared to be subsidiaries or associates of the publisher.

1197. IG was incorporated on 8 July 2005. It made up its first accounts to 5 April 2006. By then the 77 individual members had subscribed and IG recorded the total of members' capital (including the CM's capital) as £53,374,000.

1198. The game contracts made by IG and their subsequent history are summarised in the following table. The four contracted in 2006/7 were all console games.

2005/6	2006/7	2007/8	2008/9	2009/10
Colin McRae: DiRt----------	-------→--------	--Released-----	-------→	
Hei$t----------	--------→-------	-----→----------	--Abandoned	
Urban Chaos--	------→---------	---Abandoned		
Highlander---	-----→---------	---Abandoned		
		Fuel----------	----→----------	Released--→
		Five 0----------	------→--------	--Abandoned

		Crash Club----	-----→---------	--Abandoned

1199. It can be seen from the table that only two of the games for which IG contracted between 2006 and 2009 were finished and distributed.

1200. In 2000/11 IG contracted for five games on hand-held platforms with smaller budgets (less than 10% of those earlier games).

1201. We discuss the nature of the activities of Ingenious personnel in relation to the games under section 3 – Trading below.

Performance

1202. Mr Forster's exhibits show that, on the Ingenious basis, by the end of 2012/13 £26m had been expended on non-abandoned games and £9m of income had been received giving rise to a loss of £17m on games development; projected income (the equivalent of a lifetime Ultimate film income) was comparatively negligibly different (because of the absence of a tail in the receipt of games' income) so that the Ultimate loss for IG is of the same size (£17m). Mr Forster explained that in part losses were due to difficulties in obtaining of payments from financially embarrassed publishers, but had those problems not arisen there would still have been losses.

3. Trading

1203. Mr Reid told us that in late 2005 the process of finding games for IG started with an approach to Sony made by an Ingenious employee, Patrick Bradley. Between November 2005 and January 2006 there was a telephone call and an exchange of short e-mails between Mr Bradley and Sony, one of which attached an outline paper on the proposal, and then some further telephone calls. In the end nothing came of this approach.

1204. Also in December 2005 Mr Reid met the managing director of Eidos Interactive Ltd. On 13 January 2006 Mr Reid e-mailed Rob Murphy at Eidos reminding him of their earlier meeting and IG's "ability to bring 30% finance to your games". Mr Murphy replied suggesting a meeting on 30 January, but after a few more exchanges a meeting was fixed for 8 February (which Mr Reid wrote left IG with "less time than is ideal to complete the deal". On 7 February Mr Murphy e-mailed Anthony Price (whom we assume to be a colleague):

> "We have a meeting with Ingenious tomorrow. They want to fund a game. We are considering Chaos for this."

1205. It seems that discussion of transaction documents began in February 2006. By March 2006 it had been agreed that IG would contract with Eidos for *Urban Chaos 2* (part of a franchise) and *Highlander* (a game which related to a film and TV programmes) both of which were being developed by Eidos.

1206. Negotiations with Codemasters Software Co Ltd ("CSC") took place in the first quarter of 2006. Negotiations moved fairly fast and it seems that documentation was settled over the final couple of weeks of March 2006 for contracts for *DiRT* and *Hei$t*. It appears that *Hei$t* was a late replacement for *The Fixer*.

1207. Like IFP2, IG had an Executive Committee whose approval was required for games' contracts. The committee met for the first time on 30 March 2006. It comprised:

(a) Kevin Meade and Duncan Reid from Ingenious,

(b) Andrew Pisher, a hedge fund manager,

(c) Michael Thomas, a lawyer with games experience and

(d) David Austin.

1208. The day before the meeting a list of four games (comprising the name of the game, the publisher, and the budget) had been sent to the participants, possibly together with an Ingenious standard form request for approval and financial illustrations for *DiRT*. The list of games on that list included *The Fixer* but not *Hei$t*.

1209. The draft minutes of that meeting show that it approved *Urban Chaos*, *Highlander*, *Colin McRae DiRT*, and *Hei$t* (the last minute replacement for *The Fixer*), and that there was some discussion of the terms of the deals – about completion bonding, copyright ownership and financial arrangements. The minutes note that Mr Reid:

> "explained that typically Eidos'and Codemaster's own internal greenlighting of projects of this scale was based on minimum estimates of 1 million games sold. It would take approximately 2 million sales for the partnership to make a profit on each game. Notwithstanding that, it was noted that even at a level of 1 million sales, investors would receive sizeable distributions from the partnership".

We refer to this later in relation to the question of whether IG had a view to profit.

1210. Thus by 5 April 2006 IG had contracted for two games with each of Eidos and CSC.

1211. All this activity took place after IG had been incorporated, and the actions of those conducting the negotiations can be taken as the actions of the Operator, and in turn, as the actions of IG.

1212. This activity in March and the first days of April had a parallel with that which ITP and IFP2 conducted in relation to negotiations for Studio films: although there were a number of complex documents adapted from the IFP2 structure IG had no significant involvement in putting together a package for a film or a game, and there was no indication that it had any input into the framework or specifications for the

making of the game. IG was effectively inserted into a process which was already going on.

1213. After signing contracts for the first four games just before 5 April 2006 Mr Reid discussed with an independent games consultant the possibility of a technical check on the two CSC games and then monthly monitoring of progress. It seems, however, that this came to naught, and instead Ingenious employed a video games specialist, Richard Williamson. Mr Reid said that Mr Williamson played a role similar to that performed by Paula Jalfon in respect of films.

1214. We saw some evidence of his activity: receiving a game's code, seeking documents to "fill out" Ingenious' records from April 2006 to March 2007 and reporting on issues which arose in relation to *Colin McRae* and *Highlander* during 2006 and 2007. We saw minutes of a meeting in November 2006 attended by Mr Williamson, Eidos, Film Finance and Rocksteady in relation to *Urban Chaos*. Rocksteady had the employees who were writing the game code. There was little evident input recorded from Mr Williamson save as regards Ingenious' name appearing on the credits; the main discussion of the progress of the game appears to have been between Rocksteady and Eidos.

1215. Whereas Paula Jalfon had been involved, particularly for Independent films, before contracts were signed and afterwards in giving approvals, as well as in activities which were more like monitoring and filling out files, there was no evidence that Mr Williamson had played those other roles.

1216. Mr Williamson was made redundant in April 2007 following the changes to the tax loss regime. Mr Reid said that the main reason for Mr Williamson's departure was the rather unpleasant experience Ingenious had had with its venture into games and the resultant decision not to continue in that field. We doubted that answer because: (i) the earlier games were not abandoned until 2007 and the difficulties with CSC arose in 2009/10, and (ii) an email sent by Mr Williamson indicated that the 2007 changes were the trigger for his departure.

1217. It appeared that Mr Williamson's duties were taken over by Mr Bower (whose great interest was in film), Dylan Jones and Sam Sniderman. E-mails from Mr Bower in 2008 in 2009 show him discussing the timing of funding payments and seeking information from Codemasters about milestones and delivery dates. E-mails from Mr Jones show him seeking information about the progress of *Crash Club* and *Five O*.

1218. *Colin McRae DiRT* was released on Xbox 360 in June 2007 and, on PlayStation3 in September 2007. On the day after its PlayStation 3 release the racing driver Colin McRae, after whom the game was entitled, died in a helicopter crash. CSC withdrew their advertising campaign to preserve its relationship with the McRae family and to preserve its ability to release future iterations under this franchise. IG was powerless to prevent this. In Mr Reid's estimation, which we find wholly reasonable, this had a significant depressing effect on the game's financial performance. It also illustrated the differing interests of IG and CSC in the game.

1219. During 2007 problems arose with the Eidos games, *Urban Chaos* and *Highlander*. Eidos decided to abandon them on 4 April 2008, and, under the CPA, IG was repaid the funding it had advanced. That funding was used by IG for contracts with CSC for *Fuel*, *Five 0* and *Crash Club* which were signed by 5 April 2008. *Fuel* was released in summer 2009.

1220. In 2009/10 problems arose with CSC (there had been some earlier intimation of financial difficulties in 2007 reported by Richard Williamson). CSC fell behind in making payments in respect of *DiRT* and *Fuel*.

1221. There followed some difficult decision-making and negotiations with CSC which resulted in an agreement of 3 August 2010 between IG and CSC under which *Five 0*, *Crash Club*, and *Hei$t* were abandoned and arrangements made for payments to IG.

1222. In general film contracts entered into by ITP and IFP2 were signed before principal photography began. By contrast the development of the games entered into by IG in the case of three of the first year's four games had already begun when contracts were signed.

1223. In the case of *Colin McRae DiRT* we heard that CSC had been developing the game for some 12 months before contracts were signed. On the making of the contracts Codemasters Ltd (the DSC, which we understood to be a subsidiary of or associated with CSC) undertook to do the development work. Mr Reid said that CSC transferred the benefit of the work it had done up to that time to Codemasters in return for a payment made by Codemasters Limited to CSC.[30]

Conclusions – Trading

1224. Overall the activity of IG in seeking and contracting for the four games it participated in in 2005/6 appears to us to share many of the characteristics of the Studio films rather than the Independent films part of IFP2's business. (Indeed Mr Reid described the games as the equivalent of Studio films). In the case of IG there was no evidence of creative input, evaluation of the merits of potential games (save the last minute replacement of *The Fixer* by *Hei$t*), no pulling together a financial package, but instead the insertion of IG into an existing project. Further, whereas in the film LLPs, the LLPs stepped in generally before filming began, IG could step in after development had started and a publisher had already committed funds to the development of the game. There was none of the more complex involvement which ITP and IFP2 had with Independent films.

[30] It appeared likely that employees of CSC had not been seconded to Codemasters. If that was the case then the copyright in the game accruing as a result of their work became the property of CSC, not Codemasters. That would have meant that Codemasters had no new intellectual property to transfer to IG, and IG had none to transfer to CSC. Thus even formally IG could not be said to sell something to CSC. That would be an important consideration if whether or not IG was trading depended on whether formally it could be said to have made a sale, but in our view the question of trade is one of commercial substance, not formality, and whether or not IG was trading is unaffected by this.

1225. Even if the approaches to Sony, Eidos and Codemasters are regarded as having been made by Ingenious personnel as agents of IG, they appeared to us to be more of a search for an investment. In section 4 (ix) below we quote an e-mail from Patrick Bradley of Ingenious which conveys that flavour.

1226. Later in this Chapter we describe the research undertaken by Ingenious in the preparation for the launch of IG. Our impression was that it lacked depth: there appeared to have been less of the detailed garnering of market information and planning for profit which are indicative of a serious approach to a commercial undertaking.

1227. There was less depth and grit in IG's involvement in games than there was in the involvement of IFP2 in films (particularly Independent films). The games documents were complex but they were apparently agreed fairly speedily following the format of the film agreements. There were difficulties on the way but they did not appear to have had the same density as those for many of the films. There was much less evidence of work done on what might be called the product (the provision of finance) by Ingenious personnel. In Appendix 8 we note Mr Scheurer's evidence of provisions which it was normal to find in games development contracts which were absent from those in the IG contracts; their absence suggested to us a less commercial approach to the detail of the agreements.

1228. The composition of the Executive Committee and its recorded deliberations were financial in nature. IG's activity in relation to the games appeared to be mainly that of a financier. We accept that an entity may engage in a financial trade, but we would normally expect such a trade to involve more than a few transactions.

1229. Also the after-care of the games appears to have required, and been given, less attention than that of the films. Mr Williamson clearly did some work but there was no evidence of the modest giving of approvals for changes and the regular chasing for information which Paula Jalfon conducted for films. There was no evidence of interaction between Mr Williamson and the publishers which indicated any participation in the progress of making the game.

1230. Mr Reid said that the structure of the contracts enabled IG to be at the heart of games development – not carrying on the day to day work, but having involvement in the development of the game so that if it did go wrong, it would be in a better position than a mere investor. It was apparent from the *Urban Chaos* minutes that Mr Williamson was able to monitor the progress of the games. But the nature and scope of the LLPs' involvement in the monitoring of films was greater and grittier than that of IG.

1231. There must have been serious negotiations surrounding the abandonments of games in 2008 and the problems with CSC in 2009/10, but these appeared to us to be the kind of restructuring that might happen when an investment went wrong and did not indicate that earlier activity had a trading flavour.

1232. The difference between IG on the one hand and ITP and IFP2 on the other seemed to us to have some similarity with the difference between a person placing a bet and a bookmaker, or between an individual making a loan and a bank. Both deal in money and take risks, but the bookmaker and the bank undertake more transactions and have an organisation devoted to setting terms (or odds) and appraising the market and its risks and rewards. IG's activity had more in common with that of Mr Degorce.

1233. The activity of IG involved some organisation, some modest repetition and was speculative in nature, but overall and on balance it seems to us to have been more the acquisition of a few financial assets dressed in a complex contractual framework than the conduct of trade.

4. With a View to Profit

1234. We address the evidence on this issue under the same headings as Chapter VII.

(i) Actual and Projected Results

1235. At 5 April 2014 IG had made a loss on games of £17 million on the Ingenious basis. Its projected lifetime loss on games was about the same.

1236. We note that *DiRT*'s contribution to IG's results was hampered by the death of Colin McCrae and that despite his death it seems to have sold over 1m units. (But as we note below it would have to have performed at a truly exceptional level to make up for the other losses.)

(ii) Market Information

1237. Ingenious had access to material of a general nature and about economics of the games market. It is reflected in the Information Memorandum's statement that "now [2006] is a good time to invest" in games. That material may have pointed towards the growth and buoyancy of that market, but the Appellants did not suggest that it contributed to any quantitative estimate of possible profits or losses if IG contracted for games under the commissioning distributor model.

1238. Mr Divnich told us, and we accept, that, like film, gaming is a hit-driven industry in which it is difficult to forecast success. Despite a somewhat more gloomy picture recorded by Mr Crossley in a note of a conversation with Lionhead which indicated that only a small number of games recoup costs, we accept Mr Divnich's expert evidence that only 20% of games launched on PlayStation and Xbox achieved considerable profitability (a return of 150% of cash laid out or more), that 20% were considerably unprofitable, and that the remaining 60% were close to break-even (receipts = expenditure), and that this would have been common knowledge in the industry at the relevant time.

1239. That division of performance, however, is by reference to total receipts; the position of IG, like that of IFP2, was that, on the Ingenious accounting basis, it laid out 100% of the cost and received at the most 54.45% of the available income. If Mr Divnich's metric of success were applied to IG's position the hits would be fewer than

20%, and the misses greater than 20%. And for IG to be profitable the hits would have to pay for the misses.

1240. That effect was well illustrated in the passage from the minutes of the first Executive Committee meeting quoted above where it was noted that for the publisher to break even 1 million units sold were required, but that for IG to break even 2 million units needed to be sold.

(iii) The CD Model

1241. The conclusions we reach in section 3 of Chapter VIII in relation to the CD model are equally applicable to IG. It did not provide substantial support for the contention that IG's business was conducted with a view to profit.

(iv) Green-lighting

1242. We note that the minutes of the first Executive Committee meeting do not expressly address the question of profit or profitability. The summary of their decision records that the first four deals "appeared to be well structured and that the strength of the publishers gave some comfort". Not a conclusion indicating any expectation of profit.

1243. The more detailed account of the discussion of the four games makes note of the successful and established nature of Eidos, the fact that *Highlander* was based on the film and a TV series and that *Urban Chaos* was the latest in a franchise: all indicators of potential market success, but there is no express recorded consideration of whether that success would result in a profit for IG. The only comment in relation to profitability was that cited above in which it was acknowledged that 2 million unit sales would be needed for profit whereas the publishers would base their estimates on 1 million (that being an effect of the structure of the waterfall and the Ingenious basis of accounting).

1244. Whilst a clumsily-inserted self-serving reference in those minutes to having a view to profit would not have evidenced such an intention, the lack of any reference to results other than that in the quoted passage does not support a contention that the members were green-lighting a portfolio of games which they thought had a realistic possibility of delivering a profit for IG on the Ingenious basis.

1245. It does not seem to us that the activity of the Executive Committee evidences that IG had an expectation or hope of making a profit on the Ingenious basis; indeed the recorded comment in the section of this Chapter on Trading that, even at a level of sales which would not result in a profit for IG, the investors would receive handsome distributions indicates an interest and desire for revenue as opposed to an interest in profit for IG.

(v) The Evidence of the Controlling Minds of the LLPs

1246. In Chapter VIII we have recounted this evidence chiefly by reference to films. However, save where that evidence was specific to films, in our view it represented

the mind-set of Messrs Reid and McKenna (and to any relevant extent Mr Clayton) in relation to games and IG.

(vi) The IG Information Memorandum

1247. The Information memorandum contained a fairly detailed introduction to the games industry together with a financial illustration.

1248. From Mr Reid's evidence we find that the illustrated profit and loss account in the Information Memorandum for IG was prepared in a similar way to that in which the IFP2 Information Memorandum was prepared. After a period considering the variable elements and the profits or losses to which they might give rise, a modest 5% profit was selected for a five-year period and the required sales results estimated on the basis of the intermediate variables.

1249. The spreadsheet calculations behind the Information Memorandum illustration assumed:

(a) five games with retail sales varying between 40% and 600% of game budget with a weighted average of 431%. Whereas the illustrated profit was dependent upon the achievement of the weighted average sales performance ratio, it was not dependent upon the ratios for the five games whose results were illustrated so long as their weighted average performance was at 431%;

(b) retailer/local taxes at 25% of retail sales;

(c) distribution costs of 3% of after-tax retail sales;

(d) a distribution fee (which would, under schedule 7 of the CPA waterfall be retained by the publisher) of 10%;

(e) marketing costs of 75% of game budget; and

(f) royalties costs of 20% of the excess of distributable income (sales less taxes, distribution costs and distribution fee) over the game budget.

1250. On this basis the model illustrated the level of retail sales required to produce the selected modest 5% profit on games activity.

1251. IG did not engage an expert in games (such as Mr Divnich) to assist in determining whether it could be profitable. Mr Reid referred to two sources for the ratios described above. The first was data acquired from a report Ingenious purchased for a few £k from Screen Digest, a games industry analyst. The second was data obtained by Nick Crossley in a telephone call with Philip from Lionhead Studios, a games development company in which the Ingenious group had previously made an investment. Mr Reid also referred to other general information about the games industry considered by Ingenious but did not indicate that any of it had been used to obtain figures for the assumptions lying behind, or benchmarking, the illustrative profit and loss account.

1252. We now consider each of those ratios:

(a) Retail Sales.

Mr Reid explained that figures from the Screen Digest report were used to benchmark the level of sales (the ratio of sales revenue to development cost) required to achieve the selected modest profit. The model showed that for a profit on the basis of the other assumed ratios, sales of about 4.3 x games cost were required.

The Screen Digest report, "Games Software Publishing: the Strategies for market success", contained a table analysing gross margin according to the platforms on which games had been released in 2004. This was the data relied upon for benchmarking. The table compared the compared release on single platforms (e.g. just GameCube) and multiple platforms (e.g. GameCube + PlayStation 2), and thus related only to console games.

The title of the Screen Digest table is "Gross margin analysis for different platform launch strategies (US Data)". That initially suggests that it relates only to US sales and costs[31] or that the data was from the US market only. But an entry in the table records the "Average *global* [sales] volume per title". That suggests that the sales data (and for consistency the cost data) refers to countries other than the US. In the text of the report (at page 21) it indicates that the table has been prepared to investigate the relationship between platforms on which a game is released and profitability "using 2004 sales data in the US and Europe … limited to the 3 main consoles … estimate[ing] likely average gross margins for titles within each of these categories." Taking all this together, it seems to us that the table is not limited to US revenue and costs although the data may be based on reports from US and European manufacturers only.

The following table contains extracts from the published table together, in italics, with our calculation of the ratio of retail sales volume to game cost. The bold column is that relied upon by Mr Reid:

	GC + PS2	GC + Xbox	**PS2 + Xbox**	GC + PS2 + Xbox
No of titles released	15	2	**67**	47
Average global sales volume per title: k units	283	107	**706**	1,693
Retail revenue $k	8	2	**25**	71

[31] HMRC suggest this in their Evidence Note and in the Appellant's Note of the May Evidence a similar point is made. Mr Reid suggested that it would mean that the sales figures were very conservative, perhaps being understated by a factor of 2. For the reasons above we reject that suggestion.

Wholesale revenue $k	4.7	1	**14.5**	41.3
Development cost $k	4	4	**4**	5
Gross Margin $m	-2	-4	**+3.5**	+5
Sales as % of cost	*200*	*200*	***625***	*1420*

Mr Reid relied upon the PS2 + Xbox multiple of 6.25 as a benchmark for the average ratio of 4.3 used in the Information Memorandum illustration. It showed, he said that the illustrated 4.3 multiple was conservative (and thus that the illustrated sales were achievable).

He accepted, however, that there was a "disconnect" between the make-up of the games in the Screen Digest report (which were all console games) and the games in which the Information Memorandum suggested that IG would invest, namely "a balanced portfolio of games in terms of budget, publishing partners, genre and platform". As we understood his evidence it was that the Screen Digest data, although it related only to 2004, related only to information from US and European manufacturers, and only to consoles, was the best independent information IG could get for the relevant ratios for a portfolio of games on different platforms, and that it was in fact likely that IG would focus on PlayStation and Xbox games. He accepted that (as the Information Memorandum indicated) had games been released on PC or other platforms as well there would have been further or different costs and different income.

The Screen Digest report's conclusion on the results in its table is that whatever the precise reason for the differences in game gross margin between different combinations of platforms "publishers should focus on their most promising titles and launch them across as many platforms as possible". The table and this analysis highlight the variation in outcome with the platform. The adoption of 6.25 as a benchmark would be defensible if there were a strategy of contracting for games to be launched on PS2 and Xbox: for it may show that that ratio is achievable on those platforms. But there was no evidence of an intention to adopt that strategy, and thus little support in this that achieving profit on that benchmark was IG's view.

HMRC criticised the reliance on the 6.25 ratio in the Screen Digest material because it related to a year in which *Grand Theft Auto* had been released. That game had achieved sales in excess of 10 x budget and would have distorted the average for the year. However, when broad-brush adjustments are made to the Screen Digest figures to remove the *Grand Theft Auto* sales, the ratio appears to reduce to about 5, leaving a modest margin over the 4.3 ratio used by IG.

HMRC also criticised IG's apparent failure to take into account the sales volume data received from Lionhead in benchmarking the ratio of sales to cost. The extract above from Screen Digest's table shows averages of the numbers of units sold globally of between 107k and 1,693k, depending on the platform on which the game is released, with PS2 + Xbox releases at 706k. In contrast, Lionhead's data indicated average Xbox sales of 70k to 100k units.

On the basis of the Lionhead volumes HMRC say that for an Xbox-only release the ratio of sales to cost would have been no more than 1.5, not 6.2. That calculation assumes a release only on Xbox and compares with a ratio in Screen Digest's table for Xbox-only releases of 5.5 (with global volume for games released only on Xbox of 248k units). Mr Reid accepted that whilst IG had used Lionhead's information on costs, it had relied upon Screen Digest's (more optimistic) data for income.

Although Screen Digest may have had a greater access to the results of the whole of the games market than Lionhead, it seems to us that the Lionhead information casts some doubt on the Screen Digest ratios. Overall it seems to us that only a little comfort can, or could in 2004, have been drawn from the Screen Digest figures in relation to the realism or otherwise of the 4.3 ratio: at best they show that hoping to achieve a ratio of more than 4.3 if a particular strategy were to have been adopted may not have been a flight of fancy.

(b) The Retailer/Local Taxes Ratios

As we have recounted, the model behind the IM illustration used 25% as the ratio of retailer taxes to retail sales.

Mr Crossley's manuscript note of his conversation with Lionhead included the phrases "retailer taxes" and "25% retailer" fairly close to one another, but also indicated that if the retailer sold for 49 the wholesaler would receive 33–35 which, Mr Reid agreed, indicated retailer/local taxes of 29–33% of retail sales. Further the Screen Digest figures in the table above, show that the wholesale revenue for all multiple platform console releases is about 58% of retail revenues: that suggests a deduction of 42%. But if distribution costs were part of that reduction, and are taken at 3% as estimated in the spreadsheet, the retailer/local taxes costs would have been 39%.

Amending the assumption that retailer taxes would be 25% and increasing it to 29% turns a modest illustrated profit of 5% into a modest loss of 2%.

This not only casts some doubt on the chance of achieving the illustrated profit but shows that a modest profit can easily be affected by small variations in assumed parameters. A strategy for a small profit might well deliver a small loss. It becomes less clear that the business is conducted to achieve a profit.

(c) The Distribution Costs

Distribution costs were taken as 3% of after tax sales.

Mr Crossley's manuscript note contains a phrase "distribution is not sig. cost" but also makes reference to the £5 per unit charged by Microsoft. He also records that manufacturing, sale, freight returns and replacement costs were about $1 per unit against a wholesale price per unit of $33–35: a cost ratio of 3%. We were not offered any other evidence supporting IG's selection of this ratio. It seems to us that the evidence offered was thin.

(d) The Distribution Fee

In the underlying spreadsheet the distribution fee is assumed to be 10%. In films the best Ingenious had achieved was 15%. If the distribution fee in the IG's spreadsheet is amended to 15% the 5% profit becomes a 3% loss.

This again to our minds illustrates the sensitivity of the results when only a modest profit is illustrated and indicates that the chance of achieving a profit on the Ingenious basis was smaller than the illustration at first suggests.

(e) Marketing

The illustration was based on the assumption that marketing costs were 75% of the cost of the game. Mr Reid said that this ratio appeared to have come from Mr Crossley's note in which he records that marketing costs for the game *Fable* were 71% of the cost of the game.

It seems to us that this one example was thin support for the assumed ratio.

(f) Royalties

Royalties were assumed as 20% of the excess of distributable income over game budget. Mr Jones suggested that by applying 20% to the excess only, royalties were underestimated; but given our finding in section 1 above that the game cost was treated as an advance payment of the royalty, we accept that it was a conservative estimate. And to the extent that it failed to recognise royalties paid to others, such as a car manufacturer, the conservatism of the calculation in relation to the latter was likely to compensate for the absence of the latter.

The Information Memorandum – Conclusion

1253. It does not seem to us that the illustration in the Information Memorandum provides much comfort that IG had any realistic expectation or hope of making a profit on the Ingenious basis on games development, or that the illustrated profit indicated that the illustrated result was realistic.

(viii) Expert Evidence

1254. We heard expert evidence from Mr Divnich and Mr Sheurer. We set out the detail of our consideration of their evidence in Appendix 8. In summary our conclusions were these:

(a) *DiRT* and *Urban Chaos* would have had to have sold about 2m units each for IG to break even on them on the Ingenious basis, but only about 1m units if profit was calculated on a 30:30 basis.

(b) It would not have been a flight of fancy to hope that one of the games would sell 2m units, but it would have been an unlikely result. It was unrealistic to hope that more than one of four games would so perform.

(c) For the profit on one game to make up for the expected losses on the others it would have to sell more than 2m units. That was really unlikely.

(d) It was not unrealistic to hope for sales of more than 1m units on these games. On the 30:30 basis the games would have been profitable at that level. It seemed possible but unlikely that more than one game could perform at that level, and not unreasonable to hope that one game's sales might so exceed 1m that it made up for the losses on the other games.

(e) There were elements in ordinary publishing and development contracts which provided benefits and protection for the developer which were not present in all the games contracts.

(ix) A 30:30 Basis

1255. In section 12 of Chapter VIII we recounted examples of the evidence which indicated that Ingenious personnel (and those who dealt with Ingenious) knew that the commercial and economic effect of the agreements was a 30:30 model and that their common sense view must have been that profit or loss would arise on that basis. The material provisions of the IG agreements were the same, and the same Ingenious personnel were involved. IG must have known through Ingenious' personnel that commercially and economically it was entering into 30:30 deals. The following are examples from the evidence of particular relevance to IG:

(a) Patrick Bradley of Ingenious e-mailed Lionhead in November 2005 as part of Ingenious' approach to them for financial information on the games sector, and said:

> "We are currently in the process of setting up a corporate games fund. This will provide 30% of production expense for new games, with the balance normally being provided by the publisher. Our participation will entitle us to a gross recoupment corridor of 30% and subsequently 30% of the upside of the game."

On a common sense view of the meaning of profit it would be determined by deducting the 30% of cost from the 30% of revenue.

(b) The Request for Approval for *Colin McRae DiRT* addressed to the Executive Committee attaches example figures which expressly show that at every level of distributable income, the publisher would receive 70% of that income so that implicitly 30% would be retained in return for IG's 30% equity.

(c) An e-mail from Eidos' lawyers to Eidos in March 2008 recites the entry of the parties into the CPS by which Eidos "commissioned [IG] to develop the game", and the DSC by which IG "subcontracted the development of the game to" the DCS, and summarises the effect:

> "Pursuant to the Agreement Ingenious Games LLP agreed to contribute provide 30% of the development budget for the game "Urban Chaos I" in return for a share in the revenues for the game delivered in accordance with the provision of the Agreement".

(x) Conclusions: With a View to Profit

1256. The games industry was complex and risky. IG had, through Ingenious, conducted some research into it. From the evidence we saw, our impression of that research, the level of IG's knowledge of the games industry and its knowledge of the revenues and expenses which arose, was that it was fairly superficial. IG did not appear to have immersed itself in the detail enough to be able to estimate, with any real hope of being correct, the returns which it might make by contracting for any particular game or combination of games.

1257. The illustration in the Information Memorandum provided no or minimal support for any hope that IG would make a profit: even though its estimating methodology was crude and not based on particularly sure foundations, it knew that a game had to perform exceptionally well to make a profit on the Ingenious basis, and that this was unlikely. It must have known that for a hit to make up for the losses the hit had to do even better than break even. It must have known that this was very unlikely.

1258. IG had identified the handicap to profitability presented by the Ingenious basis and the waterfall: it knew its games had to perform substantially better than they would have to perform for an ordinary publisher to make a profit on that basis. In our view it did not have a (realistic) view of profit on that basis and it was not realistic to hope for an overall profit for IG on that basis.

1259. On the other hand, IG knew that on a 30:30 basis it had a chance of profit on individual games which approximated that of the publisher; the publishers were well regarded entities and the games undertaken had commercially appealing characteristics. If, as seems likely, the publishers could reasonably hope for profit then so could IG on that basis.

5. Wholly and Exclusively Incurred

1260. The conclusions we reached in relation to films are equally applicable to the expenditure on games by IG.

6. Accounting

1261. Our conclusions in relation to the application of GAAP in relation to the film LLPs applied equally to IG.

1262. In calculating the NRV at the end of each period, IG adopted the same policy as IFP2 – that of equating it to their estimate of the virtually certain income from the game. The method of estimation adopted was also broadly similar (and similarly cautious) to that used by IFP2:

(a) A database of US sales income for all games over the previous 2 years was compiled; comparable games were selected;

(b) The lower performing comparables were selected and an average US performance calculated;

(c) That was grossed up to give a global figure;

(d) Special reductions were made, e.g. for *Colin McCrae*;

(e) Estimations were made for distribution costs (at 45% of gross revenues) and other costs;

(f) These figures were applied to the waterfalls to obtain schedule 7 receipts;

(g) A further 12.5% discount was applied.

1263. Ingenious' internal meeting notes of 8 September 2005 recorded that "as with IFP we need to be able to justify the carrying value (NRV) of games … The possibility of bundling together a number of mobile games was discussed. It was thought that it might be harder to justify lower NRVs in such a scenario" Mr Reid argued that one could not read into this a drive to produce low NRVs: it would be surprising if there had not been any discussion of the method of NRV calculation. We, however, regard the language as an indication, albeit not a weighty one, of a desire to produce low NRVs: if the question was how to estimate NRVs then "estimate" rather than "justify" would have been a more natural choice of word.

1264. Overall, such evidence as was before us in relation to the NRV calculation did not indicate that our conclusion should be any different from the one we reached in relation to the Studio films undertaken by IFP2. In particular it was clear that IG had inserted itself into the production of the games produced in the first period and that, for an appropriate fee or turn on the deal, and without giving the LLP the benefit of the 5% equivalent of the EP fee, it was very likely that Eidos or Codemasters would agree that it could extract itself; and that each would agree to buy back IG's rights to the income flow under the relevant agreements, and thus that the NRV of IG's rights should be calculated in a similar fashion to that applicable in the case of IFP2's Studio films.

7. Conclusions

1265. IG was not trading during the accounting periods at issue.

1266. Its business was not conducted with a view to profit calculated on the Ingenious basis, but it was conducted with a view to profit on a 30:30 basis.

1267. The expenditure incurred on each game was 30 and not 100, and only that 30 was incurred wholly and exclusively for the purposes of its business.

1268. IG's accounts were not prepared in accordance with GAAP.

CHAPTER XIII: CONCLUSIONS

1. Summary Conclusions

1269. The following conclusions relate to each of the fiscal years in relation to which the appeals were made.

(a) Were the LLPs carrying on a trade?

1270. In our judgement ITP and IFP2 were carrying on a trade but IG was not.

(b) Were they doing so "with a view to profit"?

1271. None of the LLPs were carrying on a trade with a view to profit if "profit" is to be determined on the Ingenious basis. But if "profit" is understood to be determined on the 30:30 basis then the businesses were conducted with a view to profit: the businesses were conducted in such a way as to afford a realistic possibility of such a profit, and the LLPs knew that the financial consequences of their transactions could in substance be computed on that basis.

1272. (c) Did they incur expenditure equal to 100% of the budget of the film or game?

1273. ITP incurred only 35% of the contracted budget cost of each film; IFP2 and IG incurred only 30% of the budgeted cost of each film and game respectively.

(d) Was their expenditure incurred wholly and exclusively for the purposes of their trade?

1274. If we are wrong in the forgoing conclusion and the expenditure incurred was 100% of the budgeted cost, then it was not incurred wholly and exclusively for the purposes of the trade or business. If we are correct, the expenditure incurred was incurred for the purposes of the trade or business apart from an amount equal to 5% of the budget which was incurred to provide the EP fee.

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

1275. The profits were not computed in accordance with GAAP. If they were correctly computed the profits and losses would, in particular, be computed by reference to expenditure of 30% (35%) of budgeted cost and income which excluded BDR.

1276. **Accordingly** to this extent we dismiss the appeals of IG and allow in part the appeals of IFP2 and ITP. Formally we adjourn those two appeals for the parties to agree the computations; if they cannot agree they may apply for the hearing to be

resumed. We say "to this extent" because the Appellant says that HMRC seek further to adjust the untaxed interest in IG's 2007/8 return to £174,000, and to bring into tax miscellaneous income of £790,000 for 2008/9. We have heard no argument on these issues and have made no decision in relation to them.

2. Rights of Appeal

1277. 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.

APPENDIX I

WHAT DID THE LLPS DO?

1278. In this section we consider what actions were taken on behalf of the LLPs by people at Ingenious. It is not concerned with the contractual obligations undertaken by the LLPs but with the activities of the LLPs which led to, and took place in connection with, the films with which the LLPs were involved.

1279. We heard evidence from a number of witnesses of their activities. Each was an officer or employee of an Ingenious group company. In this section therefore we address:

(a) who were the Ingenious personnel involved with the LLPs;

(b) what they did;

(c) who they did it for;

(d) and, as a result, what the LLPs did.

1280. We start, however, with an account of some of Mr McKenna's evidence to set the scene.

1281. "Our business", said Mr McKenna, "was to make films happen, it was to facilitate their coming into being". The business of film was about a group of film makers, individuals, all of whom are self-employed or freelance, coming together and being corralled into making a product. By "our business" we took Mr McKenna to refer to the activities of Ingenious personnel.

1282. In relation to Independent films, Mr McKenna told us that:

(a) Ingenious staff received many hundreds of film submissions each year; he told us that if a proposal was not fully developed it could not be for production in that year. On that basis we concluded that their consideration could not have benefitted the LLP closing in that year and the work of considering them could not have been done for that year's LLP;

(b) in some cases Ingenious played an important part in finalising the package of finance for the film: this could include rounding off the finance package and finding sales agents.

(c) but their object was to identify films which had been developed to the stage where the screenplay, talent and the majority of the funding was in place, so that the LLP could step in and allow the film to be made;

(d) ITP would invest in a film only if:

(a) an experienced line producer had been secured;

(b) a recognised sales agent was in place who had provided sales estimates and made presales. For IFP at least one major territory presale was required;

(c) a completion bond was available, and all insurance organised;

(d) funding was in place for 65% (70% in the case of IFP) of the budget for the film (such finding could include loans secured on presales commitments); and

(e) the parties agreed to the Commissioning Distributor Model.

These requirements were formally recognised in the Information Memoranda for the IFP LLPs.

(e) it was desirable that presales amounted to about 30% of budget;

(f) the film would be taken on only if it was thought that its collectable gross receipts (i.e. presales + unsold territories) were likely to be 2x budget. (His evidence on the exact multiple fluctuated: later he said 2.2x budget.)

1283. It was fairly clear to us that not much artistic evaluation came into the equation even for Independent films. Yes, scripts were read, but Mr McKenna did not emphasise artistic evaluation in his evidence. Rather he said that in exercising a commercial judgement the members of the green-lighting committee were able to draw on their experience of creative projects. Our conclusion is that they took their cue from others: if there was a good director, well known actors, a good sales agent, then they relied in essence on the fact that those people had signed up.

1284. He told us that the task of the Committee was different in relation to Studio films: there was no need to consider issues such as sales agents, presales and other sources of funding. The Studio would provide the finance of 65% (ITP) 70% (IFP) of the film via the loan to the CM. Mr McKenna explained that in a case where a Studio wished or was willing to take a "partner" in a film, then, when such a film came to the Committee, the Studio would have told them that it wished to make the film, and the Committee would then consider whether they liked the film. The Studio would have green-lit the film itself subject to the LLP providing the 30% additional finance and entering into the suite of agreements.

1285. Mr McKenna explained that whilst, for ITP there had been a fairly informal green-lighting process under which a committee had to approve involvement in a film, this was made more formal for the IFP LLPs whose Information Memoranda set out the criteria the committee would apply. In relation to IFP2 he told us that one collateral benefit of the Committee procedure (when taken with the 50:50 raising of capital for the LLP) was that it meant that Ingenious could have an Ingenious entity as CM without having to consolidate the LLPs in its accounting.

1286. Mr McKenna explained that as time went by they gave greater prominence to the Studio films. In judging whether it was likely that the 2x multiple (or 2.2x multiple) would be achieved the crucial feature was identifying talent – writer, director, cinematographer composer etc.

<u>1. Who were the personnel at Ingenious involved in the LLPs' activities?</u>

1287. Patrick McKenna; Duncan Reid; James Clayton, from 2003; Paula Jalfon from 2003; and Nicholas Bower from August 2006. When Mr Bower joined the other members of the team were: Jane Moore (an accountant), Judith Chan (a former banker) Peter Touche (an accountant) Guillaume de Chalendar (a former banker) and Josie Lindop (a lawyer); John Jaggon (who had finance expertise).

1288. Of these, we heard oral evidence from Patrick McKenna, Duncan Reid, James Clayton and Nicholas Bower, and saw copies of e-mails from Paula Jalfon, John Jaggon, Mark Fielding and others.

1289. The activities with which we are concerned took place over six or seven years and involved many films. The evidence we heard and saw related to a selection of films and events. We took into consideration the difficulty of describing accurately what happened over such a period and several years after the events. We set out below *examples* of evidence of the activities as indications of what we find was done in this period.

2. What did they do?

1290. The activities undertaken by people at Ingenious which related to the LLPs can conveniently be divided into seven categories:

(1) Making contacts, soliciting films, talking to Studios, making and maintaining relationships;

(2) Selecting films;

(3) Considering films for green-lighting commitment by an LLP;

(4) Contract Negotiation;

(5) Monitoring the filming, in particular expenditure against budget;

(6) Monitoring the income arising;

(7) Accounting, NRV production, projections and reporting.

2.1. *Making Contacts, Soliciting Films, Talking to Studios, Making and Maintaining Relationships*

1291. Mr Clayton told us that, particularly in the first six months of 2003/4, they put a lot of work into strengthening relationships with potential distributors. He gave examples:

(a) talking to Marty Katz and others at the Toronto Film Festival in September 2003 about *Hotel Rwanda*;

(b) seeking to cultivate relationships with Graeme Broadbent and Pete Czernin at Mission Pictures, Kurt at Myriad, and Societe General (in connection with undertaking *Piccadilly Jim*);

(c) exploring commercial terms with Miramax in 2004;

(d) going to Los Angeles in 2003 and 2004 to talk to Fox, Universal, Disney, Warner, Sony and DreamWorks, and again in 2005;

(e) travelling to the Isle of Man, Paris, USA and the Venice, Toronto (2003) and Cannes (2003 and 2005) film festivals;

(f) liaison with Vicki Rossellini at Fox from 2005 and then establishing a long-term working relationship: Vicki Rossellini had said that Fox had "plenty of top high visibility commercial films to partner you on", which Mr Clayton said was exactly what IFP was looking for.

1292. Mr Clayton told us that Paula Jalfon had an extensive network of contacts, particularly in the British Independent film world, which enabled her to track projects of the right calibre, and that she developed this network to attract future projects. She lunched and dined with agents and directors and attended film festivals. She received unsolicited proposals from writers, directors and producers. Mr Reid confirmed Paula Jalfon's role in sourcing projects after her arrival in 2003.

1293. Mr Reid explained how Ingenious' relationship with Working Title/Universal led to *Wimbledon* being adopted by ITP.

1294. Mr McKenna told us that semi-complete projects were brought to them which they would help on their way. This was a way of establishing relations with the creative elements in the industry.

1295. Mr Reid noted that on behalf of Ingenious Films Limited he had put considerable work into trying to bring together all the financial components which would enable *Oyster Farmer* to be made. However, he said that the work went "unrewarded, but it was done on the basis that Ingenious Films Ltd would have been compensated by an executive producer fee had the film gone ahead". (By contrast he said that *Wimbledon* happened to be a reasonably straightforward film to put together but the executive producer fee remained payable.)

1296. Ingenious personnel were not invited to the premier of *Australia*. An e-mail from Mr Clayton protests that it was a lost marketing opportunity (presumably for Ingenious). There were "ruffled feathers" in the Ingenious organisation when no mention was made of Ingenious at the premier of *Brick Lane*.

1297. *We conclude* that Ingenious personnel put a considerable amount of time and effort into activity (1), making contacts etc. This activity brought potential projects to Ingenious' attention some of which were undertaken by an LLP. From references to the sale and leaseback of films we conclude that some of the projects also resulted in Ingenious arranging sale and leaseback transactions in the films.

2.2. *Selecting Films*

1298. Mr McKenna said that "in our search for suitable films to produce we evaluated literally hundreds of potential projects at different stages of development, but only selected a few which met our strict commercial criteria. We then worked closely alongside the commissioning distributor during the crucial pre-production stage to

complete the creative, commercial and financial elements of the overall film proposal ... sometimes this process involved considerable work (and this was often the case in relation to Independent films) but in some cases a project would come to us (often from a Studio) with mostly all the creative and financial elements in place."

1299. He told us that the Ingenious team read scripts, evaluated their creative and commercial prospects, and lent assistance in different stages of the physical production process. We noted, however, that in some cases an LLP had committed to a film with out having seen a finished screenplay.

1300. He said that a lot of work went into getting all the pieces of the financing jigsaw (for an Independent film) in place, from the financing through to the distribution arrangements and the creative team. Once these elements were in place a view was taken on whether the film would meet the criterion that box office receipts would exceed the relevant multiple of budget.

1301. Mr McKenna told us that there was an element of creative evaluation based on an understanding of the industry, the writers, directors etc.; we accept that these later considerations played a part; but would not describe it as creative evaluation.

1302. In an e-mail of 26 September 2007 Mr Bower gave a synopsis of the way Ingenious' Independent film involvement worked and described the financial mechanics. He explained that the main criteria for selection were strong commercial potential evidenced by presales, the sales agent condition and the director's track record.

1303. Mr Reid provided a list of about 200 films which had been rejected by Ingenious for Inside Track. He said that proposals were rejected for a variety of reasons including the following:

(a) the developer had failed to attract the 70% finance required for Ingenious; involvement;

(b) doubts over the quality of the proposed financial commitments of others;

(c) failure to attract a sales agent;

(d) failing to sign the star or director needed.

1304. He explained that Ingenious was searching for films which could be "made ready to go into production in the short term" and which met certain objective criteria:

(a) commercial viability (by which he meant that the project involved well-known actors or directors);

(b) an experienced day-to-day producer;

(c) market validation (in the form of presales or other market finance);

(d) a sales agent for Independent films;

1305. Mr Clayton said that key components of Ingenious' commercial strategy (for Independent films, we understood) were (i) to insist on at least two presales or an

adequate loan to the commissioning distributor, and (ii) to insist that presales income passed through the waterfall.

1306. Mr Reid said that screenplays were read, and Mr Clayton referred to Paula Jalfon's role in this. Mr Reid said that Ms Jalfon read screenplays in most cases while in others she concerned herself with the availability of talent.

1307. Mr Clayton said that they operated an open door policy which resulted in a huge volume of submissions. In addition, top individual producers, directors etc. were targeted. At any one time Ingenious would be discussing dozens of live projects. The team, he said, invested a lot of time working projects into sufficient shape for submission to the green-light committee. In this context he explained the need for a sales agent of standing who believed in the project. He gave examples of films being rejected: (1) because of concerns over the probity of one of the production entities, (2) because a proposed film had a first-time director and producer in whom they did not have confidence, and (3) because of the attachment of a sales agent with an unsatisfactory record. On the whole, he said, rejections were for commercial rather than creative reasons.

1308. Mr Clayton also explained that the team would test the proposals put to them. Sometimes an actor or a sales agent would be specified in the proposal, but on attempting to verify their attachment, Ingenious would be told that they had not been contacted or contracted. Ingenious also assessed the ability of the commissioning distributor to make the 70% commitment by reference to its sources of funding. Film-makers he said were optimistic. For *Brick Lane*, Paula Jalfon had been active in arranging for distributors of the film.

1309. For *Happy Go Lucky* Mr Clayton undertook an exercise with Gail Egan, the individual producing the film, to contrast the merits of two sales agents which were being considered to handle the film. For the same film Mr Clayton said that Ingenious had itself helped complete the funding by lending the commissioning distributor the money which would eventually be paid to the PSC in the form of tax credits. Generally Mr Clayton said that he had helped Gail Egan with arranging the distribution network and the finance for the film.

1310. Mr Clayton told us that his discussions with Vicki Rossellini at Fox were frequent: they spoke three or four times a week. This contact, we gathered, would relate to the sourcing of films, the negotiation of the terms and post-agreement matters such as when *Used Guys* was abandoned.

1311. The preparatory investigation of Studio films was a little less intense. Mr Clayton told us that in March 2006 Fox provided key creative details and synopses in relation to *Australia*, the agreements for which were signed on 21 March that year.

1312. When the likely level of subscription for IFP2 was known Mr Clayton discussed the application of some of the available funding in two New Line films, *Hairspray* and *The Golden Compass*. He explained that New Line had been difficult about the negotiations so they wanted to line up some other deals in case the New Line deals

did not go ahead, and as a result he started to explore other titles offered by Fox. Apparently two of those offered were not considered to have the same commercial appeal as two others, *Used Guys* and *Die Hard 4*, although *Used Guys* was preferred to *Die Hard 4* since there were concerns on the executive committee that the *Die Hard* franchise was becoming tired. Mr Clayton relayed the discussions to Vicki Rossellini.

1313. For films made with Fox, Mr Clayton accepted that it was very much a question of choosing the best of the slate Fox had to offer. Great comfort was taken from Fox's track record and the fact that they would provide 70% of the capital. The degree of oversight was greater for Independent films.

1314. In an e-mail of October 2007 in which Mr Bower explained the Ingenious financial structure to a film maker, he said that Ingenious was open to doing an animation project and had no problem with the proposed sales agent. He said that in terms of other talent attachments to the film they tended to focus on the director and the producer.

1315. Mr Bower related meetings with producers, sales agents and financiers to talk about their projects: this included talking about the proposed cast and testing whether the proposed cast were in fact attached to the film. His notebook recorded salient features for later consideration.

1316. For *Alien v Predator* (2006) there was discussion between Mr Clayton and Vicki Rossellini: about the giving of a guarantee by the Ingenious group to fund any shortfall in the funds raised by the LLPs, shortfall funding by Fox, and as to whether the contract should be with an Inside Track LLP or an Inside Films LLP (which had corporate investors).

Our Conclusions on 2.2: Selecting Films

1317. Our overall conclusions from this evidence were these:

(i) In relation to Independent films selection was made from a large pool of films which had come to Ingenious attention; in the case of Studio films the choice was more limited;

(ii)Ingenious did not make a weighty assessment of the artistic value of a film or of whether its artistic nature was such that it would be successful: it cared about the films with which the LLPs could be involved but was concerned principally with objective issues such as finance and the engagement of talent. It relied mainly on others' judgements of the likely success of the film as those judgements were reflected in a Studio's willingness to take it on or distributors' willingness to engage in presales;

(iii) in relation to Independent films Ingenious' activity could be substantial but that activity was mainly in relation to bringing together the necessary finance from other sources to meet its requirement that 70% (65%) would be provided: that included the introduction of possible providers of finance and the negotiation of terms with those providers;

(iv) in relation to Studio films its main activity was the matching of the funds it expected the LLP to be able to raise to the films which the Studios would agree to share, and the settling of the commercial terms of the deal.

2.3. *Green-lighting Films for Commitment by an LLP*

1318. In section 4 of Chapter VIII we discuss green-lighting in the context of whether what was done evidenced a view of profit. Here we consider the activities of the process.

1319. ITP had a committee consisting of Patrick McKenna, Duncan Reid and Kevin Mead (then the CEO of the Ingenious group). Mr Reid explained that at this time they were quite a small team and the procedure was fairly informal.

1320. We have recorded that IFP2 had a more formally constituted committee, three of whose five members had media business and film industry expertise and were independent of Ingenious. The independence of this committee had accounting advantages. To this committee more formal proposals for green-lighting were made.

1321. The IFP2 Information Memorandum set out a list of criteria the committee would apply for green-lighting a film:

(a) a producer and director with a successful record;

(b) attractive cast preferred;

(c) for Independents, a recognised satisfactory sales agent;

(d) again for Independents, one significant major territory presold.

1322. We have discussed, in Chapter VIII, Mr Clayton's evidence that his approach was to try to find films to submit to the committee which were capable of hitting the 2.2 x budget = box office hurdle by reference (mainly) to the ingredients of the film listed above. He said that the Ingenious team member working on the film would submit a paper to the committee containing key information, but that in the early days of ITP there were also informal communications between team members and members of the green-light committee. We have noted that it was clear that there was some tension between in-depth evaluation of films and the need to commit to sufficient films before 5 April in the relevant year to use the capital which had been subscribed by the individual members.

1323. Mr Clayton explained that for ITP 1 and 2, there was a shortlist of 48 films of which 13 were green-lit, and for IFP the shortlist was 138 out of which 22 were green-lit. We understood the short list to relate mainly to Independent films.

1324. Mr Clayton accepted that on occasion documentation could start before formal green-lighting. Indeed *A Good Year* and some other films were signed up before the meeting to approve them was held.

1325. We refer the reader to the e-mail chain described in Chapter VIII section 4 which starts with an e-mail of 4 April 2006 in which Mr Clayton updates the committee

members on the progress of the slate for IFP2 LLP, explains that negotiations over *The Golden Compass* and *Hairspray* have been difficult and slow, and says that there is a back-up plan to do another film with Fox (which turned out to be *Avatar* and in the event was contracted for in a later year). He states the budget, the director and the genre, and says he will call each of them to get their thoughts.

Our Conclusions: Green-lighting

1326. In relation to Studio films we consider that the green-lighting committee relied on the Studio's evaluation of the commercial prospects of the films. If the Studio were willing to put up 65%/70% then unless there was something really odd about the film, the film would be accepted if the LLP had the funds and it could be documented in time. Where more than one film was available the committee would express a preference. Mr McKenna's evidence on the green-lighting of Studio films did not indicate that there had been an intensive enquiry by the Committee.

1327. HMRC suggest that the green-lighting process was simply the rubber-stamping of decisions already made by Ingenious employees. We consider those criticisms in our consideration of whether the business was carried on with a view to profit. But even if the green-light committee did simply rubber-stamp decisions already made, those decisions were made: consideration was given to a number of possible films and a decision was made to proceed with some of them. Green-lighting may have been a formality, but knowing that you have to go through a formality often means that you prepare to defend a position you have taken. It gives more substance to the preparation.

2.4. *Contract Negotiation*

1328. The format of each film's contracts was, we understood, broadly the same: in each case there was a CDA and a PSA each either in the Studio format or that for Independent films, and each with substantially the same terms in relation to the rights and obligations for the production of the film. All contained a schedule-7-style waterfall in one of the documents with associated alteration provisions of the Deed of Acknowledgement etc. or an analogous document. Thus there could have been little negotiation of the contractual framework for any film, particularly with counterparts such as Studios with whom deals had been done before.

1329. Nevertheless there was evidence, of which we give examples below, of considerable time and effort spent in the finalisation of the detail of the terms of these documents. This was plainly more complex for the Independent films than for Studio films and appears to have involved the detail of the contract – the budget, contingency and overhead provisions, and dealing with shortfalls in the available funds. In some cases it involved knitting the requirements of a sale and leaseback into the fabric.

1330. E-mails for Messrs Bower and Clayton to prospective Independent film-makers indicate that a deal took some 6 to 8 weeks to close.

1331. Mr Antoniades spoke of the rigour of Ingenious' negotiations and gave some examples of the issues involved: participation in tax credits, participation in

distributions advances, the title to the intellectual property in the film and details of cast and crew.

1332. *Wimbledon*: Mr Reid told us that general discussion over structure had been held with Universal for the film *Wimbledon* in May 2002 (before the formation of ITP in September 2002), and that there were negotiations over the waterfall from July 2002. The issues discussed related to: caps on P&A, the size of the distribution fee, the recoupment of DVD costs and whether TV revenues should suffer from P&A recoupment. There were further negotiations in December 2002 and lawyers were engaged in March 2003. There was a last-minute concern about insurance. A waterfall was "just about" agreed by the end of March 2003.

1333. There were further discussions about providing the actors' contracts with the PSC to Ingenious, about the fees of Messrs Bevan and Fellner, interest on under-drawn funds, merchandising receipts and insurance. The deal was closed on 4 April 2003.

1334. Mr Reid said that Universal wanted Ingenious to commit to other films but ITP had the capital for only one; but an informal undertaking was given by Ingenious to support *Shaun of the Dead* which was later undertaken by ITP 2.

1335. There were discussions with Pathé in relation to *Girl with a Pearl Earring* and *Suzie Gold* about contracts with key actors, which provided for payment whether or not the film went ahead.

1336. Mr Reid said that for the later deals, when the basic structure of the deal had been established, the commercial discussion was relatively brief.

1337. *Blackball*. Mr Reid told us that the negotiations for *Blackball* had taken two months. This was an Independent film and other entities were involved in providing finance to the commissioning distributor and the CM. There were problems with getting the banks, which were providing funds to the commissioning distributor, to agree to the commissioning distributor model and with the mechanics of the waterfall. The fee charged by Ingenious as executive producer was cut by 50%.

1338. There were concerns about insurance, who should be the collection agent, the risk of a defamation action and the title to the rights to the film, all of which had to be settled.

1339. *Girl with a Pearl Earring*. Mr Reid explained that contract negotiations with Pathé for *Girl with a Pearl Earring* began in July 2002 and continued until contracts were signed in December 2002, although the basic commercial terms were agreed at a fairly early stage. There were disagreements in September about play or pay deals with some of the stars (Pathé asked Ingenious to go 50:50 on the expense of $675k to secure Colin Firth and Scarlett Johansson for *Girl* and Summer Phoenix for *Suzie Gold*; Ingenious declined) and over the treatment of presales as part of the waterfall receipts.

1340. Mr Bower's work. In his first 10 months (starting in 2005) Mr Bower worked on the contractual documentation for a number of films and continued to play some part in that work thereafter. He described the negotiation as an intensive period of structuring and sorting out the legal rights, documents and money flows in which there was a frenetic flow of e-mails.

1341. Mr Clayton explained that some deals were straightforward to put together and others more difficult. He gave examples of difficult negotiations with the Interstate Development Corporation of South Africa in closing the documentation for *Hotel Rwanda*, and the period from June to November 2003 for the evaluation, negotiation and completion of the deal for *Piccadilly Jim*. Mr Clayton also referred to issues which arose in the negotiations for *Stardust*: the degree of control to be exercised by the individual producer, whether the budget was adequate and the detail of the waterfall.

1342. *Hot Fuzz*. Mr Reid related a difficult discussion about the amount of sale and leaseback proceeds which should come through the waterfall. (In an interesting e-mail to Universal in relation to this issue he points out that Universal had in other deals profited in aggregate by £63m in its dealings with Ingenious entities.)

1343. *Stardust*. There were negotiations about the composition of gross receipts for the purposes of the schedule 7 waterfall.

1344. *Avatar* and Fox. Mr Gammie explored with Mr Clayton an e-mail he sent to Fox seeking production information on *Avatar*. It appeared to us from Mr Clayton's responses that the information was being sought principally to ensure that the documented position of the LLP was that of a person in possession of such information as would enable him to be more likely to be styled a "producer" in the sense that Mr Finney attributed to that word.

1345. Mr Clayton said that they had a template deal with Fox although they would always seek to "tweak it". It was, he said, a constant process of improvement. Mr Clayton's discussions with Fox included matters such as the level of notional Fox overhead to be added to its advertising expenditure (Fox wanted 10%, Ingenious argued at one time for 5%), and the nature of the information on distribution which would be provided to the LLP.

1346. With Fox, Mr Clayton said transaction documents could be completed quickly whereas he recalled staying up all night to complete the transaction documentation for some of the Inside Track deals which had required documentation to be agreed within a couple of weeks.

1347. In relation to *Alien v Predator* there were discussions between Mr Clayton and Vicki Rossellini in relation to (i) the staging of levels of distribution fees, (ii) unspent contingency, (iii) the eventual split of monies at the back end of the waterfall, (iv) an option over a sale and leaseback.

1348. In relation to *The Big Nothing* Paula Jalfon e-mailed Pathé asking that the appointment of the editor and the post-production supervisor be settled prior to the

making of the agreement. She made some suggestions. Pathé responded, a little dismissively, that it was not possible to specify the person who would fulfil those roles in time.

1349. *The Golden Compass*. There were difficult negotiations about the size of the contingency in the budget.

1350. Mr Bower's notebooks for the period 20 February 2006 to 19 September 2006 are full of lists of items to discuss, agree, obtain or check in relation to the negotiation of contractual documentation. Currency, security, copyright, budget, cash flow, sale and leaseback deals, delivery materials, insurance, remuneration, reporting, notice periods, completion bonding, cast availability, cash flow requests during pre-production, whether fees had been inflated, creative block, escrow provisions and more all appear.

Conclusion 2.4: Contract Negotiation

1351. Our assessment is that the process of the negotiation of the deals, both in their broad commercial terms and the contractual detail, was a serious business which consumed large amounts of time and effort. It was much more complex than that involved in investing in shares or securities or in making simple loans (with or without security). Some of that complexity arose from Ingenious' requirements that the LLP should appear to have the role of a producer, some may have arisen because of the need to dovetail with sale and leaseback arrangements and other sources of finance for a film, but much went to the commercial grit of the LLPs' deals.

2.5. *Monitoring the Filming*

1352. Mr McKenna said that the PSC controlled the making of the film. The LLP, he said, exercised control in setting the terms of the contract. At that contract stage a lighter touch was exercised with Studios than with Independents, but it was at the contract stage that the LLP's influence was brought to bear. Thereafter it was unwise to interfere with the detail of the artistic production of the film other than to ensure that expenditure fell within the set budget and cash flow. After the key transaction documents were in place "we hoped that the involvement of the [LLP] in the production process could be minimal". Once green-lit the film became "something of a juggernaut and the sheer momentum of the project left little time for changes of mind and extensive reworking."

1353. In the same way the LLP had no control over the level of P&A expenditure incurred by a Studio or an Independent distributor on the distribution of the film. This was left to the judgement of the distributor because, he said, it had as much to gain from a film being successful as the LLP.

1354. Mr Reid said that people in the entertainment business wanted the investors' capital, but once they had got it they really wanted you "to go away and leave them alone and they will make all the decisions … we … would give ourselves the right to be involved, to oversee and to be there." He said that they were not going to act in a way which would prejudice the production.

1355. Mr Bower's e-mail of October 2007 and Mr Clayton's e-mail of September 2007 referred to above make no mention of any involvement in monitoring production.

1356. Over-runs. Mr McKenna said that films occasionally overran their budget. If so the LLPs could choose to participate in funding the over-run. That was a decision which would have been made during the filming process. There were negotiations about the funding of an overrun on the budget of *The Golden Compass*.

1357. Mr Reid said that, particularly in the case of Independent films, Paula Jalfon would "often be in constant contact with the on-set production team to ensure that the project was going ahead as planned and within budget". We think that "constant" was a bit of an exaggeration. This he said might involve:

(a) studying call sheets (we saw examples of call sheets for *The Golden Compass* which had been sent to her and concluded that mere study of them would have been very boring);

(b) making suggestions to the production team (we saw an example of an e-mail from her passing on information about cast availability);

(c) providing creative feedback to production teams: the example provided of this was a short e-mail in which she said they had loved the trailer;

(d) attending meetings with production personnel. We saw e-mails making arrangements for a visit to the *Stardust* shooting;

(e) monitoring production cost reports. We saw a cost report which had been sent to Ingenious in relation to *The Golden Compass* and an e-mail in relation to *Wimbledon* in which Paula Jalfon asked to see the budget against which the cost report was made, and asked if it was likely that the film would be delivered to budget.

1358. Paula Jalfon described her role in an e-mail to Patricia Gill of Pathé in September 2003 as "selecting films to finance and monitoring their production and exploitation thereafter".

1359. Mr Reid related difficulties Ingenious had had in monitoring costs for *Wimbledon*. Paula Jalfon had told him that it was difficult to get information out of Working Title once a film had closed. Requests were made and chased; Universal eventually provided information on a regular basis. There was further discussion about interest calculation.

1360. For *Blackball* Paula Jalfon made arrangements to see the film before it was "locked". There was a screening by Ingenious to ITP investors. Mr Reid said that as they watched they became concerned about certain elements of the film. Additional funding was agreed to make changes to the film, and the contractual documentation altered to reflect this. Mr Reid told us that Paula Jalfon had also been concerned with the presentation of the credits of the film.

1361. For *Girl with a Pearl Earring* Mr Reid explained that production went smoothly and Paula Jalfon's role was broadly confined to making sure the credits were correct, and ensuring that underspent budget amounts were correctly dealt with.

1362. For *Churchill*, Pathé decided to spend some £89,000 on re-editing the film and sought permission to recover this as a distribution expense. James Clayton agreed to this.

1363. *Used Guys* was abandoned. The unwind had to be managed. The LLPs joined Fox for the production of *Avatar*. The negotiation of the contribution to *Avatar* is explained in section 11 Chapter VIII and Appendix 5 but it was clearly a complex matter.

1364. For *Happy Go Lucky* changes to the allocation of the budget were discussed and agreed by Paula Jalfon (UKFC, Film Four MSL and Summit, the other providers of finance for the film, were similarly consulted). Changes in the location of filming were also agreed by Mr Bower.

1365. Mr Reid referred to disputes in relation to fees and underspend on *My Country* in which Alison Brister had been involved in settling changes to the financial arrangements affecting the Collection Agreement (including the Sale and Leaseback benefit).

1366. In an e-mail of 19 August 2008 to James Clayton, Emily Ng explains that Fox did not draw down the final tranche of the *Avatar* cash flow and that Fox could no longer draw the funds without Ingenious' confirmation, but she says "Cost reports – we never receive any cost reports on *Avatar* so we won't know whether there's an underspend and if we really need to send the money."

1367. Mr Clayton said that as a representative of the LLP, and along with Film Four and UK Film Council representatives, he had attended the showing of a rough cut of *Happy Go Lucky* and commented, with them, on certain scenes (but as it happened to no avail given the strong views and approach of the director).

1368. Mr Clayton gave examples of activities he had conducted for ITP partnerships: (1) amendments to the *Millions* agreement to deal with the BBC licence fee (2) considering a US deal for Vera Drake, (3) dealing with an expense overspend on *Bride and Prejudice*. The correspondence we saw on these issues generally consisted of a request to agree to changes in the agreements or the giving of a consent required by the agreements.

1369. There was an exchange of e-mails between Mr Clayton and Vicki Rossellini about the replacement of Russell Crowe by Hugh Jackman in *Australia*. Mr Clayton and Miss Rossellini had telephone conversations about production issues.

1370. We saw e-mails from Paula Jalfon which exhibited to some extent a building of files rather than executive involvement in the filming process. Approvals were sought and fairly automatically given by Paula Jalfon for the appointment of certain actors

and staff, although for *The Big Nothing* Ms Jalfon declined to approve a proposed production accountant.

Conclusions 2.5: Monitoring the Filming

1371. Our overall impression of the evidence is that what Ingenious did in relation to the physical making of the film after the documents had been signed was this. For Independent films it was not at all deeply involved in the day-to-day production of the films – an eye was kept open on what was going on: there were set visits and viewings, but Ingenious had no significant involvement in the creation of the films. It also kept an eye on costs (and was consulted about cost overruns), but it did so at one remove. It was consulted about changes in key dates, personnel and entities involved in the process of finishing and distributing the film, but it was not in general the instigator of these changes. Its role was that of a concerned onlooker rather than principal: more like the role of parents taking a child to University than a tutor or lecturer. For Studio films its substantive role was lighter still and was confined principally to dealing with matters of finance.

2.6. *Monitoring the Income Arising*

1372. Mr Bower explained that although the system may have been less sophisticated in the past, during at least the latter part of his time at Ingenious:

(a) a spreadsheet was maintained of reporting obligations and dates alerting them to the due date of statements;

(b) overdue statements were chased;

(c) the statements were checked by a commercial analyst;

(d) errors were raised with the Studio/collection agent.

1373. Ingenious were not particularly successful in getting statements from Universal for *Wimbledon*. Mr Bower said that Universal agreed to produce periodic statements but the first four quarterly statements were all seriously late. He explained that in the period after the first release it sometimes took the Studios a while to get their reporting systems up and running. The initial statements were often delivered late. There were later periods of both compliance and tardiness. Mr Bower was uncertain about whether Universal had been chased. There were other examples of late distribution statements.

1374. Mr Bower said that he was not aware of ITP statements being audited, but IFP2 had required the audit of some of the statements for some films (and a Fox audit of seven titles had led to a $5.25 million settlement).

1375. The statements sent by the Studios were complex. That for *Australia* for the period ending 31 January 2014 extends to 3 pages detailing different sources of income, expense and participation. They were a long way from dividend vouchers.

1376. Mr Reid said that Paula Jalfon and her team paid close attention to collection statements. We saw an e-mail exchange relating to the May 2003 *Blackball* statement

in which John Jaggon had queried one of the items, and the statement had been correspondingly revised; and an e-mail of March 2004 in relation to the same film questioning the omission of sale proceeds from the Middle East, and the signing of contracts in Malaysia the USA and South Africa.

1377. Mr Reid told us how Nick Crossley and James Clayton had chased sale statements from Universal in relation to *Wimbledon* and, when they were received, had questioned the level of theatrical rentals in one of the statements when compared with publicly available box office figures.

1378. For *Blackball*, Mr Reid exhibited e-mail correspondence in which between 2003 and 2006 Paula Jalfon and others had queried a handful of items on the distribution statements, and had had a brief consultation about a sale of North American TV and video rights. There was similar monitoring of statements for *Girl with a Pearl Earring*.

1379. There were e-mails between Peter Touche of Ingenious (who had a financial background) and Pathé in relation to his audit of the income and expense statements.

Conclusions 2.6: Monitoring the Income

1380. Overall, our impression was that distribution statements were fairly diligently pursued and examined, rather in the same way, although by reference to more complex arrangements, as a landlord might examine distribution statements from a property agent in relation to the letting of a property, or a sleeping partner might examine the accounts of the partnership.

2.7. *Accounting, NRV Production, Projections and Reporting*

1381. We saw, and have recorded elsewhere, the progress of Messrs Fielding and Jaggon's calculation of NRV of the films. Accounts were produced and audited. Mr Touche sought further details from Pathé to prepare forecasts of revenues.

2.8. The Golden Compass: A Review of the Documentary Evidence of What Was Done

1382. The Appellants provided a helpful summary of documents before the tribunal which related to *The Golden Compass* and *Happy Go Lucky*. They relied upon the summaries to illustrate the volume of material relating to these films. We find them a useful illustration of the conclusions we reach in 2.4 to 2.7 above.

The Golden Compass

1383. The summaries showed that some 1162 documents, mainly e-mails, had been disclosed. 118 of these related to the negotiation and completion of the contractual documentation, and the remainder to post-completion events.

1384. Of the 118 e-mails relating to the contractual documentation some 20 were e-mails principally between the lawyers for each party. The remainder included some purely administrative actions, but also e-mails relating to the details of the deal. These

later e-mails included: (1) discussions on the effect of the new tax credit regime on provision for the unwinding of the deal in case of difficulties, and provisions dealing with a possible shortfall in the funding to be provided by the LLP; (2) internal discussions within Ingenious as to whether a backup film could be found if negotiations foundered; and (3) the figures for the budget and the Executive Producer fee.

1385. The internal Ingenious e-mails show that this was not an easy negotiation, and an e-mail from Mr Reid *(number 704 M3/103581)* suggests that some negotiations with Fox had been more straightforward. The negotiation he referred to related to terms of the deal which affected the income of the LLP but did not materially affect the structure of the deal or the broad economic effect of schedule 7.

1386. The post-completion e-mails consist mainly of the provision of phone records, call sheets and progress reports to Paula Jalfon. At best these look like record keeping. Some, however, relate to costs, accounting for payments, and approvals given by Paula Jalfon for certain actors, directors and additional scenes. All the approvals sought were given. There were also a number of e-mails relating to the finalisation of the film, its premier and box office performance. E-mails from Ingenious show an interest in the box office performance of the film on its release.

1387. In section 5 of Chapter VIII above we recorded the (unusual) e-mail from an Ingenious investor asking whether in the light of the good box office figures and the reported budget of the film, the film would be profitable for IFP2, and the proposed reply.

1388. In the autumn of 2008, after the film had been released there were discussions about an amendment to deal with P&A. An agreement was executed in January 2009. In 2010 there was an e-mail about distribution statements.

3. Who Did they Do It For?

1389. If A works for B and B is C's agent, then for the purposes of this section we regard work done by A in the course of B's agency as done for C and so by C. But if A works for B and then B provides the results of A's work to C we do not regard A as working for C or her work as having been done by C.

1390. The Ingenious group was involved in a range of activities in addition to promoting, and acting as Operator for, the LLPs. These included arranging the sale and leaseback of films (some of which appeared to have been in relation to films which some of the LLPs undertook), the activity of the private equity and asset management division (started in 2003), managing TV music and live entertainment funds, and the provision of consulting services to media clients. The number of Ingenious staff grew from 2003 and the different activities became more formally segregated between different groups of Ingenious personnel: thus Mr Clayton told us that by 2009 there were separate media, clean energy and sport and leisure divisions within Ingenious, and that a division of personnel was sought between those working for the IFP LLPs on films and those working on non-production activities for them.

1391. This raises the question of whether any of the activities of Ingenious personnel described in heading 2 "What Did They Do?" above can be attributed to any LLP. Activities undertaken before an LLP was in existence could not have been undertaken for (and therefore by) that LLP; and activities which benefitted other parts of the Ingenious group, in particular perhaps the garnering of contacts and introductions and the arranging of sale and leaseback transactions we regard as not having been performed by the Operator for the LLP.

1392. When Mr McKenna was asked how it was known which LLP someone was working for when looking for prospective films or helping with the arranging of finance for an Independent film, he said that there was not a formal mechanism but that as there was one production LLP per year it was "first come, first served"; he told us that since the investment in each LLP closed on 5 April each year, work done by Ingenious staff in considering proposals, developing proposals, and negotiating contracts for films was done in any year to 5 April for the LLP which closed in that year.

1393. On the other hand Mr McKenna also said:

(a) "we often had a rollover from one year to the other of projects" which did not get done in the earlier year. He said you were looking for the best opportunities: if there were too many for the available finance some of the projects might go forward to the next year. Ideas which came in at the end of one fiscal year would be developed for the following year's LLP;

(b) that although when a film was contracted no option was granted to, or sought for, the LLP to participate in a sequel (and he regarded early sequels in particular as having a better chance of success than a new project) "we would like to do sequels … we had a number of discussions about *Alien* sequels" and that "we expect to be doing *Avatar* sequels as well" with Fox. (It was not clear to us that "we" was IFP2.);

(c) that one of the advantages of being at the heart of production is that you gain access to information;

1394. In each of these cases work appeared to be done which would benefit Ingenious itself or an LLP other than the LLP for the year concerned.

1395. It seems to us that the import of this is that at least some of the work in sourcing films was done for Ingenious' benefit because it was done to enable Ingenious to promote an LLP in the following year. That LLP was not yet in existence so that the work could not have been done for it or, vicariously, by it. We have also noted the work done for Ingenious in relation to sale and leaseback transactions.

1396. Further: (1) *Avatar* was co-produced by IFP2 and IFP3 in 2006-7 (IFP2 using capital returned from the 2005-6 slate when *Used Guys* was abandoned); (2) in an e-mail of 19 August 2003 Jason Porter says that there will be 2 Inside Track partnerships this year so 2 different tax years can be targeted."; and (3) in 2003 there were, we understood, three LLPs, IT1, IT2 and IT3 in action. There was a discussion between Mr Clayton and Mark Fielding as to which LLPs *Hotel Rwanda* and *Closer*

should be allocated. Thus even after selection of a film for a given year it may not always have been clear for which LLP the work was done.

1397. Mr Clayton was asked how, when sourcing, or arranging finance for, potential films an Ingenious employee knew whether he or she was acting for the LLP or the executive producer. He replied that there was an overlap between their duties to the LLP through the Operator and to the executive producer (and thence to the PSC). He considered that the sourcing of films and their monitoring was done for the Operator and more granular involvement in the films – the getting of films ready to close – for the executive producer.

1398. If Mr Clayton was right about this then the work he describes as done for the executive producer was not done for the LLP since the EP was not contracted to the LLP but to the PSC. And, as the work was done before it was appointed as executive producer (because that appointment took place only on closing) it can only have been done for Ingenious. In our view, however, Mr Clayton's division of responsibilities was a confused attempt to justify the EP fee and made no sense.

1399. We said above that activities undertaken before an LLP existed could not easily be regarded as having been performed by it. The following examples show that there was often a period in which activities were performed which related to films undertaken by an LLP in which the LLP was not in existence, that it was common for film sourcing activities to be performed before the relevant LLP was in existence, but that for most of the films undertaken by the LLPs the detailed negotiation of the documentation was undertaken after the formation of the LLP and the making of the Operator contract:

(a) IT LLP

1400. IT LLP was incorporated on 24 September 2002. It entered into the Operator's Agreement on 16 October 2002. (Paula Jalfon would have had no role in relation to the negotiation and sourcing of these films since she arrived at Ingenious in 2003.)

(a) Girl with a Pearl Earring

Mr Reid said that correspondence showed that negotiations began in July 2002. An e-mail of 7 September 2002 shows further negotiations and arrangements for a sale and leaseback. The documents were signed on 5 December 2002 (although it appears that filming started on 18 November 2002).

Thus all of the work in sourcing the film and much of the negotiation took place before IT LLP was formed.

(b) Blackball

The documents were signed on 8 November 2002. Mr Reid said that this was the culmination of 2 months of negotiations, but he also said that there had been discussions about finance in August 2002. He told us that work on the legal documents started on 19 September 2002. It appeared that photography started on 14 October 2002.

Given the start of photography some 20 days after IT LLP was incorporated it seemed likely the negotiation would have taken place both before and after its formation, and all the sourcing activity before then.

(c) Wimbledon

Mr Reid said that he first came across this film at a meeting with Universal in December 2002, although he had discussed the CD structure with Universal in May and July 2002. Documentation commenced in February 2003 and closed in April 2003.

Thus all of the negotiation activity and some of the sourcing took place after the LLP had been formed.

(2) IFP2

1401. IFP2 was incorporated on 5 July 2005. The Operator's Agreement was entered into on 20 July 2005.

1402. Preparatory Work

(a) Mr Clayton said that between July and October 2004 he had discussed the structure of IFP2 with Studios. They had meetings with film-makers after the Cannes festival in May 2005 and used their contact networks (including projects that had been considered for ITP) to look for films for IFP2 in the spring and summer of 2005.

1403. The Films Undertaken by IFP2. Mr Clayton told us that:

(a) *A Good Year* came to Mr Clayton's attention in late July 2005. Contracts were signed on 25 August 2005.

(b) The timing of *Notes on a Scandal* was similar to *A Good Year*.

(c) *Sixty Six*. Mr Clayton said that Working Title approached Ingenious at the end of July 2005.

(d) *Children of Men* followed from the Cannes film festival in May 2005. Terms were agreed at the end of June 2005. The documentation process started in July 2005. Mr Clayton said that strategically this project helped Ingenious widen its relationship with Universal.

(e) *Amazing Grace* was first considered after July 2005. There were discussions in October 2005 and the documents signed on 29 October 2005.

(f) *The Big Nothing*. Negotiations began at the end of October 2005, photography started on 1 December 2005. Mr Clayton said this was attractive because "we wanted to maintain our relationship with Pathé and [were] keen to partner on a black comedy".

(g) *Night at the Museum* came up in a meeting with Fox in November 2005.

(h) *Hot Fuzz* arose from an approach made by Working Title in late 2005. It was green-lit in 2006.

(i) *Brick Lane*. Mr Clayton started negotiations in December 2006. Paula Jalfon sent e-mails about sales and distributors in January 2006.

(j) The Fox "Mini Slate": *Die Hard 4*, *Avatar*, *Life of Pi*, *Fan Fair*, *Used Guys*. Mr Clayton started negotiations about these at the end of 2005. Documents were signed in late 2005 / early 2006. Mr Clayton said in relation to these films that Fox wanted a long-term relationship to "partner with you on".

4. What the LLPs Did

1404. Overall we conclude that activities (1) and (2), the making of contacts and the sourcing of films, were not carried out by the LLPs. They were carried out by and for the benefit of Ingenious group companies. For example the building of relationships with Studios permitted Ingenious to promote the LLPs with the expectation that films would be found for them; the relationships did not provide a benefit to the LLP and much of the relationship building was done when the relevant LLP did not exist.

1405. Activities (3) to (7) – from green-lighting to accounting – could in general have been carried out by the LLPs because generally they were in existence at the relevant time.

1406. But the fact that these activities could have been carried out by the LLPs does not necessarily mean that they were. It is possible that they were carried out for Ingenious and an Ingenious company supplied to the LLP the result of its work. As we noted, Mr Clayton suggested that that was the case when he attributed the "granular" involvement in the films – the getting ready to close – to the executive producer. We do not, however, think that Mr Clayton's analysis can be right. The negotiation of the deals was for the benefit of the LLPs not the PSC, and the executive producer was bound to deliver services to the PSC not the LLP.

1407. Under the terms of the relevant Operator's Agreements, the Operator (Ingenious Films Ltd for IFP2, Ingenious Ventures Ltd for IT LLP, and Ingenious Media Investments Ltd for IG) agreed to identify suitable films, to negotiate the terms of arrangements for films, to represent the LLP in negotiations and dealings with counterparties and to undertake other mainly administration activities. Thus activities (3) to (7) could have been undertaken by the Operator on behalf of the relevant LLP.

1408. Neither Mr Clayton nor Mr Bower expressly represented themselves as employees of any of the Operators (they said they worked for Ingenious Media saying various activities and entities constituted Ingenious Media), but we accept that employees and officers of one of a closely knit group of companies may be employed by one of those companies but have authority to act for others. Thus we accept that the activities described above could have been undertaken for and on behalf of the relevant Operator.

1409. A division between sourcing, selecting and green-lighting would not be possible in every case; it was apparent that the activities merged or were broadly continuous.

Nevertheless it was fairly clear to us that generally the earlier activities were carried out for Ingenious entities (who might supply some of the benefit therefore to the LLP, rather than do the work as agent for the LLP) and that the preparation for green-lighting was carried out for the LLPs, so that once a film had become a likely candidate for an extant LLP, the work in relation to it was carried out by the LLP through the Ingenious personnel.

1410. We conclude that activities (3) to (7) were undertaken by the LLPs. As a result, to our minds the activity conducted by the LLPs can be described as constituted by the following principal elements:

(a) Considering for green-lighting films proposed by Ingenious entities. This excludes the sourcing of films: we do not regard the LLPs as having engaged in that activity except in relation to some of the conversations Mr Clayton had with Fox close to the year end in relation to matters such as valve films and permitting Fox "flexibility" of allocation. Most of the sourcing was done for and by Ingenious entities who passed some of the benefits to the LLPs;

(b) Complex, serious and detailed negotiation of the commercial terms of agreements for the making of films and the division of film income;

(c) Entering into contracts for the making of films and their exploitation under which substantial sums were put at risk;

(d) Keeping an eye on what was going on in the making of the films and in particular paying some attention to the costs of production but without any significant involvement in the creation of the films.

(e) Reviewing revenue statements from films;

(f) Accounting and administration.

APPENDIX 2

MR SILLS' EVIDENCE

1411. Mr Sills had 32 years of experience in the auditing of film revenue and Ultimates. We accept his expertise in these fields.

1412. Mr Sills' evidence consisted of:

(a) computations of how well *Wimbledon*, *Blackball*, *Australia*, *Avatar* and *Hot Fuzz* would have had to have performed to meet certain targets;

(b) a commentary on certain aspects of the contractual relationships; and

(c) a detailed review of the 2010 Ultimates for *Australia*, *Hot Fuzz* and *Avatar*.

(a) How well did the five films have to perform to meet the targets?

1413. There was no dispute about the accuracy or basis of Mr Sills' calculations. The following does not do justice to the complexities required by the terms of the waterfalls, but in essence Mr Sills took the most recent distribution statement (from Fox, Universal or the collection agent) and worked out how much more (or less) income would have had to have been made in order for each particular target to be reached.[32]

1414. The chameleon word in the previous paragraph is "income": like "profit" it can have many meanings. Mr Sills' calculations worked back from a target performance to Gross Receipts, that is to say the sum of:

(a) theatrical rentals: rentals paid to the distributor after the cinema took its commission (of usually 45% to 60% of the ticket price). (Thus "Worldwide Box Office" or "WWBO") is generally about twice the theatrical receipts.);

(b) home video receipts (videos and DVD sales);

(c) non-theatrical rentals (receipts from airlines, prisons etc.);

(d) pay television receipts (receipts from television providers who charged their customers to view);

(e) free television rentals (rentals paid to the distributor by television networks who showed the film without charge); and

[32] Mr Sills made various assumptions in this process about the comparative rates of growth of certain expenses. Save as noted these were not challenged and lay within his expertise. We accept them.

(f) flat sales (receipts from territories where a Studio did not have a distribution branch).

less (for some Studios) a 10% distribution fee for sub-distribution territories in each case both for Domestic (that is to say North American) and rest-of-the-world territories.

1415. Thus Gross Receipts were ascertained before the deduction of distribution fees, distribution costs and the rights of the LLPs, the CD and any other parties.

1416. Mr Sills, having determined the level of Gross Receipts which would ensure that the relevant target was met, then worked out what level of theatrical receipts and so WWBO would produce the target figure. He did this by assuming that the proportionate relationship between the elements comprising Gross Receipts remained the same for differing levels of Gross Receipts. Thus, for example, if in the last distribution statement theatrical rentals were 10 and Gross Receipts 30, and if Gross Receipts of 60 were required to meet a particular target, then he calculated that theatrical rentals of 60/30 x 10 = 20 would be required to meet that target.

1417. Mr Sills then commented on the likelihood of that level of WWBO being achieved.

1418. The logic and consistency of this particular part of Mr Sills' methodology was challenged on the following bases.

1419. First Mr Sills accepted that the income from a film generally arose in phases after theatrical release. He said that 98% of total domestic theatrical revenue would be expected to arise in the first six months after release. This component of Gross Receipts would then diminish and home-view video/DVD and pay television would assume dominance, followed later on by free television income. Thus in the early months after release Gross Receipts were generally comprised almost entirely of theatrical revenue and in later periods the accretion to Gross Receipts would be principally from other sources. As a result, 18 months or so after release, the proportion of Gross Receipts represented by theatrical rentals required to meet a target would not be in the same proportion as the proportion of theatrical rentals to Gross Receipts at the date of the last statement: incremental income (if any) was likely to come from non-theatrical sources.

1420. Second, Mr Sills accepted a rule of thumb, which was implicit in the long-term ratios he used in his consideration of the 2010 Ultimates, that in the long run the ratio of Gross Receipts to WWBO was usually about 2:1. It was therefore inconsistent with this rule to assume that the proportion which theatrical revenues represented of the Gross Receipts required to reach a particular target was the same as the proportion in the last distribution statement if those ratios were not about 2:1.

1421. We accept the theoretical validity of both these challenges. It seems to us that it is not always appropriate to assess the likelihood of the target being reached by reference to a calculation of WWBO needed to meet that target which has been made by assuming that the ratio of theatrical to other revenue remains the same as that in

the latest distribution statement. But when the distribution statement used is one in relation to a period some years after the launch of the film (as will be seen to be the case), the ratios of the amounts derived from each source are more likely to approximate to the long term ratio.

1422. In the summaries of Mr Sills' results which follow we have appended, to Mr Sills' figures for the various WWBO levels calculated by him to reach the relevant targets, one based on a 2:1 ratio of Gross Receipts to WWBO, as a comparator. It will be seen that because in fact Mr Sills generally started with a statement several years after the release of the film there is often little material difference between the two measures.

1423. Mr Sills was asked to report on at what point (what level of income):

(a) the LLP's net entitlement (its entitlement under the waterfall net of any loan payments) would be equal to the film's net budget (the total budget of the film less the amount of the loan to the CM).

In other words if the LLP were regarded as agreeing to a joint venture with the CD to make the film together, and from which the LLP would receive only the amounts actually receivable by it under the combined effect of all the waterfall documents, his calculations determined when the LLP would make a profit from that joint venture;

(b) when the sum of what the LLP would be entitled to be paid and the amounts held back in repayment of the loan would be equal to the film's budget.

That is to say if the LLP were regarded as bearing the cost of the monies paid under the loan to the PSC together with the payment to the PSC derived from its ordinary members, and if the payments towards the loan were regarded as receipts of LLP's business, when it would be that the LLP, so regarded, would make a profit from the film; and

(c) when the CM loan would be repaid.

1424. We summarise Mr Sills' results in the following tables:

(i) When does the LLP make a joint venture profit (thus ignoring the role of the CM)?

Film	Period from release to statement used	Latest statement Gross Receipts **$m**	Gross Receipts to meet target **$m**	Sills' WWBO to meet target **$m**	WWBO to meet target on 2:1 basis **$m**	Actual WWBO at 2014[33] **$m**
Australia	5 years	250	463	391	232	211
Hot Fuzz	6 years	157	102 *achieved early 2008*	52	51	81
Avatar	3.5 years	2,062	c1,250[34] *achieved mid 2010*	c1,600 *achieved*	625 *achieved*	2,782
Happy Go Lucky	5 years	3.8	6.3	n/a	3.1	19
Wimbledon	9 years	79	176	92	88	42
Blackball	9 years	**£**1.3m	**£**5,5m	**	**	**

** This was an Independent film. The distribution statement used by Mr Sills was that from the Collection Agent. This showed gross receipts into the collection account and did not divide the receipts between box office and other receipts. Thus his estimate

[33] There was some discussion on Day 40 between Mr Milne and the tribunal as to the date on which Actual WWBO had been determined. Unfortunately the tribunal and Mr Milne were at cross-purposes. Mr Milne was considering the Ultimates calculation which was done in 2010 by reference to actual figures at that date, and analysis from that perspective by Mr Sills; the tribunal was thinking about the comparatives used in the first part of Mr Sills' report in relation to which his calculations had been made by reference to the 2014 distribution statements. The figures in the column above are taken from the 2014 distribution statements, which differ little from the 2010 figures affirming the evidence that almost all box office revenue arose in the first 6 months after release.

[34] Mr Sills' calculations divided the income and expense between the A budget and the B budget. These income streams achieved the target result at different levels of gross income. The figure in the tables is between the two. The inaccuracy does not affect the import of the figures.

was of the collected gross receipts needed to meet the relevant target and it is not possible to state the WWBO figures.

1425. Two films, *Hot Fuzz* and *Avatar*, thus achieved this target. That and the differences between actual performance and target performance measured in terms of WWBO or Gross Receipts permits (but does not require) a conclusion that it would not have been unreasonable to expect this target to have been achieved for these films at the outset.

(ii) When does the sum of the payments actually made to the LLP and the CM loan retention equal the budget?

Film	Period from release to statement used	Latest statement Gross Receipts **$m**	Gross Receipts to meet target **$m**	Sills' WWBO to meet target **$m**	WWBO to meet target on 2:1 basis **$m**	Actual WWBO at 2014 **$m**
Australia	5 years	250	673	575 (which would put it in the top 100 films of all time)	336	211
Hot Fuzz	6 years	157	133 achieved autumn 2008	68	66	81
Avatar	3.5 years	2,062	c2,150	c2,900	1,075	2,782
Happy Go Lucky	5 years	3.8	20.8	n/a	10.4	19
Wimbledon	9 years	79	217	114	108	42
Blackball	9 years	**£**1.3m	**£**5.9m	**	**	**

** see previous table

1426. Thus one film achieved the target. That and the levels of shortfall of the other films permit (but do not require) a conclusion that it would have been very optimistic when the CDA was executed to expect to meet this target for more than a small proportion of films.

(iii) At what level is the CM loan repaid?

Film	Period from release to statement used	Latest statement Gross Receipts **$m**	Gross Receipts to meet target **$m**	Sills' WWBO to meet target **$m**	WWBO to meet target on 2:1 basis **$m**	Actual WWBO at 2014 **$m**
Australia	5 years	250	1,192	1,007 *(In the top 17 films of all time)*	596	211
Hot Fuzz	6 years	157	235	120	167	81
Avatar	3.5 years	2,062	c3,000	c4,000	1,500	2,782
Happy Go Lucky	5 years	3.8	10.2??	n/a	5.1???	19
Wimbledon	9 years	79	259	135	129	42
Blackball	9 years	**£**1.3m	**£**6m	**	**	**

** see first table

1427. These results permit a conclusion that with the possible exception of *Avatar* (for which only 3 ½ years actual figures were available) it would have been unreasonable to expect that the CM loan would have been repaid for most films.

1428. We were not certain that Mr Sills had taken account of the Avatar Hedge in his calculations. The effect of the Hedge (see the Funding Side Letter referred to in section 4 of Chapter IV) was that IFP2 was to be treated as having allocated all of the additional funds to *Avatar* but its income entitlement would be as if it had contributed a lesser amount to that film and greater amounts to *Die Hard 4* and *Life of Pi*. Thus a fair determination of the level of performance at which *Avatar* would meet the hurdles

considered by Mr Sills would involve comparison of the income received with a cost reduced to reflect the income allocation in the Hedge.

1429. We asked the parties about this and they kindly provided formal replies. The Appellant replied that Mr Sills had correctly taken the cost of *Avatar* from the Deed of Termination Release and Amendment under which the new budget for *Avatar* was set so that there was no need for adjustment. HMRC said that there was no need for any adjustment. Our concern remained that it was the effect of the Funding Side Letter rather than the Deed of Termination etc. which affected the fairness of the relevant comparison, and that, were we correct, *Avatar* would have met Mr Sills' targets sooner, but given the parties' unanimity on this issue we make no further findings in relation to it.

Commentary

1430. In section 13 of Chapter VIII we consider whether the LLPs could be regarded as conducting a business with a view to a profit if profit is determined on a 30:30 or joint venture basis. In Chapter XI we suggest that each arrangement for the production and exploitation of a film could be regarded as a form of joint-venture or partnership between the LLP and CD under which the LLP provided 30% (35%) of the funds and the CD 70% (65%). We also consider whether such ventures could be said to have been conducted with a view to profit.

1431. The figures produced by Mr Sills for joint venture profitability cannot prove that such joint ventures were conducted with a view to profit or indicate that the LLPs' businesses were conducted with a view to profit determined on a 30:30 basis, but they indicate that a conclusion that they were is not vitiated by later experience: had the necessary Gross Receipts for joint venture profitability been greater than actual receipts by a large margin in every case it would have suggested that there would have been something wrong in any reasoning which led to a conclusion that such joint ventures were conducted with a view to profit.

1432. The levels of Gross Receipts necessary for the LLP's direct receipts together with the CM loan repayment to exceed the films' budgets are significantly larger than the levels necessary to provide a 30:30 or joint venture profit. To our minds they do not indicate that it would have been fanciful to expect one of the films to deliver such a result, but indicate that only a real optimist would have hoped for more than one of the films to deliver such a result.

1433. The levels of Gross Receipts necessary to enable repayment of the CM loan support the conclusion in Chapter III section 3; The 'Tap' that no one really cared about the repayment of the CM loan; the CD was happy so long as it got its share of the Gross Receipts – it did not matter commercially whether its receipts were called participation or loan repayment or commission. It did not matter whether the loan was likely to be repaid. Mr Sills' figures indicate that a conclusion that it was thought *ab initio* unlikely that the CM loan would be repaid is not an unreasonable view.

(b) Mr Sills' Commentary on Certain Aspects of the Commercial Relationship

1434. Mr Sills noted:

(a) that the CDAs provide no revenue from merchandising or music associated with the film. He noted that for some films (*Star Wars*, *Saturday Night Fever*) substantial revenues had arisen from these sources and that generally he would expect a film investor to acquire an interest in rights of that nature. He accepted, however, that not all films gave rise to substantial income from these sources, and that this would be a matter for negotiation between the parties;

(b) that in the calculation of P&A Fox added a 10% charge for overheads. At least one investor he knew did not bear such a charge. He thought that there was a significant profit margin built into the overhead charge;

(c) that there was no cap on the costs deducted for checking, collection and trade dues in the Fox/*Australia* CDA. He said that such amounts are often subject to caps in such agreements. But he agreed again that this would be a matter for negotiation between the parties;

(d) that the agreements with Universal provided for a completion guarantee to be given by a Universal subsidiary and for Universal to guarantee its subsidiary's performance in return for a fee. He said that in normal circumstances when Universal was co-financing its own films no completion guarantee was used and Universal financed any overages. Mr Sills did not, however, suggest that the fee charged was not at arm's-length.

1435. We accept Mr Sills' evidence of these matters.

1436. Mr Sills noted that, one way or another, for each level of GDI Fox took 70% of GDI (or otherwise (ITP and *Avatar*) in the ratios of their respective fundraising for the films) and Universal took 70% up to the time of CM loan repayment (an event we accept was unlikely whether viewed prospectively or with hindsight).

1437. Mr Sills figures show starkly the proportion of the budget for a film which represented monies going directly to the CD or Ingenious and not towards the making of the film. *Australia*'s direct cost budget was $128 million; the addition of contingency, guarantee fee, overhead and Ingenious' fee took that to $171 million, an increase of some 33%.

1438. Mr Sills noted that the PSC was often an associate of the Studio.

(c) Mr Sills Review of the 2010 Ultimates

1439. Mr Sills considered the 2010 Ultimates for *Avatar*, *Australia* and *Hot Fuzz*. There was to this extent a direct overlap between some of his evidence and that of Mr Briggs.

1440. In outline Mr Sills adopted the following methodology. He estimated ultimate income of each type by applying to Domestic or International net Box Office a

fraction, and generally treating expenses as increasing *pro rata* to the relevant additional income. The relevant fractions were taken from the range of those he had observed in practice over the period he had worked in this area. In some cases he applied a cap to a particular expense or income – thus he treated the free TV income from *Avatar* as being subject to a cap of $30m rather than as being 30% of Domestic Box Office. We accept that the fractions he presented are generally observed and his reasoning for applying a cap or other adjustment.

1441. These calculations led Mr Sills to his conclusion that, adopting the end of each range most favourable to Ingenious, the Ultimates for *Australia* and *Hot Fuzz* were reasonable. Mr Briggs considered the Ultimates as a whole including those films but excluding *Avatar* and opined that taken as a whole they were reasonable.

1442. However Mr Sills regarded the Ingenious Ultimate for *Avatar* based on gross receipts of $8,367m as excessive. On the favourable basis of his calculations his projection was based on gross receipts of $3,959m. Although he accepted that it was a blockbuster and therefore its figures would lie outside the normal range of films, he nevertheless thought that in particular Ingenious' estimate of $3.38bn for home video income included within the total was unreasonable: he had never seen a film make even $1bn from that source worldwide.

1443. Mr Briggs excluded *Avatar* from his opinion on the 2010 Ultimates as a whole because of its unique success and qualities. Its WWBO was 50% higher than the previous second highest grossing film of all time, and that box office performance and the opportunity for sequels meant that there was a possibility that it might continue to earn after the normal 30 year horizon after which almost all films stopped earning. This meant that it fell outside the data for comparable films and he could not opine on the reasonableness of the Ultimate, but it was a unique film and might not conform to the industry norms.

1444. In their joint report Mr Sills and Mr Briggs discuss the proper figure for "second-cycle receipts" in the *Avatar* 2010 Ultimate. This is TV and flat sales revenue which arises after the first distribution cycle (which ends after the expiry of the initial syndication licence). There was some uncertainty as to whether Ingenious' calculations took account of distribution fees and expenses on this income. Mr Sills had assumed it did not; if this was wrong Mr Sills would have calculated an Ultimate which was $216m greater. Some small adjustment would also be required to the *Australia* and *Hot Fuzz* Ultimates.

1445. In our view, Mr Briggs' and Mr Sills' evidence shows that it was possible but really unlikely that the Ultimate for *Avatar* should be based on gross receipts of $8,367m, and that it was reasonable to hold the view that *Avatar*'s ultimate would be gross receipts of about $4bn.

1446. In their joint report Mr Sills and Mr Briggs note that if the *Avatar* Ultimate calculated by Mr Sills were applied to the Waterfall, the LLP would receive a total amount which exceeded *Avatar*'s budget. We also note that with Ultimate revenue of $4bn the CM loans for *Avatar* would have been repaid (see third table above).

APPENDIX 3

MR BRIGGS' EVIDENCE

1447. Mr Briggs co-founded the Salter Group in 2003. That group is widely recognised as having particular expertise in relation to valuation in the entertainment industry. The group was acquired by FTI Consulting Inc in 2012 and Mr Briggs leads the Valuation and Financial Advisory Service practice in FTI. We accept that Mr Briggs has extensive experience of forecasting and valuation in the film industry and of the financial results and structures in that industry.

1448. Mr Briggs gave his opinions on a number of questions put to him by the Appellants. The first group of these questions asked him to consider what revenues would have arisen to the LLPs from *Australia*, *Life of Pi*, *Avatar*, *Wimbledon*, *Hot Fuzz*, *Stardust* and *The Golden Compass* (the "Sample Films") if each of them had performed at the box office as well as the average of a group of "Benchmark Films" (chosen in relation to each Sample Film by the Appellants). Mr Briggs was also asked to consider as part of this question whether the chosen group of films was "comparable" with the corresponding Sample Film.

1449. The second group of questions related to the 2010 HMRC Ultimates. Mr Briggs was asked to opine on whether, taken as a whole, they were reasonable.

1450. The last group of questions related to IFP2's proposal to acquire a film library: Mr Briggs was asked whether the library would generate a 12% return.

<u>(1) Comparable Films and Ultimates for the Sample Films.</u>

1451. For each Sample Film Mr Briggs had been given a set of one or more other films (the "Benchmark films") which had been released before the LLP committed to the Sample Film. He was asked:

(a) whether each set of Benchmark films, taken as a whole, was comparable with the related Sample Film;

(b) to derive an average (a mean) for NABO and IBO, and thus WWBO, of the set of films. This mean was termed the "Benchmark Box Office" of the Benchmark films;

(c) to develop a lifetime Ultimate (on the Ingenious basis of calculating profit) for each Sample Film on the basis that it achieved the Benchmark Box Office; and

(d) to develop a lifetime Ultimate for *Wimbledon* on the basis that it achieved the same WWBO as *Notting Hill*. (*Wimbledon* was included in the Sample Films so Mr Briggs produced an Ultimate for it on the basis of the given Benchmark films, but he also provided, in answer to this request, a separate Ultimate for *Wimbledon* on the basis that it performed as well as *Notting Hill* at the box office.)

1452. In addition Mr Briggs answered a number of subsidiary questions which were dependent upon his work in answering the main questions listed above.

1453. Mr Briggs was at pains to point out that he was not opining on the likelihood of the results he obtained.

1454. There was little challenge to the way Mr Briggs had gone about the mechanics of the calculations required for (b) to (d) above. The calculation of Benchmark Box office was an arithmetical exercise drawing on published information. The production of the lifetime Ultimate involved considerably more expertise and experience.

1455. HMRC's challenge to Mr Briggs' opinions focused on the first question: if the set of Benchmark films represented optimistic outcomes what did the Ultimate represent? We shall return to that later, but we should first say a little about the mechanics of Mr Briggs' answers to questions (b) to (d).

1456. Question (b) required an arithmetical exercise drawing on published information for the Benchmark films. We accept Mr Briggs' conclusions as to the relevant Benchmark box office amounts.

1457. Mr Briggs' approach to question (c) consisted of estimating the various elements of income and expense from the Benchmark Box Office by the application to those figures of fractions, or ratios, drawn from Mr Briggs' extensive experience and the data held by FTI, and the insertion of the results into the waterfall for each film to calculate the total income which, over its life, would accrue to the LLP from the film on this basis.

1458. We need to provide a truncated guide to Mr Briggs' methodology to assist in the understanding of our later comments on his review of the 2010 HMRC Ultimates.

1459. Each waterfall had been provided to Mr Briggs in the form of a spreadsheet. He inserted into the spreadsheet the elements of income and expense drawn from the fractions he had applied to the Benchmark Box Office. There was no challenge to the operations of spreadsheets. We sampled a few of the calculations and found they corresponded to the provisions of the relevant CDA.

1460. Mr Briggs estimated income and expenses from the Benchmark Box Office figure in two parts. The first part was for the period of 10 years from the Sample Film's release (the "first cycle"), and the second part, the "second cycle" was for the remainder of the film's life.

1461. In his calculation of the elements of first-cycle income and expense Mr Briggs divided income into North American and International gross box office (NABO and IBO), and within each area into theatrical (NAT and IT), home video including DVD (NAHV and IHV), free television rentals (NAFT and IFT), pay television rentals (NAPTV and IPTV) and other (NAO and IO). He derived NAT, NAHV, NAFTV, NAPTV and NAO from NABO so that, for example, for the *Life of Pi* he estimated NAT/NABO as 50%, and NAFTV/NABO as 12.5%; and likewise for international income estimating IFTV/IPO as 15%.

1462. In the same way first-cycle expenses, likewise divided between North America and International, were subdivided into P&A, home video costs and other costs, together with residuals and participations. Each of these was estimated as a fraction of the related income. Thus, for example, for *Life of Pi*, the ratio North American home video to costs ("NAHVC")/NAHV was taken as 30%.

1463. In this way each first-cycle income and expense element was calculated as a percentage of either NABO or IBO – so that, for example, for the *Life of Pi*, NAHVC was 30% of NAHV, which was 30% x (80% x NABO) = 24% x NABO.

1464. The fractions or ratios selected by Mr Briggs were not the same for each Sample Film. Thus he selected a NAHV/NABO ratio of 72.5% for *Australia*, 80% for *Wimbledon* and 105% for *Hot Fuzz*. Mr Briggs explained that in his experience this particular ratio tended to reduce as NABO increased:

$m	Benchmark NABO	NAHV/NABO ratio used
Hot Fuzz	$70m	105%
Wimbledon	$98m	80%
Stardust	$226m	72.5%
Australia	$252m	72.5%
The Golden Compass	$287m	72.5%

1465. For the separate "*Wimbledon* on the basis of *Notting Hill*" Ultimate, Mr Briggs was asked to use the actual P&A costs plus 20% (and 5% for participations), rather than those he would have calculated using his ratios.

1466. Mr Briggs then calculated second-cycle revenues and expenses as fractions of first-cycle revenue and expenses.

1467. We accept Mr Briggs' expertise and experience in relation to the selection of appropriate ratios to be used in these calculations and the accuracy of his calculations. We have also accepted that the spreadsheets he used for the waterfalls reflected the mechanism of the CDA (calculated on the Ingenious basis). We should say that whilst we accept Mr Briggs' ratio for second-cycle revenues we have real doubts about the likelihood of such revenues arising.

1468. As a result we conclude from this part of his evidence that it would not have been unreasonable at the time the LLPs committed to the films to expect or hope that, if a film achieved the box office success of its Benchmark and earned second-cycle revenues, the Ultimate aggregate partnership receipts (including the payments in respect of the CM loan) and the LLP's profits would have been (as calculated by Mr Briggs):

$m	Ultimate Aggregate Receipts	LLP Profit/loss for the film
Hot Fuzz	$48m	$26m
Wimbledon (Benchmark) *Wimbledon* (*Notting Hill*)	$70m $100m	$22m $52m
Stardust	$176m	$73m
Australia	$215m	$44m
The Golden Compass	$244m	$17m
Life of Pi (Initial) *Life of Pi* (Additional) *Life of Pi* (Aggregate at later date)	$123m $28m $116m	$55m $3m $23m

1469. Mr Briggs' instructions asked him to carry out two separate calculations for the *Life of Pi*. IFP2 had made two contributions to this film, the first under a CDA of 31 March 2006 (acquiring an additional participation right on 5 April 2007 under the Avatar Hedge), and the second on 29 April 2010. Mr Briggs was asked to treat these commitments as if they were commitments to two separate films with separate budgets and separate sets of Benchmark Films.

1470. Mr Briggs calculated that the further entitlement arising from the Avatar Hedge would have been $5.7 million.

1471. We find that Mr Briggs' calculation for the *Life of Pi* shows that if it performed at the Benchmark level and earned second-cycle revenues it would not have been unreasonable to expect or hope at the time of both the initial commitment and the additional commitment that IFP2's aggregate receipts (including the amounts in respect of the CM loan) and profit would have been as Mr Briggs calculated.

1472. We have said that Mr Briggs prepared two Ultimates for *Wimbledon*: the one on the basis of a set of Benchmark Films and the other on the basis that its box office takings were matched by those of *Notting Hill*. We also noted that in the *Notting Hill* calculation Mr Briggs had been asked to eschew his recourse to fractions for P&A and to use actual costs +20%. The effect of so doing was to reduce the expenses which Mr Briggs would have estimated using his fractions by some $88 million. We accept that whilst P&A costs generally increase with the box office the relationship may not be

linear so that the proportion of box office they represent reduces as box office returns increase.

Second-cycle Revenues

1473. We have explained that Mr Briggs made his calculations in two parts. In the first part he calculated first-cycle revenues and expenses, that is to say those which arose in the first 10 years after the film's release. In the second part he calculated second-cycle revenues and expenses, being those which arose after the first 10 years. Second-cycle revenues could in the case of some films (the *Sound of Music* or *Gone with the Wind*) last for many years after the initial 10 year period, but for most films second-cycle revenues were very much less important than those of the first 10 years.

1474. In his calculations Mr Briggs estimated second-cycle North American and International receipts as a fraction of first-cycle North American and International receipts. In each case he estimated second-cycle revenue at 30% of the first cycle. He estimated second-cycle costs as a fraction of second-cycle receipts (27.5% in the case of North America and 20% for International).

1475. In relation to the estimation of second-cycle revenue Mr Briggs said, when he was speaking about the COC ratio (see below) that it excluded income and expense beyond year 10 because that "tends to be a bit more subjective", and also that it was "far more complex to estimate subsequent cycle performance because your historical information ... would be films that are 10 or 11 plus years old".

1476. Mr Gammie demonstrated that for *Australia*, if Mr Briggs' second-cycle net revenues were excluded from the Ultimate, the film was loss-making for the LLP on Mr Briggs' calculation method. We found the same to be the case for *The Golden Compass* and *Stardust*.

1477. Both Mr Sills and Mr Briggs, however, regarded it as possible that, given *Avatar*'s exceptional performance, it might generate value even 30 years after release. It was a unique film and did not conform to industry norms.

1478. The uncertainty and subjectivity of second-cycle revenues acknowledged by Mr Briggs leads us to the conclusion that even if the Sample Films were to perform as their respective Benchmarks, there was considerable uncertainty as to whether they would or would not be profitable on the Ingenious basis. That uncertainty was reflected in the Information Memorandum statement that most income was generally received in the first 5 years and in the 5 year horizon in the Information Memorandum illustration.

1479. In our judgment, even assuming that the Sample Films performed in line with the Benchmark Films, the prospect of significant income arising during a second cycle was too remote to be taken into consideration in determining what was realistically possible or could realistically be hoped for.

Comparability

1480. The Benchmark Films were not selected by Mr Briggs but by Ingenious. In the case of *Avatar*, only one Benchmark Film was supplied to Mr Briggs; that was *Titanic*.

1481. Mr Briggs opined that each set of films was as a whole "comparable" with the selected film. Mr Briggs reached this conclusion by considering in relation to each relevant film:

(a) its genre: romance adventure, horror, comedy etc.;

(b) its production budget – as an indication of the quality of the film – talent, effects and editing;

(c) its rating (PG etc.);

(d) its release year; and

(e) its key talent.

1482. Mr Briggs produced at our request a report in which he considered whether the addition of one or more of certain other suggested films would improve the comparability of the pool. In that report he set out the arguments for and against the inclusion in the pool of each suggested film. His conclusions were not dependent on the number of arguments on each side but on his overall assessment of whether the comparability of the pool would be improved.

1483. In that later report Mr Briggs also had recourse to consideration of whether the distributor was a Studio or an independent entity. He also viewed clips of the suggested comparable films.

1484. In Mr Briggs' opinion, which we accept, each of the factors would influence the commercial success of the film.

1485. Mr Briggs compared these factors for the related Benchmark Films with those of the related Sample Films. He concluded that, taken as a whole, the Benchmark Films were comparable with the respective Sample Films. He told us that this exercise did not require each of the Benchmark Films to share all the qualities of the related Sample Film: the fact that one film in a pool did not share a particular quality did not make the pool as a whole not comparable.

1486. There was, perhaps, a degree of conflict between Mr Briggs' initial assessment of the Benchmark pools and his approach to adding additional films to the pools. For example, in the Benchmark pool for *Australia*, which had a budget of $171m, were films with budgets of $19m and $48m, but this did not prevent him concluding that the Benchmark pool, as a whole, was comparable with *Australia*. But when considering whether to add other films to that pool he leant against adding films with a budget of $50m because it would lower the mean budget of the pool films.

1487. Mr Briggs explained that, in assessing whether a pool of films was "comparable" with a particular film, the goal or object of the comparison was relevant. If the object was to show that the film was "capable of being financially successful" you would, he said, "identify historically produced and relevant films that share common elements with the film you are investing in or assessing and gain comfort that those films represent a reasonable basis for projecting the success of ... the individual film you are assessing". "Another goal: ... might be reflecting a ... disaster type scenario for a film ... any projection that has an underlying rationale that may vary significantly depending on the goals of the investor". He gave an example of a bank (a conservative investor) asking "how bad can it get?" and distinguished it from an equity investor who was interested in the potential upside.

1488. Mr Briggs told Mr Stafford that as a general matter of practice for investors in the States it was always useful to identify some historic precedent in terms of assessing future returns. Many factors came into play but "at its core if you are asked to make a $200 million investment and you can't get comfortable that it has some genuine possibility of success, it would be hard to support". Thus from a broad pool of comparable films one might select those that had been financially successful if one wanted to know whether the structure of your investment had a genuine possibility of providing a return. "What level of box office would the films generate if they found their audience and if they were generally successful, and can the films we are investing in be reasonably compared to those: is it a fair comparison?"

1489. The exercise Mr Briggs performed was not, however, as simple as saying "were there films which were successful which were comparable with the Sample Films?" because what he did was to determine what the return to the LLP would have been if the Sample Films had been as successful as the Benchmark. The structure of the deal – the extent to which monies percolated to the LLP – could possibly have meant that even if a Sample Film had performed at the Benchmark the LLP might not have made a profit.

1490. Thus Mr Briggs' evidence is relevant in relation to this question: given the structure of the CDA, was it reasonable to regard it as *possible* that the Sample Film would be profitable? If a film performed as successful films of the same type had performed, would such a level of performance give rise to a profit for the LLP? It does not address what the probability is that the film would so perform other than through the determination of comparability.

1491. But the difficulty is: what makes the film of the same type or "comparable"? How great must similarities be for there to be a reason for hope? How "comparable" was *Avatar* with *Titanic*?

1492. Mr Briggs' supplemental report in relation to *Hot Fuzz* and *Australia*, on whether the comparability of the Benchmark pool for those films could be improved by the addition of one or more films on a list volunteered by HMRC and his cross-examination gave us some insight into the process by which he addressed comparability.

1493. The effect of adding to the relevant pool the films which Mr Briggs considered would improve its comparability was to reduce the Ultimate profit projected on each of the two films: by 43% in the case of *Australia* – from $44m to $25m, and in the case of *Hot Fuzz* by 10% from $26m to $24m.

1494. That suggests to us that the conclusion which may be drawn from Mr Briggs' calculations is that there was in relation to each Sample Film a pool of other films which had, as a whole, characteristics relevant to their economic success in common with the Sample Films and that if the Sample Films performed in line with those Benchmark Films they would be profitable, but there might also be other pools of films which also shared as a whole such characteristics whose performance indicates that the Sample Films would not have been so profitable or profitable at all. In other words Mr Briggs' calculations show that the result is possible but shed little light on the magnitude of the possibility.

1495. Although the factors Mr Briggs took into account in his assessment included objective factors such as the distributor, the budget, and the talent, the exercise Mr Briggs undertook was principally a subjective assessment on the basis of his experience. The evidence we received would not enable us to replicate the exercise in relation to other films.

1496. We tend to the view therefore that, given Mr Briggs' experience and expertise, his exercise shows that a person receiving a report from him at the time of committing to a film would not be unreasonable if he hoped to make the profit predicted by the exercise. But that is not the same as saying that a person who had not had the benefit of that advice at the time of committing could reasonably come to the same conclusion. If you are told you have a particular cancer you may hope for a cure; if you are told by an oncologist that 70% of those with that cancer are cured, you will have reason for hoping that you will be cured.

1497. There is one further point to be made. Mr Gammie drew Mr Briggs' attention to the Box Office Mojo tables of the worldwide gross box office (WWBO) of films in the years 2003 to 2010. The Benchmark worldwide box office figures used in Mr Briggs computations place the notional performance of the sample Films in the following places in those tables:

	Benchmark $m WWBO	Effective rank 2013	Effective rank 2006	In top 100 films of all time
Australia	712	3rd	4th	yes
Life of Pi (initial)	442	8th	7th	
Life of Pi (Additional)	757	3rd	3rd	yes
Avatar	1,843	1st	1st	yes
Wimbledon (FTI)	274	15th	9th	
Wimbledon (*Notting Hill*)	363	11th	10th	
Hot Fuzz	186	21st	25th	
Stardust	587	5th	5th	yes
The Golden Compass	744	3rd	3rd	yes

1498. Mr Briggs, as we have said, did not give an opinion on the likelihood of a Sample Film, or of all or some of the Sample Films, achieving the Benchmark performance. But this comparison with reported WWBO performance does give some feel for that issue. Given that the Benchmark Box Office in each case placed the Sample Film so high in the rankings, it seems to us that it would have been very unlikely that all, or even a majority, of the Sample Films would have achieved the Benchmark result, and accordingly, that it would have been, at the time of contracting, unreasonable to expect or hope that such would have been the case. It would therefore have been unreasonable to hope or expect that each of the Sample Films would have made the Ultimate profit calculated by Mr Briggs. That said, however, it would not have been unreasonable for a person in possession of Mr Briggs' advice to hope that one or perhaps two of the films would generate a profit at that level.

1499. Given that, for example the average budget for IFP2's first year Studio films was some £59m, and Mr Briggs' Ultimates lay between £23 and £73m, and considering our view on the likelihood of achieving that Ultimate (whilst accepting that a smaller profit or a break even also lay within the range of possible outcomes), we are unable from this evidence to say that it would have been reasonable, even if one had been in

possession of Mr Briggs' advice at the time of contracting, to hope for a net profit from an LLP's slate.

(2) The 2010 HMRC Ultimates

1500. Mr Briggs opined that the 2010 HMRC Ultimates taken as a whole but excluding *Avatar* were reasonable. He was unable to opine on *Avatar*.

1501. Mr Briggs addressed this question by considering whether the ratio of gross margin to WWBO in the 2010 Ultimates reflected industry norms. He observed that across the 13 films in the 2010 HMRC Ultimates (that is to say excluding *Avatar*) the ratio of total gross margin to WWBO was 69.7%; in his opinion the industry norm for this ratio was 66.1%. On this basis he concluded that the 2010 HMRC Ultimates were reasonable.

1502. Mr Briggs excluded *Avatar* from this conclusion because the gross margin (GM)/WWBO ratio in the 2010 HMRC Ultimates for *Avatar* was 180%, well outside the norms; but he regarded *Avatar* as exceptional although he commented in passing that the inclusion in the *Avatar* Ultimates of $5billion for home entertainment was not reasonable.

1503. We have a number of concerns about Mr Briggs' conclusion. The first is that it seems to us that he mistakes the logical consequence of the exercise he conducted. He should have concluded, not that the 2010 Ultimates were reasonable, but that they were not shown by this review to be unreasonable. This is illustrated by our second concern.

1504. The second concern is that the 2010 Ultimates are computations of income flow and not of ratios. In simple (simplistic) terms, if doubling the WWBO of a film in the 2010 Ultimates resulted in doubling the gross margin for that film, the ratio GM/WWBO would remain the same because the LLP's ultimate total income would be proportionately larger. As we have explained in relation to the first group of questions put to Mr Briggs, he estimated the elements of cost and income based on fractions of WWBO, NABO, IBO and ratios of elements derived therefrom. It is not therefore unreasonable to suppose that an increase in WWBO might come with a proportionate corresponding increase in other income and expense, and that, although the expected change in any particular element may not be of exactly the same percentage, the result may not be a gross margin which is a significantly different proportion of the increased (or decreased) WWBO. Thus the test applied did not address the magnitude of WWBO used in the 2010 HMRC Ultimates.

1505. Our third difficulty with Mr Briggs' approach related to his calculation of an industry norm for GM/WWBO. Mr Briggs did not produce this from direct data but by a calculation which started from a common observation in the film industry that first-cycle receipts divided by first-cycle costs (which include production costs) was between 1.15 and 1.18. This is he called the Cash on Cash or "COC" ratio.

1506. To get from the COC ratio to the GM/WWBO ratio Mr Briggs asked himself, for a given production cost, what level of WWBO had to be achieved (on set assumptions

as to the ratio of the elements of income to NABO, IBO and of costs to those levels of income) to give that COC ratio. This exercise resulted in figures for the elements of first-cycle income and expenses.

1507. NABO and IBO are estimated as a percentage of WWBO; each item of expense (apart from production budget) is estimated as a percentage of either NABO or IBO. Thus total income will be (say) R% of WWBO and total expense will be (say) E% of WWBO (once all the percentages are multiplied out and added up). If the production cost is B then the Cash on Cash ratio will be:

(R% x WWBO)/((E% x WWBO) +B)

And, since E, B, and R are known, the level of WWBO needed to achieve a set COC may be found; and from that the amounts of the elements of first-cycle income and expense.

1508. From the first-cycle income and expense, second-cycle income and expense is calculated using set ratios again. That gives an Ultimate for total income and total cost and results in the Ultimate gross margin. That Mr Briggs calculated as 66.1% whether the COC ratio was 1.15 or 1.18.

1509. The difficulty we have with this is the question of the sensitivity of the results to differences in the percentages set for the estimation of the components of income and expense. For example we noted that Mr Briggs had, in completing the first-cycle income and expenses elements, used percentages which were generally the same as those used in the Ultimate he developed for *Hot Fuzz* in relation to the first group of questions. For that film he used the ratio of NAHT (North American Home Video) to NABO of 105%, which was some 20% above the highest ratio used for any of the other Sample Films. A reduction in the set percentage for Home Video would mean that another income line had to be increased to obtain the same COC ratio. If that income line were NABO its increase would entail an increase in WWBO and result in a reduction in the GM/WWBO ratio. The required increase in WWBO would depend on assumptions made for the increase in P&A costs, but if it led to an increase in WWBO by 50% that would entail a reduction in the GM/WWBO ratio from 66% to 44%, which would call into question the reasonableness of the 2010 Ultimates ratio.

1510. Finally we compared the ratios inherent in the total income figures for the 13 (excluding *Avatar*) Studio 2010 Ultimates with the ratios used by Mr Briggs in his calculation of the GM/WWBO ratio:

Income element	2010 Ultimate $m	2010 % WWBO	Briggs notional Ex C-2 $m	Briggs % age WWBO
Box Office	3,060		120	
Theatrical	1,273	41%	53	44%
Home Video	1,907	62%	49	40%
TV	1,133	37%	93	77%

1511. We find it difficult in the light of this comparison – albeit of income undifferentiated by territory – to find support in Mr Briggs' standard ratios for those used in, and therefore for, the 2010 HMRC Ultimates.

1512. We conclude that Mr Briggs' evidence in relation to the 2010 HMRC Ultimates, provides little support for them.

(3) The Film Library

1513. Mr Briggs was asked to opine on whether it would be reasonable to assume that, if a film library were acquired, it would generate annual net receipts in the order of 12% of the acquisition cost, assuming that 5% of the acquisition cost was reinvested each year in acquiring new films.

1514. He answered this question by reference to a hypothetical library acquired for $100 million. He produced a cash flow model which assumed that the library initially generated cash of 22.5% of its cost and that that income decayed at the rate of 10% on a reducing balance basis. He assumed that the fresh investment would generate an overall return of 10% starting two years after the investment and reducing by 70% in the third year, 30% in the fourth year and thereafter at 10% on the reducing balance.

1515. The cash flow from this model showed an average return over the first 10 years of 12%, but an average return of 8.6% over 20 years.

1516. In Mr Briggs' opinion, derived from much expertise in advising on the acquisition of film libraries, the rate of return of 22.5% on the cost of the library, and the rate of return on the replacement stock, was in line with industry statistics.

1517. We accept Mr Briggs' evidence of the rates of return which were achievable, but there is a difference between cash yield and profit. The determination of profit must take account of depreciation. It seems to us that if depreciation were provided at 10% on a reducing balance basis, the average annual profit would be well under half the cash yield calculated by Mr Briggs. We also note Mr Briggs' evidence that a large

amount of due diligence is necessary on the acquisition of a film library and consider that that would be expensive.

APPENDIX 4

THE "TAP" CALCULATION

1518. The descriptions in this Appendix use the characterisations and sequence of events which are suggested by the Appellants – thus we use "loan" to refer to the relationship between the CM and the CD created by the Loan Agreement, and treat drawings as being allocated to the CM and then assigned to the CD. This does not mean that we accept this characterisation.

1519. This Appendix explains the calculation of the figures in the second table in section 1 of Chapter III and the conclusions which we state there. In it we explain how the relevant provisions have the monetary effects we detail in that Chapter. The effect of these provisions depends on the level of GDI – the "Stage" that GDI has reached. We call this the "tap" calculation because the provisions of the IFP waterfall taken with the Deed of Acknowledgement etc. act as a tap to siphon net after-tax income to the CM.

Stage (1): 0 < GDI < 1.65 x Budget

1520. During this stage Studio Participation is set at 15.45 % of GDI and BDR at 90% of BR. The Studio retains 30% of GDI + 15.45% of GDI. That leaves 54.55% of GDI for the LLP. That is the amount which accrues to the LLP under schedule 7. When GDI reaches 1.65 x budget, 54.55% of GDI is:

54.55% x 1.65 x budget = 90% budget

In other words this "band" relates to the period during which the LLP is treated as recovering the first 90% of the budget. The proportion retained in reduction of the CM loan at this Stage will be 90% x 50% x 54.55% = 24.55%, so the total so retained in the period is 24.55% x 1.65 x budget = 40.5% x budget.

Stage (2) 1.65 x Budget < GDI < 2.04 x Budget

1521. During this Stage Studio Participation is 34.71% of GDI and BDR is 30% of BR. The Studio retains commission of 30% plus 34.71% of GDI, a total of 64.71%, leaving 35.29% for the LLP. Thus when the level of GDI reaches 2.04 x budget the LLP's recovery under this band will be:

35.29% x (2.04 - 1.65) x budget = 13.76% x budget

1522. During this band BDR is 30% x BR so the percentage going in reduction of the CM loan is 30% x 50% x 35.29% = 5.29%. Thus at the end of this Stage the loan will have reduced by a further 5.29% x (2.04 -1.65) x budget = 2.06% x budget.

1523. Thus at the end of this band the total allocated to the LLP under schedule 7 will have been 90% (under Stage (1))+13.76% (under stage (2)) =103.7% of budget.

Stage (3) 2.04 x budget < GDI where the CM loan has not been repaid, and Stage (4) 2.04 x budget < GDI where the CM loan has been repaid

1524. In Stage (3) Studio Participation is 21.14% of GDI, and BDR is 60% of BR. In Stage (4) Studio Participation remains at 21.14% of GDI. The loan has been repaid so no deduction is made for BDR. That balance is shared 70:30::CD:LLP.

1525. Thus in these bands the Studio retains:

30% (Commission) + 27.14% (Studio Participation) = 57.14%

of each £1 of GDI leaving 42.86% for further division. Until the corporate loan is repaid schedule 7 allocates all this extra GDI to the LLP, but after it is repaid the allocation is 30:70::Studio:LLP.

1526. In Stage (3), before the CM loan is repaid, of the 42.86% of GDI attributed to the LLP under schedule 7, 50% x 60% = 30% is taken as repayment of the CM loan. This amounts to 12.86% (= 42.86 x 30%) of GDI. In total, up until the end of stage (2), an amount equal to 42.56% of the budget had been retained in the repayment of the CM loan (being 24.55% x 1.65 = 40.5% of budget at Stage (1) and 5.29% x (2.04 – 1.65) = 2.06% of budget at Stage (2)). Thus there remained a loan of 70% - 42.56% = 27.44% of budget at the end of Stage (2). Since in Stage (3) 12.86% (=60% x 50% x 42.86%) of the incremental GDI passes to the CM loan repayment, the loan would be treated as repaid when GDI reached (204% + 27.44%/12.86) x budget = 4.174 x budget.

1527. Thus the period after stage (2) divides into two:

(a) Stage (3): the period when 2.04 x budget < GDI < 4.174 x budget; and

(b) thereafter, Stage (4): the period when GDI > 4.174 x budget.

1528. These allocations must now be read with the provisions of the LLP Members' Agreement relating to the division of profits and losses and taking of drawings. It is convenient in the following description to start by assuming that a film had a budget of 112 (56% of the sum of the individual members capital of 100 and the further 100 treated as contributed by the CM) and was written down to an NRV of 20% of that budget so that a loss of 90 (= 80% x 112) had been, or was expected to have been, recognised by the LLP. The relevant detail works in the same way at other levels of write-down. The pertinent provisions of clauses 8 and 9 of the IFP2 members agreement provided (taking the particular film to have been the only activity of IFP2):

(a) for the allocation of losses to the ordinary (individual) members up to 90% of their capital contributions. Given that their capital contributions were to be 100 for every 112 invested in film production, we can take the full 90 of loss to be allocated to them ;

(b) above that for losses to be allocated to the CM up to its capital contribution;

(c) for profits to be allocated first to ordinary members up to the amount of losses allocated to them, then to the CM up to its loss allocation, and then 50:50 (unless the Operator exercised discretion under clause 9.8); and

(d) for drawings to be taken from income

50:50 :: ordinary members : CM.

1529. Initially therefore the loss of 90 is allocated to the ordinary members. Then income starts to flow from the film:

Stage (1): 0 < GDI < 1.65 x budget

1530. By the time the top of this band is reached (when GDI = 1.65 x budget) IFP2 will have been expected to account for a right to receive 90% of the budget i.e. 90. At that level it is likely that it would have treated the previous loss as reversed. A profit of 90 would thus be recognised. It is allocated in full to the ordinary members to absorb the loss previously allocated to them. They are entitled to drawings of half of 90 i.e. 45 which enables them to pay their tax and to retain a small margin.

1531. Drawings of 45 are also allocated to the CM. But they do not all reach the CM because, in this band, 90% x 50% =45% of IFP2's notional right of 90 under schedule 7 is BDR retained in repayment of the CM loan. The CM thus receives only 5% of Remaining GDI (i.e. GDI remaining after the Studio's share) from the LLP. Thus in this band the CM is allocated no profit, pays no tax, and receives, net, 5% of Remaining GDI, which it retains.

Stage (2): 1.65 x budget < GDI < 2.04 x budget

1532. In this band 90% of budget has already become part of the LLP's notional schedule 7 accrual. At the top of the band its aggregate notional schedule 7 accrual will be 103.76% x budget (being allocated 13.76% of budget under this Stage plus 90% of budget under Stage (1)).

1533. By the time the top of this band is reached the LLP will have accrued an additional notional schedule 7 entitlement to 13.76% of budget. So it is generally likely that in this period the LLP will recognise an overall profit on the film of (at least) 13.76% of budget. There are now several possibilities:

(1) the write down of the film exceeded 80% and was to 10% of budget (i.e. to 11.2).

In that case the excess loss of 11.2 will have been allocated to the CM[35]. Once income flows in, the loss is reversed; initially the profit is allocated to individuals up to 90 (see Stage (1)) and then it is allocated to the CM. Thus there could be a profit of 11.2 to be allocated to the CM. The CM will be liable

[35] Although the Members' Agreement provided that losses would be allocated first to the individual members up to 90% of their capital contributions and then to the CM up to 90% of its contribution, the limitation on the use of IFP2's funds in film 'production' to 56% of the capital raised meant that the loss allocated to the CM would be no more than 22% of its notional capital. Take the individual members' capital as 100. Then total capital is 200. 56% of that is spent on films, i.e. 112. Those films are written down to zero. The loss to be allocated would be 112. 90 of that is allocated to the individuals and so 22 is allocated to the CM. Thus the maximum loss from film production which can be allocated to the CM is 22. Hence the uneven allocation of losses.

to corporation tax on that profit at say 30%. Thus for each 10 of income in this Stage the CM will suffer 3 of corporation tax.

Drawings, however, remain allocated 50:50. Thus notionally 50% of the incoming income is allocated to the CM. Of that, 30% is retained in repayment of the CM loan, leaving available funds for the CM of 35%. Thus after the tax bill of 30% the CM retains net of tax 5% of notional LLP schedule 7 entitlement arising.

(To the extent that the additional income exceeds the excess of the write down over 80% the position will be on the following principles.)

(2) The write down on the film did not exceed 80%.

In that case no loss will have been allocated to the CM. Once the loss is reversed and the individual members have caught up, the profit will be allocated 50:50 between the CM and the ordinary members. The CM will pay corporation tax at 30% on the allocated profit.

For each incremental 100 of LLP notional schedule 7 entitlement in this Stage, the CM is notionally allocated drawings of 50. 30% of that is retained in repayment of the loan leaving 35. It pays corporation tax of 30% x 50 = 15 and retains 20 net of tax.

For each 100 of schedule 7 notional entitlement the ordinary members have a profit of 50 allocated to them. The ordinary members receive cash of 50 to pay the tax on the profits and make a small net turn.

(3) The write down exceeds 90% but is less than 100%. In this case the results are a mixture of those in cases (1) and (2).

1534. Thus in this Stage the CM retains a net accessible profit of at least 5% of the notional schedule 7 LLP entitlement.

<u>Stage (3): 2.04 x budget < GDI < 4.175 x budget.</u>

1535. This is the period before the repayment of the CM loan. In this period the Studio receives 30% + 27.14% = 57.14% of GDI leaving 42.86% of GDI for the LLP.

1536. The LLP expects to recognise each pound of such GDI as profit and allocates that profit 50:50 between the corporate and the ordinary members. The drawings are allocated similarly.

1537. For each such 100 profits the ordinary members are allocated 50, and have 50 of cash to pay their tax.

1538. The CM is also allocated 50 of profit. The notional drawings entitlement of the CM is 50, but BDR of 60% x 50% = 30% of the LLP's schedule 7 accrual of 100 is subsumed in the repayment of the CM loan, leaving 20, which passes to the LLP and on to the CM.

1539. The CM is not obliged to use this sum repaying the CM loan. It pays tax, at say 30%, on its profit allocation of 50, i.e. 15, and retains free and clear of any obligations 20 - 15 = 5.

Stage (4): GDI < 4.175 x budget

1540. In this band the CM loan has been repaid and after the Studio's 30% and 27.14%, the receipts are divided 30:70 between the LLP and Studio.

1541. Any such receipts will be profit to the LLP. The profits will be divided 50:50 between the ordinary members and the CM.

1542. For each 50 of profit allocated to the ordinary members 50 of cash will flow: giving them a profit after tax.

1543. For each 50 of profit allocated to the CM 50 of cash will flow to the CM. The CM will pay tax at 30% and retains 35. (This result is different from what Mr Bower might be taken to have suggested in an exchange with the tribunal, but it was not clear that this Stage was being addressed in the particular part in the discussion.)

APPENDIX 5

THE AVATAR HEDGE

1544. This Appendix contains a review of Mr Bower's calculations in relation to the Avatar Hedge, and his conclusions as to the income foregone by IFP2 as a result of it.

1545. Calculation of Income Lost to 30 April 2013

1546. The income lost as a result of the Hedge is:

(a) the income lost from *Avatar*

(b) less the income gained from *Die Hard 4*

(c) less the income gained from *Life of Pi*

Part A: The Income Lost from *Avatar*

1547. Step A1: Calculate what the shortfall percentage would have been without the Hedge:

IFP2 provided: £84m + £65m	= £149m
Total budget was:	= £182m
So shortfall	= £33m (or about 18%)
Budget B was	£98m (of which IFP2 paid to £92.59)
So shortfall percentage = 33/92.59	= 35.63% of Budget B.

But IFP provided £5.3m, so part of shortfall is taken up by that, leaving a percentage of (33-5.3)/92.59 = 29.91%. Mr Bower used 29.66%, which is not significantly different. We shall use 29.66% therefore.

1548. Step A2: Calculate the shortfall percentage actually applicable to Budget B:

1549. Clause 4.1 of the Funding Side Letter deems IFP2 to have paid 54.58% of the additional funding towards the *Avatar* B budget. The additional funding was up to £92m, but IFP2 supplied £65m. 54.58% of £65m is £35.5m, which is some 38% of Budget B. So the Shortfall would be about 62%.

1550. Mr Bower's calculations use the Shortfall percentage in the statements from Fox. That is 61.61%.

1551. Step A3: Calculate the part of the income actually received by IFP2 which represents B income:

1552. Actual *Avatar* income recognised to 30 April 2013 = £129,290k (taken from Neil Forster's evidence).

1553. The Funding Side Letter provides that:

A income derives from 49.17% of Receipts,

B income derives from 50.83% of Receipts.

1554. The shortfall percentage applied to B income [in the Fox Statements] was 61.61%. Thus the B income in which IFP2 was interested was:

(100 - 61.61)% x 50.83% = 19.51% of Receipts.

1555. Thus IFP's income derives from:

49.17% of Receipts (A Receipts), and

19.51% of Receipts (B Receipts).

A total of 68.68% of Receipts.

1556. So 19.51/68.68 = 28.4% of the income IFP2 actually received derives from B Receipts. [Take this, as Mr Bower did in his calculations as 29.17%.]

1557. Thus 29.17% x £129,920k = £37,885k of IFPs's actual *Avatar* income was B income (£36,426k per Mr Bower).

1558. Step A4: Calculate what B income would have been if there were no shortfall:

1559. Using the shortfall percentage of 61.61%:

Actual B income / (1 - shortfall fraction)

= 37,885/(1-61.61%) = £98,684k

1560. Step A5: Calculate IFP2's share of B income if shortfall was only 29.66% (ex Step A1):

£98,684k x (1-29.66%) = £69,414

1561. Step A6 Calculate diminution in income from *Avatar*:

Actual B income	37,885
Could have been	69,414
Loss	**31,529** (30,319 per Mr Bower)

Part B Calculate additional income received from *Die Hard 4* as a result of Hedge.

1562. Mr Bower treats Budget A for *Die Hard 4* as having been funded by the payments already made by IFP2 and the notional contributions under the Funding Side Letter as attributable only to Budget B. The result of this is that these calculations do not need to consider the effect of changing the shortfall contribution since all that is needed is to determine the income which accrued to IFP2 under Budget B since that income would not have accrued to it without the Hedge. On this basis:

1563. The (notional) *Die Hard 4* Budget B was set in the Funding Side Letter as 77.55% of the total budget. The total Budget was £90,461,773. Therefore notional Budget B was £70,153,104.

1564. Although the Funding Side Letter spoke of an additional contribution of up to £92m, Mr Bower treated the additional funding supplied as £65,129,365. By the Funding Side Letter 41.35% of this was allocated to *Die Hard 4*, that is to say £26,930,992. That represented 38.39% of Budget B (Budget A being treated as fully funded by past contributions), so the shortfall percentage was 61.61%, as shown in the Fox reports.

1565. The Funding Side Letter waterfalls for *Die Hard 4* had different levels of Studio participation for notional Budgets A and B. For A Receipts it was 15.46%; for B Receipts it was 20.24%. Thus the portion of GDI receivable by IFP2 (and the Lender) under the A schedule was reduced by 30% (Studio Commission) + 15.46% (Studio Participation) = 45.46%, and under the B schedule by 30%+20.24%=50.24%.

1566. The Funding Side Letter allocates receipts: 22.45% as A Receipts, and 77.55% as B Receipts.

1567. As regards the A receipts, the reduction of GDI by 45.46% means that the portion of the total Receipts allocated to IFP2 (including the CM loan) represents 22.45% x (100% - 45.46%) = 12.24%.

1568. The B receipts are also affected by the Shortfall percentage of 61.61%. Thus the portion of the total Receipts allocated to IFP2 under the B corridor represents:

> 77.55% (B proportion) x (100% - 61.61%) (part not subject to shortfall) x (100% - 50.24%) (part not allocated to Studio) = 14.81%.

1569. Thus the actual receipts of IFP2 represent A income and B income in the ratio 12.24 to 14.81.

1570. IFP's actual receipts from *Die Hard 4* for the period were £17,898k. Thus:

> 14.81/(12.24 +14.81) x £17,898k = £9,799k

1571. This was the amount which derived from B Receipts and thus the extra amount of *Die Hard 4* income received as a result of the Hedge.

Part C: Calculate the additional income received from *Life of Pi* as a result of the Hedge.

1572. Again, Mr Bower treated Budget A as having already been funded by IFP2 and Budget B as relating to the notional Funding under the Funding Side Letter. Thus if the income recognised from Budget B could be isolated, that would be the extra income arising from *Life of Pi* as a result of the Hedge.

1573. The accounting records showed that the only income recognised for *Life of Pi* was the debtor originally set up on the delivery of the film. The records showed that the Budget B element of this was £432k.

1574. £432k was thus the extra income which derived from *Life of Pi* under the Hedge.

5 **Part D:** Calculate the net effect of the Hedge.

1575. £31,529 (Lost income from *Avatar*) - £9,799 (extra *Die Hard 4* income) - £432k (extra *Life of Pi* income) = **£22,162k.**

APPENDIX 6

MR OLSBERG AND MR FINNEY

Mr Olsberg's Evidence

1576. Mr Olsberg had had some 32 years experience in the film industry. He had worked as, or for, a sales agent, a distributor, and a film producer. He currently works for a consulting practice providing film and media advice. We accept that he had expert experience and knowledge of the production, financing and distribution of Independent films.

1577. Mr Olsberg's evidence related to 3 Independent films. He was asked whether:

(a) at the time ITP committed to *Blackball* there was a realistic possibility that receipts into the collection account would be at least £8.3 million;

(b) at the time ITP committed to *Girl with a Pearl Earring*, there was a realistic possibility that receipts into the collection account would be at least £14 million, and

(c) at the time IFP2 committed to *Happy Go Lucky* there was a realistic possibility that receipts into the collection account would be at least £21.1 million[36].

1578. Mr Olsberg was advised by Weil, Gotshal & Manges that if such revenues were received into the relevant film's collection account the film would be profitable for the relevant partnership. Mr Olsberg was not asked, and did not comment upon, whether the threshold figure provided to him would, in accordance with the relevant waterfall, in fact give rise to a profit for the relevant LLP.

1579. We turn to Mr Finney's particular evidence later in this Decision, but Mr Finney also commented on the reasoning and conclusions of Mr Olsberg. We discuss below the criticisms made by Mr Finney.

1580. We note that Mr Olsberg was not asked whether there was a realistic possibility that all three films might achieve this level of success. There is, of course, a significant difference between the possibility that any one of three dice might come up six and that all three dice might come up six.

1581. Mr Olsberg explained that he approached the question of whether or not there was a realistic possibility by asking whether there was a level of performance of the film at which the threshold could be reached or exceeded and then whether it was a realistic possibility of that happening, that is to say, a possibility that was not fanciful.

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[36] Mr Olsberg's initial instructions in relation to *Happy Go Lucky* asked him whether there was a realistic possibility that the collection account receipts would be at least £16.7 million but, as we shall explain below, this was later revised to £21.1 million.

1582. He told us that it would be very hard to predict whether or not a film would be successful before principal photography started, but that one might be able to predict failure. In that light we understood Mr Olsberg's notion of a possibility being "realistic" as meaning that there were some grounds for thinking that it could be achieved and no grounds for predicting fairly certain failure.

1583. Mr Olsberg concluded that there was a realistic possibility in each case that the film would achieve the specified threshold, although he said that to get there "there would have to, to some degree, be breakouts". There was perhaps some circularity in what Mr Olsberg meant by "breakouts" for at one stage he suggested that breakout meant that it would perform at the threshold level, but it seems to us that he was really using the phrase to describe a film which performed at well above a median level (a level at which overages would be received).

P&A Costs

1584. Mr Olsberg was asked if he knew whether the threshold figures given to him were calculated before or after the deduction of P&A costs. He replied that he did not know.

1585. HMRC say that this is a flaw which undermines the whole of his evidence. If it meant that Mr Olsberg had not had regard to whether the threshold receipt he believed to be achievable had been an amount before or after the deduction of P&A costs, we would agree, for the later calculation of profit does not deduct such costs.

1586. But we do not understand his evidence in that way. He said that P&A costs were, in his experience, taken off before monies reached to the collection account, and the table in Appendix 1 to his report shows the same effect. Thus we took his evidence to be that there was a realistic possibility that an amount above the threshold number he had been given would be received into the account, and that that amount would have been net of the deduction of P&A costs. We understood Mr Olsberg to mean he did not know whether P&A costs had been taken off (again) in the computation which started with the collection account receipts and ended with the LLP receipts. In other words that he was denying knowledge of whether or not a particular level of collection account receipts would or would not give rise to a profit – and knowledge or opinion on that matter was not part of his evidence.

1587. Our understanding of Mr Olsberg's evidence on this issue is strengthened by his instructions, which explain in relation to each film that the gross receipts are monies due "after deduction by [the] distributors of the distribution costs and fees from the net proceeds ... from retailers".

1588. Whether or not the threshold amounts would have resulted in profitability was not something relevant to Mr Olsberg's evidence. It was not disputed that the achieving of the particular collection account thresholds for the sample films would have resulted in a profit for the LLP.

1589. Mr Olsberg told us that his estimation of collection account receipts would not have suffered a deduction of the collection account manager's fee. In assessing

whether a particular level of receipts into the collection account therefore gives rise to a profit for the LLP it would therefore be necessary to determine whether the formula reflecting the waterfall makes proper allowance for the collection account manager's fee, but the size of the that fee is not large and in our view would make no material difference to an assessment of profitability.

Mr Olsberg's Approach

1590. Mr Olsberg approached the questions he had been asked by making a qualitative, rather than quantitative, assessment of whether the film had the potential to perform "well". On the basis of that assessment he was able to conclude that there was a realistic prospect that it would meet the threshold. In making these assessments he considered:

(a) budget;

(b) the attractiveness of the film's concept and genre: whether there was an audience for the film of the relevant specification and whether that film would reach that audience;

(c) the competence and experience of the production team and acting talent and a recognition in the market;

(d) the sales estimates provided by the sales agents; and

(e) In the case of *Happy Go Lucky* he also had the IFP2 green-light committee papers.

1591. The step or mechanism by which Mr Olsberg moved from a conclusion that the film could perform well to the conclusion that it was realistically possible that it would meet the threshold was not wholly clear, for whether the threshold is reached would depend on <u>how</u> well the film would perform. It seemed to us that this was the "seat of the pants" view of an expert.

1592. Mr Olsberg did not employ quantitative techniques to any significant extent in making his judgements although in an appendix to his report he set out a range of "typical" relationships between the revenue streams and costs which made up the receipts in a collection account. This showed how these typical relationships differed with differing levels of film performance. These he described as rules of thumb.

1593. These rule of thumb ratios between the various elements were similar to those used by Mr Briggs in his evidence. Mr Briggs accepted that Mr Olsberg's ratios lay broadly within the range of his experience of Studio films, although TV revenues were "a bit low".

1594. These relationships permit the estimation of WWBO and other receipts which would typically be required to produce a given level of collection account receipts. Mr Olsberg was asked if he had, as part of his assessment of the possibility of achieving the threshold collection account receipts, predicted WWBO revenues etc. He replied that he had not grossed up from "the threshold to the various gross revenues in the various windows ... to determine [whether exceeding the threshold] did or did not

seem reasonable". Later he spoke of having "run some numbers" but it was not clear to us that he was at that stage talking about such a grossing up exercise rather than a numerical comparison of the sales agents' estimates and the threshold. However, Mr Olsberg did say that he considered the appendix and "looked at the various multiples". We believe Mr Olsberg did consider in broad terms what typical WWBO, video and TV revenues would have had to have been made in order to meet the threshold, although he made no express reference to it in his report.

1595. That approach is consistent with his evidence that there was no consistent relationship between the various elements of collection account receipts, and that no rule of thumb could be relied upon to give an accurate answer for any particular film, although it could give a guide to the ballpark performance required to meet a threshold. It was a reality check. He said that in the real world decisions about films were not made on the basis of granular predictions.

1596. HMRC criticise the qualitative nature of Mr Olsberg's evidence. They say that he gave no serious consideration to what levels of the elements of revenues his conclusions involved since he set out no calculations; instead they say he set out various bits of information about the films and, putting a finger in the air, came to the conclusion that there was no reason why the film should not have broken out and reached the threshold.

1597. Mr Olsberg's Appendix 1 provided some illustrations of revenues and costs for Independent films. He had a Best, a Middle and a Low case, for the performance of the film. From these it appeared that, if the LLP took 65% of GDI (the ITP case) then its receipts would exceed budget if WWBO was greater than 1.9 x budget (for the Best case) 2.8 x budget for the Middle case, and 4.8 x budget (for the Low case). These, however, did not appear to have informed his conclusions.

1598. It is true that Mr Olsberg set out no numerical analysis, but if he had it would have given rise to other figures for WWBO etc. to which further judgement tests would have had to have been applied, namely, was that level of WWBO etc. a realistic possibility for this particular film, and that, no doubt, would have involved consideration of the same factors that led Mr Olsberg to his original conclusions.

1599. Further, as HMRC point out, in order to work back to sales figures many other assumptions would have to be made about contractual terms and performance in differing territories. There could be different combinations of results in which the threshold would be achieved, each of which would require separate evaluation. Mr Olsberg's more global approach was based on overall feel.

1600. There would have been one further piece of information which would have arisen from a calculation based on the ratios in the Appendix. It would have been possible to compare the expected "typical" WWBO implied by the threshold with levels of WWBO achieved by other Independent films. But Mr Olsberg's Appendix 1 suggests that for such a film typically it would need WWBO of just over 2 x collection account revenues. That would suggest that the three films would have to

reach WWBO of between $17 million and $61 million, figures which did not seem obviously impossible.

1601. It seems to us therefore that the sparsity of numbers in Mr Olsberg's appraisal is not a reason for rejecting it. A finger in the air exercise carried out by someone without any experience in the film industry should be rejected, but one carried out by someone who knew this world and which was done, not to predict success, but to judge whether success was fanciful or not should not be rejected unless the basis on which he made that judgment was faulty or weak. As a result we turn to look at the way in which the factors influenced Mr Olsberg's judgement.

Sales Estimates

1602. These were estimates prepared by the relevant sales agent which showed for each territory a high (or "ask") and a low (or "take") estimate, together in two cases with a medium estimate. We accept that a sales agent would seek to make such estimates as reliable as possible and that, as Mr Olsberg said, it would be unusual for a film to be sold to a distributor for less than the low estimate. We also find that it was unusual for a film to be sold at a high estimate: as Mr Finney said, only significant break out hits exceed ask estimates (when overages are paid) and ask estimates reflected best-case hopes of what the film might be sold for in a territory.

1603. The estimates do not include the effect of overages: amounts which become payable by the distributor where sales have exceeded the amount of the estimate. Mr Olsberg did not say that overages were frequently paid but he regarded them as a possibility.

1604. The comparison between the estimates and the threshold were these:

(a) for *Blackball* the high estimate was $9 million and Mr Olsberg opined that the collection account threshold of $13 million (£8.2 million) was a realistic possibility;

(b) for *Girl with a Pearl Earring* the high estimate was $8 million (which excluded North American which had been pre-sold for $700,000 and which could give rise to overages) and Mr Olsberg opined that the collection account threshold of £14 million ($22 million) was a realistic possibility; and

(c) for *Happy Go Lucky* the high estimate was $13 million and Mr Olsberg opined that the collection account threshold of £21.1 million ($36 million) was a realistic possibility.

1605. In each case the low estimates were 75% or less of the high estimates.

1606. Mr Finney regarded the comparisons between the high estimates provided by the sales agent and the threshold as demonstrating that there was no realistic possibility that the threshold would be reached. He said that in any event the high estimates were hopes, and in practice the users of the estimates (such as banks and producers) had regard to the lower (or take) estimate only.

1607. Mr Olsberg's response is that each sales estimate is a "conservative shot" at what the value of an advance royalty might be. In effect he says they are safe guesses or indicators of mid-range performance, but give no indication of what would be received if the film "breaks out". As a result he concluded that collection account receipts of respectively 1.5, 2⅓, and 3 times the highest sales estimate were not fanciful.

1608. It seems to us that the difference between Mr Finney and Mr Olsberg on this issue lies in how unlikely something has to be before it ceases to be a realistic possibility. If it is very unlikely it could not be said to be realistically possible. How unlikely is it that a film breaks out and significant overages are received? We can accept that if a film does break out the difference between the chance of receiving say 2x the high estimate and 3x that estimate may not be much.

1609. The assessment of what is likely can only be based on experience and the past performance of other films. Both Mr Finney and Mr Olsberg had such experience, so either their experiences differed or they characterised the same experience differently – one having a different view from the other of what degree of likelihood was necessary for something to be a real possibility.

The Matters Mr Olsberg Took into Account in Reaching His Opinions

1610. In addition to his consideration of the sales estimates and budgets of films, Mr Olsberg took into account the factors summarised below. These are factors which are set out in his written opinion and which were covered in his cross-examination. We present below the factors as we find them to be, which differ in some respects from those set out in Mr Olsberg's report.

Blackball

(1) A Comedy Genre

We accept Mr Olsberg's view that this genre had the ability to create major box office hits, and that, although comedy may be dependent on language, English-speaking comedy could sell well outside English-speaking countries. But it was also the case that not all comedy would travel well.

(2) The Team

Mr Olsberg regarded Mel Smith as having a strong track record in film comedy. However, he admitted that three out of the four films he had directed prior to *Blackball* had been disappointing commercially. Only one, *Bean,* had been very successful.

The screenwriters had had a recent successful track record.

(3) The Talent

There were two well-known US actors in supporting roles: Vince Vaughn, who may have been having a bad patch in his career at the time, and James Cromwell. There were also two experienced UK actors.

The lead actor, Paul Kaye, had no record as a box office draw although he had appeared in UK TV shows (the names of which Mr Olsberg could not remember).

The co-star, Johnny Vegas, was reported in 2002 as having a rising profile.

(4) Financing

Working Title had declined the film and Mel Smith had provided some £1.9 million of the £4.83 million funding for the film. When Mr Olsberg was told this he was surprised by the figure and regarded this as a negative factor.

(5) The Presence of the Sales Company, Icon

1611. HMRC say that the plot of *Blackball* was risible. Together with Mr Finney they say that these factors, particularly that there was no big-name draw cast and a highly England-centric plot, when taken together with the fact that the sales estimates fell so far below the threshold, indicated that it was fanciful to consider that the threshold would be reached.

1612. We do not have the experience or expertise to comment on the plot. We suspect there are many successful films whose plots if written down would look weak. Neither Mr Finney nor Mr Olsberg commented on the plot.

1613. It seems to us that Mr Olsberg's grounds for thinking that the film could hit the threshold were not as strong as they had originally appeared to him, and accordingly that the possibility that the film would perform sufficiently "well" was not great.

Girl with a Pearl Earring

(1) Period Drama Genre

This was a genre with which UK producers had had some success and some failures. Such films were costly. They appealed to older audiences, which at that time were difficult to attract to the cinema. (This was a time before the success of films like *The Best Exotic Marigold Hotel*.) We accept Mr Finney's description of their performance as "very variable" at the relevant time.

(2) Based on Existing Novel

The film was based on a novel which was having significant marketplace success, and knowledge of which would inform and interest an audience.

(3) The Team

The director had TV experience but not theatrical film experience.

The individual producers had been responsible for the award-winning, but probably commercially unsuccessful, film *Hilary and Jackie*.

The heads of department had experience.

(4) The Talent

Colin Firth was an established leading man; Scarlett Johansson was a rising star.

(5) The Sales Company

Pathé International was the sales company. It was a company with a long reach and experience in Independent films.

1614. These factors appear to us to be stronger grounds for Mr Olsberg's conclusion that the film would do well and could realistically achieve the threshold. Mr Finney disagreed because the threshold exceeded the high estimate by a multiple. Overages for Independent films were, he said, rare.

1615. The logical gap between doing "well" and achieving the threshold was exemplified by the example of *Hilary and Jackie*, which was acclaimed but not a commercial success.

Happy Go Lucky

1616. Comparatively little was known about this film when IFP2 committed to it. There was no script but it was known that it would be a contemporary and broadly comedic piece directed by Mike Leigh. We accept Mr Olsberg's evidence that this may support a higher chance of success than a drama film. Mr Olsberg also noted a contemporary journal story that Mike Leigh's key crew were engaged.

1617. Mr Olsberg said that the detailed assessment of such a project may not be possible and that it presents "something of a risk". The presence of Summit as sales agent, Mike Leigh's renown, and the broadly comedic nature enabled Mr Olsberg to conclude that there was a realistic prospect that the threshold would be reached.

1618. Summit Entertainment was the sales agent and had bid against Capitol for the film. That supported a level of commercial interest in Mike Leigh's output.

1619. Mr Finney pointed to the fact that, although acclaimed critically, Mr Leigh's films had not always been commercial successes. His then most recent commercial success appeared to have been *Secrets & Lies*, and thereafter he had directed four films which had not performed to a level sufficient to recoup their budget – the last of which had been *Vera Drake* (which had been financed by ITP).

1620. Given the paucity of information about the film, the chance of its being a success seemed to be principally dependent on the possibility of a Mike Leigh film being so successful as to reach the threshold.

1621. It seems to us that the difference between Mr Finney's and Mr Olsberg's approach to what was a realistic possibility may be exemplified in their approach to the last four films made by Mike Leigh: in effect one might say that Mr Olsberg regarded a one in four chance as a realistic possibility; Mr Finney did not.

Conclusions

1622. Mr Finney did not suggest that it was impossible to achieve the thresholds; he said that the possibility that the film would do so was unrealistic. He reached this view from the perspective of an investor in the film who was seeking to recover his costs. Mr Olsberg did not say that the films would be profitable; he said that it was not fanciful that they would be. Each of them applied experience in the film industry which we do not have to reach their conclusion, and each came with a different view of what level of likelihood made a possibility realistic.

1623. Mr Finney's view was anchored in the sales estimates, which themselves are the views of others who understand the market. But we accept that, given the practice of paying overages, even the high estimates do not represent a view of what a film could achieve if it broke out. Mr Finney's perspective was that of an investor, not someone who was asked "is there a realistic possibility that this film might break out?"

1624. Two matters shed light on Mr Olsberg's mode of estimation of the probability of success. The first is that he initially opined that receipts of £16.7m were realistically possible for *Happy Go Lucky* and then, when instructed that the target figure was £21.1 gave the same opinion. However, he said that if the threshold for *Happy Go Lucky* had been $36.5 million and the high estimate $8 million he would have regarded the prospect of success as fanciful. The second is that he said that if Mel Smith had not been the director of *Bean* it would have changed his view on *Blackball*. Those statements indicated to us that there was a cap on what he regarded as a realistic possibility.

1625. We consider that Mr Olsberg's grounds for his opinion in relation to *Blackball* and *Happy Go Lucky* were weaker than his grounds for *Girl with a Pearl Earring* and that it was less likely that those two films would reach the threshold than *Girl with a Pearl Earring*, but that it was not impossible.

1626. Although, as we have said, we acknowledge that once a film jumps into the hit league there may be little difference between the probability of achieving £2X and the probability of achieving £3X, we remain perturbed by the lack of an express argument in Mr Olsberg's thinking between a film doing well and it achieving a threshold. Essentially what he says is "well, for this film, that amount is in my view a possibility". Nothing we heard caused us to doubt the application by Mr Olsberg of his expertise in reaching this view, but because in the case of two of the films our view of the facts on which he based that opinion was less rosy than that expressed in his initial report, we conclude that the possibility of a break out for *Blackball* and *Happy Go Lucky* was slight.

1627. We think it very unlikely, and therefore not realistically possible, that all three films would have achieved their thresholds.

Mr Finney's Evidence

1628. Mr Finney had been a director of Renaissance Films, a film production, finance and sales company, between 1999 and 2005. He had no earlier experience in film

production. While he was there Renaissance had provided the funding for four films, two of which it had produced, had developed a number of other films which did not make it to filming, and had received, considered and worked on proposals for many other films. Later on in that period it had become involved in the sales of films. In the course of these activities Mr Finney had become aware of the nature of the activities of other operators in the Independent film sector.

1629. Since 2005 Mr Finney had written books about the film industry, provided training to those in it, and had taught on film business courses at universities including Cambridge and Exeter. Mr Finney also managed the Film London Production Finance Market, an enterprise designed to bring together producers wishing to make films and financiers.

1630. Although Mr Finney's experience related to Independent films he had in the course of it seen the way in which Paramount had collected sets of comparable films for the preparation of Ultimates, but he had no experience in the preparation of Studio Ultimates. As a result we paid little regard to the evidence he gave in relation to such Ultimates.

1631. We accept that Mr Finney had expertise in the operation of the Independent film industry. We have accorded little if any weight to his comments on comparable films in the Ultimates prepared by Mr Briggs.

Renaissance Films

1632. We noted that during Mr Finney's time at Renaissance it had been involved in the development of films and had provided funds for the making of four films it had developed and two of which it had made. These films had not been commercially successful and Renaissance had not recovered its investment in them. The funding of the films had been green-lit by the board, and Mr Finney explained the mistakes which had been made in the company's decision-making process and in the production of the films. There had been problems with inexperienced producers, films going over budget, with films which had a good story but whose execution was disappointing. There had also been an emotional impatience to produce films.

1633. After Renaissance's available funds had been lost on these films the company was unable to fund any further productions but had a number of potential films left in the stable it had been developing. Mr Finney sought to position the company as a films sales company in relation to these and other films, but unfortunately the project was not a success.

1634. In the light of his experience Mr Finney agreed, and we accept, that the working up of an idea into a film which was ready for filming and had finance was a risky business, although some producers were better at it than others. Overall he thought that no more than 1 in 4 of Independent film projects went into production. He agreed with Mr McKenna's assessment that independent producers were faced with the difficult and time-consuming task of assembling finance and spent more time on that

activity than the actual making of the film. In Mr Finney's book, *The International Film Business – A market guide beyond Hollywood* he had said:

> "Specifically, Independent film companies operate an inherently weak business model. The independent industry's modus operandi requires them to invest in the development of film projects and pay their associated overhead costs at their own risk. The business plan will usually follow a route whereby they assume that if they can develop a sufficient level of projects that can be placed into production they can both recoup their development costs and create sufficient production fees to cover both the work in producing and delivering the film, along with sunk costs in overheads to date."

The Role of a Producer

1635. Mr Finney had been asked by HMRC to provide an account of the stages and persons involved in the making of a film, a definition of "producer", and to opine on whether, and if so how, the arrangements entered into by the LLPs departed from normal or recognised industry practice.

1636. Mr Olsberg had said that the role of a "producer" was capable of encompassing a number of activities including bringing finance to the table. Mr Finney adopted the definition of "producer" in his book:

> "A film producer is the manager of the process of creating a film. He or she is usually the first person involved in a project and the last person to follow it through to completion. The producer initiates, co-ordinates, supervises and controls such matters as fundraising, hiring key personnel and arranging for distributors. The producer is involved throughout all phases of the filmmaking process from development to completion of the project."

1637. Notwithstanding this wide definition the book differentiates between a "creative producer" and a "financial producer".

1638. The creative producer, Mr Finney says, develops relationships with actors, directors, other talent and writers: they read scripts and books and manage the development of the screenplay for a film. This was consistent with Mr Olsberg's comment that a non-financing producer was someone who put together a film: who incurred low costs and who would be paid a fee after the film was green-lit of somewhat under 10% to cover work and overhead.

1639. Mr Finney's book described a financial producer as the person responsible for bringing together the different elements of the film budget. Mr Finney told us that these two roles could be conducted by a team.

1640. Mr Finney opined that the LLPs' arrangements differed from those normal in the Independent film industry and that the LLPs did not fulfil the role of a producer. The burden of his analysis, however, was that they were not *creative* producers.

1641. That analysis was made on the basis of Mr Finney's findings of fact on the material at which he looked and his interpretation of the contracts which were given to him.

1642. Our impression, from the evidence we saw, and from *our* conclusions on the contracts we construed, was that the LLPs did not occupy the position of a *creative* producer (as Mr Finney described it) in the production of many of the films which were produced. However, given that the Appellants' case is not that the LLPs fulfilled the role of producer, but that what they did, however described, amounted to a trade carried on with a view to profit, and that no point of law turns on the exact description of their activity other than whether or not it was such a trade, we do not need to say any more about Mr Finney's analysis or to reach any conclusion on this topic.

1643. We record that Mr Finney told us that the behaviour of a bank or financier involved in a film would typically be risk management, liaison with the production accountant for the monitoring of costs, liaising with the sales agent, checking with the collection agent and things of that nature.

APPENDIX 7

RULES OF THUMB

1644. Various ratios were offered to us for the relationships between the elements of income and expense, and between them and WWBO. Those used by Mr Briggs were sophisticated and varied between the films he was considering; others offered broader rules of thumb. In this Appendix we set out some of the ratios we have used in this decision. If such ratios are used to estimate likely outcome, seemingly small variations in those used can have a material effect on the outcome as the illustration at the end of this Appendix shows.

(1) WWBO:Theatrical Receipts

1645. This is the ratio between what the public pay the cinemas and what the cinemas pay the distributor. Most witnesses agreed that the net theatrical receipts were about 50% of WWBO. Mr Sills took net Worldwide Box Office to be in the range of 45% – 60% of WWBO.

(2) Gross Receipts:WWBO

1646. Mr Reid said that as good "a ready reckoner as you would find" at the time was that Gross Receipts would be 2 x WWBO, made up of: theatrical receipts (50% of WWBO), TV (50% of WWBO) and DVD revenue (100% of WWBO). Mr Sills assented to a similar crude measure.

1647. Thus the IFP2 Information Memorandum calculations embody gross revenue of 4.3 x budget, which is (very broadly) consistent with WWBO of 2x budget and Gross receipts of 2 x WWBO.

APPENDIX 8

THE EVIDENCE OF MR DIVNICH AND MR SCHEURER

Mr Divnich's Evidence

1648. Mr Divnich had been playing video and computer games since his teens. He had been a games consultant and in 2007 joined EEDAR, the largest video games research firm. There he worked in its research and market analysis division, providing qualitative and quantitative analysis, and market forecasting. In 2014 he joined Tilting Point, which invests in the development and publishing of video games (an activity which had something in common with the activity of IG). He was on the green-lighting committee of an investment fund. We accept that he had considerable experience of, and expertise in, video games, the developers and publishers of video games, forecasting and the economics of the market.

1649. Mr Divnich had not appeared as an expert witness before and was not wholly prepared for the questions which were asked of him; nor had he included in his report the back-up information for some of his thinking and calculations. Mr Jones' cross-examination carefully and helpfully explored some of the gaps in Mr Divnich's report and illuminated Mr Divnich's reasoning. We found Mr Divnich a candid and helpful witness who gave fair and concise answers to questions and did not appear to wish to favour one party.

1650. Mr Divnich was asked to opine on whether, when IG entered into the contracts for *DiRT* and *Urban Chaos 2*, it would have been reasonable for it to have had an expectation that each game would have made a profit on the Ingenious basis, that is to say on the basis that a profit arose if the share of GDI attributed to IG under schedule 7 (ignoring the effect of the other agreements) would provide a return which exceeded the total amount required to be paid to the DSC under the DSA.

1651. Mr Divnich based his opinion on (i) his knowledge of the expectation of growth and change in the market at the relevant time, (ii) his estimation of the pedigree and experience of the publishers of the two games, Codemasters and Eidos, and (iii) the genre of the games: racing and shooter.

1652. As part of his assessment he considered: the range of gross receipts he considered possible for each game (setting out a worst, a mid, a mid-optimal and an optimal case for each game), and estimated the expenses which would be incurred in making those sales. These figures he applied to spreadsheets (which had been provided to him by the Appellants' solicitors) which calculated the profit or loss (on the Ingenious basis) which would arise to IG from the game. In a joint report with Mr Scheurer he estimated for each of the two games the number of units which would have to be sold in order for the spreadsheet to deliver a break-even result.

1653. In summary these were his results:

	Worst case	Mid case	*Breakeven*	Mid-optimal	Optimal case
Urban Chaos					
Unit Sales	228k	778k	*2m-2.5m*	2,585k	3,452k
Profit/Loss	(£7.7m)	(£5.7m)	*~>£0*	£3.2m	£7m
DiRT					
Unit Sales	258k	749k	*1.83m*	3,690k	4,954k
Profit/Loss	(£6.6m)	(£3.8m)	*~>£0*	£7.2m	£10.5m

1654. We note for later the large jump in the number of units sold between the mid and the mid-optimal cases. This arose because the figures were drawn from tables of industry comparables, and games which performed at the top of the tables broke away from the pack: many games not doing particularly well, then a group with seemingly exponentially rising results[37].

1655. Mr Divnich approached this calculation by identifying and tabulating published comparable games whose unit sales, revenues and marketing spend were known. There were some 45 games in the table of *DiRT* comparables, and about 80 for *Urban Chaos*. He ranked the comparable games by revenue and divided them into four classes: worst, mid, mid-optimal and optimal. He used the mean units sold, mean revenue and mean marketing spend of each class to power his calculations.

1656. The inclusion in these computations of a mid-optimal range is in our view somewhat misleading for it gives an initial impression that each case is distinct and perhaps therefore equally likely, but whereas the worst, mid and optimal classes each comprised one third of the total, the mid-optimal class comprised the top half of the games (and therefore included the optimal class). Thus for example the average revenue of the *DiRT* comparables was £42m but the weighted average of the mean revenues of Mr Divnich's four classes was £53m. One of the effects of the presentation of four classes rather than three was to smooth the transition between the mid and optimal classes, for the results in the top end of the table outstripped those lower down by multiples.

1657. Based on these figures and his opinion as to the pedigree and expertise of the publisher, the genre of the game, his understanding of market expectations at the time and his knowledge of the industry, Mr Divnich concluded that it would have been

[37] Termed "hockey stick profile" before us although we thought that the shape of a hockey stick did not do the curve full justice.

reasonable for IG to have an expectation of profitability from each game at the time IG committed to it.

1658. Since the matter on which Mr Divnich was asked to opine was whether IG would make a profit (on the Ingenious basis), Mr Divnich's opinion was dependent upon: (i) his estimation of the likelihood of the particular games achieving a particular level of sales, (ii) his estimation of the amount of the related expenses, and (iii), because the profit or loss was dependent upon what would accrue to IG under the schedule 7 waterfall, the computations in the spreadsheet underlying the above table.

1659. We therefore consider in turn: (i) whether the spreadsheets reflected the waterfalls in schedule 7 of the CPAs, (ii) the comparison between the nature of the amounts which under schedule 7 would determine IG's receipts and the nature of the amounts which Mr Divnich used in his calculations, and (iii) Mr Divnich's estimation of the amounts he used. We then consider the arguments relating to the likelihood of a better than break-even level of sales.

(i) The Spreadsheets

1660. Although he endeavoured to satisfy himself that the spreadsheets reflected schedule 7, Mr Divnich did not prepare the spreadsheets himself or conduct a rigorous check against the provisions of schedule 7. HMRC, however, did not challenge the operation of the spreadsheets, and we conducted a few checks which did not reveal an inconsistency with schedule 7. We conclude that the use of the spreadsheets was a proper way of determining IG's profit or loss from the relevant inputs (on the Ingenious basis).

(ii) The Nature of the Inputs

1661. The spreadsheets required the input of Gross Receipts, Distribution Costs and Marketing Expenditure.

(a) Gross Receipts

1662. Mr Divnich used an estimate of the total gross lifetime receipts ("LTD Revenues") which would be received by the publisher from the retailer.

1663. Schedule 7 to the *DiRT* CDA defines Gross Receipts to be the aggregate of (i) Electronic Receipts, which are defined to be internet service charges paid for online access to the game less certain expenses, (ii) Game Receipts, defined as all money actually received by the publisher for sales of the game less taxes, discounts and returns, (iii) Licensing Royalties, defined as royalties for licensing the game to others less costs and taxes, and (iv) Credit Insurance Receipts, defined as credit insurance receipts in respect of receivables.

1664. Whilst Mr Divnich's measure of Gross Receipts encompassed Game Receipts, it did not include Electronic Receipts and Licensing Royalties. To this extent, therefore, Mr Divnich underestimated the profit which might be derived in connection with a given level of sales.

1665. Mr Divnich told us, however, that electronic distribution was not prevalent in 2005/6 and that licensing royalties would normally account for a minimal amount of revenue. We accept this, and also think it likely that credit receipts would in effect have been taken into account in Mr Divnich's figure of gross receipts. We also accept his contention that the result of the inclusion of these items in Gross Receipts would not reduce the total: it would be unlikely that a publisher would licence a product if the taxes and expenses exceeded the payments received (and in any event we accept that only a few select titles would benefit from that type of royalty) and we do not construe schedule 7 as requiring a negative receipt to be recognised as a deduction from other income.

1666. As a result we conclude that it is unlikely that if Mr Divnich had included in his figures for Gross Receipts the elements of the schedule 7 definition which he did not take into account, the figure would have been materially different, and that in any case it would have been higher so that more revenue would have been earned and the break-even point correspondingly lower.

(b) Distribution Costs

1667. Mr Divnich's estimate of Distribution Costs was of the actual costs of manufacturing shipping and packing together with the royalty which would have had to have been paid to the relevant platform owner (thus to publish a game for a Sony PlayStation 3 some £5 per game printed had to be paid to Sony). This was estimated as a cost per unit sold.

1668. "Distribution Costs" is defined by schedule 7 to mean the actual cost of goods, (that is to say the cost of manufacturing and delivering the game including packaging etc. plus licence fees paid to platforms owners such as Microsoft, but excluding marketing costs and, by implication, the development cost of the game) plus other licence fees and royalties paid in relation to the game.

1669. It did not seem to us that there was any material difference between the nature of the distribution costs that Mr Divnich was estimating and that required by schedule 7.

(c) Marketing Costs

1670. Mr Divnich used figures for Marketing Costs which represented his estimate of "all costs to market the specified video game to consumers in the Western Markets [but excluding] retail advertising costs, costs of celebrity endorsements and any public relations costs."

1671. Schedule 7 requires the deduction in the waterfall of Distribution Costs and Marketing Expenditure and defines Marketing Expenditure as "the publisher's actual expenditure for solely marketing and distributing the game".

1672. As a result there were elements of the required deduction which would not have been included in Mr Divnich's deduction (namely retail advertising costs, costs of celebrity endorsements and any public relations costs), and as a consequence the

predicted net receipt by IG would (assuming of course the accuracy of his estimates) have been too large.

1673. Mr Divnich said that obtaining figures from which to estimate the omitted costs was difficult if not impossible. Such figures were not accessible.

1674. Mr Divnich said that celebrity endorsement was rare. *DiRT* did carry a Colin McRae endorsement, but it was more likely that Colin McCrae would be paid a royalty – an example of a celebrity endorsement was when a celebrity was engaged to drive a car in a commercial.

1675. Overall Mr Divnich believed that these items were immaterial to the overall marketing costs, Mr Jones suggested to him that these areas were outside his area of expertise because of his acknowledgement that such numbers were not accessible. Unfortunately Mr Divnich did not reply directly to this question for, while he had said that matters such as credit insurance receipts were outside his expertise, he had not expressly disavowed knowledge of the general level of these costs although he had said that figures for them were not accessible.

1676. On Mr Divnich's evidence as to the frequency of celebrity endorsement, which we accept as being within his expertise, it did not seem to us that this was likely to be material. Nor do we believe that public relations costs would be. Mr Divnich gave an example of retail advertising as a Tesco newspaper with a video game system on the front page. We conclude that it is not likely that the omitted costs would have made a material difference to Mr Divnich's figure.

(iii) Mr Divnich's Estimation of the Relevant Amounts

1677. Mr Divnich's figures for units sold, Gross Revenue and Marketing Expenditure were derived from two tables of 'comparable' games (one for *DiRT* and one for *Urban Chaos*) compiled for the purpose from data collected by EEDAR. The figures in these tables included amounts which were EEDAR's estimates or projections. The tables showed the name of each comparable game, its release year, its publisher, the units sold, the LTD Revenues, and marketing spend.

1678. In each table the games were ranked in order of LTD Revenues. The top 33% were taken to represent optimal performance; the top 50%, mid-optimal performance, the middle 33%, mid-case performance; and the bottom 33%, worst-case performance.

1679. For each of these subsets or cases Mr Divnich calculated the arithmetic mean of the unit sales, the LTD Revenues and the marketing expenditure. Each of these he treated as the results for the relevant game if it performed at the level of the relevant case.

1680. Mr Divnich estimated Distribution costs at £6.64 per unit sold for *DiRT*, and £5.94[38] for *Urban Chaos*. This represented the cost of the goods sold and royalties paid to the platform owner. They were drawn from statistical averages used in the industry. That for *Urban Chaos* was lower because a percentage of the sales of that shooter game would be for PCs on which no royalty was payable to a platform owner. We accept Mr Divnich's estimation.

The Break-even Calculations

1681. In the break-even calculation Mr Divnich worked back up the waterfall from a nil or very small profit to the number of units which had to be sold to achieve that result.

1682. Mr Divnich produced a breakeven figure for *DiRT* of 1.83m units. In calculating this figure it appeared that he had used:

(i) a selling price of about £24 per unit which was either the average selling price of the racing genre or of the top 50% (but he could not recall which), or the average selling price of *DiRT*. He told us that the average retail price at that time was $59; 20% would be earned by the store, so the publisher's receipt would be $48. That was comparable with £24. Mr Jones asked why *ToCA Race Driver 2*, which appeared in the comparables table for *DiRT* with sales of 1.5m units, had a price of $18. Mr Divnich said it was a very different type of game,

(ii) distribution costs calculated as before, and

(iii) marketing expense at the average for a title which sold over 1.5m units.

1683. In their Evidence Paper HMRC say that, during the hearing, when Mr Divnich's break-even figure for *DiRT* unit sales was entered into the spreadsheet with costs derived from a comparable game from the table, a sizeable loss was produced. This was not how we understood this part of the evidence. This was part of an exchange between Mr Jones and Mr Divnich about the break-even calculations. Mr Divnich was asked what unit price he had used to calculate the Gross Receipts. He could not recall. What was then put in the spreadsheet was Mr Divnich's figure for the break-even number of units together with a price per unit of £15.60 derived from a different game in the table. The result was a loss rather than breakeven.

1684. But if a higher unit price was used then a breakeven could be achieved. It appeared that Mr Divnich must have used a price of about £24[39]. Mr Divnich said that such a price was consistent with the average game selling price at that time, that the £15.60 price related to a game released in 2004 which would have been a 6th generation platform game, and there had been a jump in prices between 6th and 7th generation games such as *DiRT*. We also note that the average unit price in the Optimal category in the table was about £20 per unit and that the prices in the other

[38] Mr Divnich said $5.94 but it was clear that in fact he meant £5.94 – see T19/170/1.

[39] £24 per unit seemed about right. Judge Hellier is recorded in the transcript as having said $24, but the context shows that £24 per unit was the relevant figure.

categories (which were also for historic pre-7th generation games) were not materially different from that. We conclude that a price of £24 per unit was used, and that it was not an unreasonable assumption.

1685. For *Urban Chaos* Mr Divnich's break-even figure was 2m units on the basis of marketing expenditure of £5m, and 2.5m units if the marketing expenditure was £10m (such marketing figures being around the average for a title selling more than 1.5m units (a hit title)). The *Urban Chaos* calculations indicate gross receipts at this level of about £50m, putting it in the top 15 out of the 80 games in Mr Divnich's table of shooters with a review score of 65+.

1686. We note, however, that the increase in 7th generation pricing indicates that in his calculations of the results in the four cases Mr Divnich will have understated gross receipts because he used historic mean prices (of about £20 per unit). We come to that conclusion despite the fact that, as he explained, the LTD revenues took account of price changes during the life of the relevant game: those were historic changes in the prices of games released on previous platforms. We conclude that to this extent and in this respect his calculations understated Gross Receipts and profit.

1687. The absence in his report of the calculations underlying the break-even figures made it difficult to test their reliability. But in relation to *DiRT* the facts: (i) that with a unit price of £24, marketing spend comparable to that used in the other cases, and distribution costs calculated consistently, the spreadsheet gave a break-even figure for 1.83m units, and (ii) that IG itself had estimated 2m units to break even, indicated to us that this figure is within 10% or so about right. We reach a similar conclusion in relation to the *Urban Chaos* break-even figure.

The 'Comparable' Games

1688. Mr Divnich accepted that within the genre to which he had given the title "racing games" there were different classes. But to divide up a class too finely failed to give a fair view of the size of the potential market. We accept that, and Mr Divnich's expertise in the selection of games of a comparable genre.

1689. EEDAR calculate a review score for published games. They do so using an algorithm compiling the results of reviews. The score is on a scale of 1 to 100. The average score is not 50. Mr Divnich told us, Mr Scheurer agreed, and we accept that a game's review score was, after marketing spend, the factor most closely correlated with sales.

1690. The comparable games chosen by Mr Divnich for *DiRT* consisted of simulation racing games for sale in the western markets which had a review score of 70 or more. Those chosen for *Urban Chaos* were general shooter games for western markets with a review score of 65 or more.

1691. Mr Jones argued that, by limiting comparables to those with scores of above 65 or 70, Mr Divnich was implicitly assuming high sales. Mr Scheurer noted that the selection of games with a score of more than 65 or 70 skewed the range of possible outcomes, and argued that lower scoring games should also have been taken in to

account. He noted: that the shooter table had about one third of the games earning more than £20m; that that was an unusual level of earnings in his experience; and that the way the table made that result seem less unusual showed the effect of omitting games with scores of below 70.

1692. Mr Divnich agreed that it was "not infrequent" for games to score less than 65, but a score of 65 or 70 was on EEDAR's information about an average score. He had never, in the thousands of forecasts he had prepared, been asked to prepare a forecast on the basis that a game would score below 65. Those developing the game would tell the publisher that they expected to score more than 65. That was the background to any forecast. Codemasters had consistently delivered games with a score of above 75. It was conservative to limit comparables to those with a score of 70 and above. In any event the difference in gross receipts between a 55-rated game and a 65-rated game was not that much.

1693. We note that had the range of review scores been extended then, even if the gross receipts for the additional games had been fairly similar to those of games rated 65, it would have extended the size of the subset of Optimal games (because 33% would encompass more games) and thus reduced the mean figures for units, and gross receipts.

1694. Thus we accept that the effect of the floor on the review scores was to skew the profit estimates in each of the cases. But the real question is how likely it was that the break-even point would be exceeded. In approaching that question therefore one factor to be taken into account is the extent to which the bias created by comparison with games with higher scores is justified.

<u>Discussion – HMRC's Criticism of Mr Divnich's Conclusions</u>

1695. Mr Jones' further criticisms of Mr Divnich's conclusions related to (i) the likelihood of sales at above Mr Divnich's break-even level and (ii) the level of units sold which was implicit in those cases in which the game was profitable (the mid-optimal and optimal cases in the case of both games).

The Level of Sales Implicit in a Break-even or Profit Result

Risks in the Market

1696. Both Mr Divnich and Mr Scheurer said, and we accept, that games publishing was a risky business. Mr Scheurer said that it was normal in this industry for a producer to risk £ms on a game specified on two A4 sheets. Mr Divnich said that only two in ten of the games he had been involved in made significant profits, the others breaking even or losing.

1697. Mr Divnich said that his experience was that 20% of games made a significant profit, 60% just about made a profit or broke even and 20% made significant losses (this was not on the Ingenious basis of profit computation). Both he and Mr Scheurer agreed that games on which an amount of work had been done or were on their way to, or past, green-lighting were very frequently cancelled or redesigned and did not

come to market. They were not agreed as to what percentage of games projects suffered that fate: Mr Divnich said 80% and Mr Scheurer thought nearer 50%, but the difference between them may well have been in the definition of the starting pool and how much development had to have been done before a game could be said to have been cancelled.

1698. It seems to us therefore that no one thinking of putting money into a game would confidently predict that it would sell at the levels of top comparable games. There would in every case be a real possibility of failure. What Mr Divnich's calculations show is that the market in the relevant genres was such that if a game sold at a level which on past performance of comparable games was possible, the game would make a profit or a loss depending on the comparisons taken. The questions were therefore: how reasonable it was to expect a game to perform at a particular level; what particular features did it have which would have predisposed it to perform at a high level; and whether the possibility of performance at a lower level was so great that it would not be reasonable to hope for success. The greater the risks of loss and possibilities of extreme success, the less likely was a median result.

1699. Mr Divnich made his assessment of the reasonableness of an expectation that the games would make a profit, or achieve at least break-even units sales, on the basis of a comparison of the necessary break-even unit sales with those of other comparable games in the light of the following factors:

(a) the expectation at that time of growth in the industry and the forthcoming release of 7th generation platforms, and the popularity of the particular genre of game;

(b) the benefits of an existing franchise;

(c) the pedigree of Eidos and Codemasters as games publishers and the likelihood of a review score at least 65 or 70.

(i) The Games Market at the Relevant Time and the Popularity of Racing/Shooting Genres

1700. It was common ground between Mr Divnich and Mr Scheurer that between 2002 and 2006 the games console market had been growing in terms of gross receipts, popularity and consumer reach, and that shooter and racing games had benefitted from that growth in that period. It was a period of optimism.

1701. We accept Mr Divnich's evidence that, by 2005, those making games would have known of the planned advent of the Xbox 360 and PlayStation 3 in 2006, and that as a result they would have had a reasonable expectation that first-person shooter games could really take off. We accept that the change from the 6th to the 7th generation of consoles presented both an added risk of failure and an opportunity that an established operator might fail and a smaller operator might step up. In other words it increased the spread of reasonably possible outcomes and increased the likelihoods of outcomes at the extremes.

1702. We therefore accept that at that time it would have not have been unreasonable to take an optimistic view of the games market as a whole, and to regard the chance of a success (as well as of a failure) as greater than in the past.

(ii) An Existing Franchise

1703. Mr Divnich and Mr Sheurer agreed that there was a greater chance of success for a new game in an existing series, like *Urban Chaos* and *DiRT* (under the name *Colin McRae*) than a totally new game. We accept this. Mr Scheurer considered that the *Urban Chaos* brand was less well established than *Colin McRae* or the best selling brands in the shooter table. Mr Divnich did not dispute that.

(iii) The Pedigree of the Developer and Publisher and the Likelihood of a Good Review Score

DiRT (Codemasters)

1704. The comparative table showed Codemasters' *Colin McCrae* games doing relatively well. *Rally 04* (2003) came 13th with 1,270k unit sales, *Rally 2005* (2004) 16th with 1,125k unit sales, and *Rally 3* (2002 – quite a while ago) 23rd with 590k unit sales. In addition Codemasters' *ToCA* (2006) game came 15th with 1,510 unit sales. Mr Divnich said that Codemasters had a high ranking across the industry but were in the top tier of racing games publishers. Only 5 publishers ranked higher.

1705. Mr Scheurer said that Codemasters had a good pedigree and regarded its *Colin McRae* team as a good one. He regarded Codemasters as good at console rally games. Although Codemasters may have been in the top tier, the very top of the tier was dominated by much larger companies. He accepted that all previous *Colin McRae* games had scored above 80, but said that there was an increased risk of a lower score in this case because the game was being made on a new platform and might not therefore be as good. Mr Divnich considered that *DiRT* had a real likelihood of achieving a score of 80 given Codemasters' experience in the genre (and on the assumption that it would use the same development team).

1706. Mr Divnich considered that there was a prospect of sales above previous levels for the *Colin McRae* games because Codemasters were known to be targeting the North American market where the franchise had not sold well in the past (the change of name to *DiRT* rather than Colin McRae (who was less well known in the US) was part of this). We accept this argument.

1707. We accept that it would have been reasonable to expect Codemasters to produce a game which sold well, and consider that it would not have been unreasonable to hope that a game in the *Colin McCrae* series would sell more than 1.5m units.

Urban Chaos (Eidos)

1708. Mr Divnich considered that Eidos was an above-average publisher. He ranked it 18 in the top 50 publishers at the relevant time. In his estimation the top publisher in

this genre would have done equally well or slightly better in producing the game, but there would have been many publishers who would have done a worse job.

1709. Mr Scheurer told us that Eidos had had financial difficulties in 2005-2006. He accepted that it might have ranked 18 out of 50, but the first ten or so in the list were very large enterprises and the rest much smaller and therefore possibly less robust with less money to spend on marketing – the factor with the closest correlation to sales. The top of the comparatives table was dominated by mega franchises of *Call of Duty* and *Medal of Honor*. The list bore out his observations. Of the 20 games selling over 2m units, 9 had been published by Electronic Arts, 5 by Activation and one by Microsoft, all of which we accept, on Mr Scheurer's evidence, were much larger and financially robust enterprises than Eidos.

1710. Mr Divnich says that a few months prior to launch a publisher would know how good a game was. If it was good enough there would be no problem in finding the funds for marketing it adequately.

1711. We accept that Eidos were competent but also that their size added risk to the game's prospects.

(iv) The Numbers in the Light of the Relevant Factors

DiRT (Codemasters)

1712. Mr Divnich said that the mid-optimal units sales of 3.7m were "at the high end of expectations". It was an outcome against which he would have bet. He agreed it was highly unlikely. We regard this as an outcome which could not reasonably have been expected.

1713. The minutes of IG's executive committee of 30 March 2006 state that it would take 2m units to be sold for the LLP to make a profit. That is not inconsistent with Mr Divnich's estimate of 1.83m units.

1714. Breakeven involved income of some £45m. That would be six times budget. Would Mr Divnich recommend that his green-lighting committee go ahead? He said he would be interested but he would want to know a lot more about the game. That level of income would also put *DiRT* 9th in the comparison table. It would therefore have had to perform exceptionally well – even allowing for generational price increases. Mr Divnich said he regarded this as "conceivable".

1715. Mr Scheurer said that in his general experience most games achieved sales of less than 1m units. An investment requiring 2m units to break even was in his view risky. That observation is consistent with the comparative tables in Mr Divnich's report: showing that only 9 of the 45 listed games sold more than 2m units and 20 sold more than 1m units. But while we conclude that at this time most comparable games sold less than 1m units, it is clear that more than a handful sold more.

1716. The comparison table for *DiRT* (which was limited to games that had scored more than 70) shows that only 9 games of 45 (20%) sold more than 1.9m units. Of

those 9 games, 6 were part of the *Need For Speed* series – an existing series in simulation racing with an arcade style which differed somewhat from the rally style of *DiRT*, and, as Mr Divnich said, was at that time a more popular style of game.

Urban Chaos (Eidos)

1717. Against the background of the industry as a whole, Mr Divnich considered that even a mediocre shooter game released at that time could achieve sales of 2.5m. He thought it was not unlikely that *Urban Chaos* would sell more than 2.5m units.

1718. The *Urban Chaos* comparatives table showed that 33 out of 88 sold more than 1m units.

1719. Mr Divnich notes that when IG committed to Urban Chaos it had already been green-lit by Eidos and the risk of cancellation would have been comparatively lower. The green-lighting indicated that Eidos would have thought a good review score likely.

1720. Mr Divnich was asked whether it was reasonable to expect 2m units sold in view of the facts that:

> (i) Eidos' most recent shooter (2006 *Rogue Trooper*) had sold only 190,000 units (although only £180,000 appeared to have been spent on marketing) (Mr Scheurer regarded *Rogue Trooper* as a good game);
>
> (ii) Eidos' *Deus Ex* (2003) had sold only 500k units (but had been a port of an existing game); and
>
> (iv) Eidos' most successful shooter had been *Time Splitters 2* released four years previously in 2002 and had sold 1.5m units – so that *Urban Chaos* would have to sell 1m more units than Eidos' best result thitherto,
>
> Mr Divnich replied, that, having regard to the specification in the CDA, it was risky, the industry as a whole was risky, but it was reasonable to expect profitability although there was an increased risk with this game over other titles.

1721. Mr Divnich argued that too much reliance on historical performance would result in forecasts which would rarely if ever exceed past performance. Industry growth, and technological advances must be taken into account. We accept this reasoning but consider that there must have been a real risk that the game would not perform at the top level.

Conclusion

1722. Mr Divnich's four case calculations: (i) understate profit to the extent of (a) excluding licensing income, and (b) using historic unit prices; and (ii) overstate profit (a) to the extent of excluding retail, celebrity and public relations costs, and (b) to the extent that by concentrating on games with a higher review score they skew the range of possible results.

1723. We regard the cases as showing what results were possible, and accordingly that it was possible that these games would be profitable. Profitability would not have been a delusionary hope, even on the Ingenious basis. The gap in unit sales and profitability between the mid and optimal cases was large as a result of the disproportionate success of games at the heads of the comparable tables. In that gap lay the break-even figures.

1724. Overall we regard the break-even estimates as about right.

1725. The games industry and the shooter and racing genres were growing in 2006. It was reasonable to anticipate better results than in the past. Although there were good reasons to fear that they would not, Codemasters and Eidos could be reasonably expected to publish a successful game and a game in an existing series, or linked to a film, as these were, was more likely to be more successful, although that was more the case for *DiRT* than *Urban Chaos*.

1726. We conclude that there was a range of possible outcomes for both *DiRT* and *Urban Chaos* which included outcomes in which they might sell more than the break-even figure. We consider that there was a real possibility of sales lower than the break-even level when IG would not have made a profit, but also that a result in which sales achieved the break-even level was not so unlikely as to make hope for it unreasonable.

1727. However, for IG to be profitable the profits on its hits had to compensate for the losses on its misses. Extrapolating from the evidence in relation to *DiRT* and *Urban Chaos*, it seemed to us that, viewed from the perspective of 2006, it would have been unlikely that more than one of the four games undertaken by IG in that year would exceed breakeven and unlikely that they would perform at very high levels. If one game did exceed breakeven it seemed quite unlikely that the profit would compensate for the losses on the other games if profit was computed on the Ingenious basis.

1728. On the other hand, in order to be profitable on the 30:30 basis, we calculated that *DiRT* and *Urban Chaos* would have each to sell some 1m units putting them respectively into the top 20 out of 45 and the top 33 out of 75 in the respective comparable tables. It seemed to us that that could realistically be regarded as a possible outcome.

Mr Scheurer's Evidence

1729. Mr Scheurer was a lawyer who specialised in games production and development contracts. His practice had given him insights into the hopes, concerns, operations and the fates of companies in the sector and their products. We accept his expertise in these areas. We have noted above various comments he made on Mr Divnich's evidence and opinions. Not all of these arose from an expert knowledge of the particular subject matter – for example his questioning of whether the average review score was indeed about 70. In our conclusions we have taken into account the degree of expertise he offered.

1730. Part of Mr Scheurer's evidence consisted mainly of a comparison, based on his experience, of the nature of the usual contractual structure for the development of games and the usual activities of the participants in the games industry with that of IG. The import of this evidence was that he did not regard IG as filling the role he would ascribe to a developer or producer of games. IG, however, does not rely upon its activities as having any particular description (other than as being trading with a view to profit), nor do we consider conformity or otherwise to a normal role is relevant to whether or not IG was trading with a view to profit. As a result we do not record or discuss his evidence on this topic further.

1731. We should also record that, to some extent, part of Mr Scheurer's evidence relied on his conclusions of law as to the effect of contractual documents and his conclusions of fact as to what happened in practice drawn from some of the evidence he saw. Whilst we read and heard this evidence we did not accord such conclusions evidential or legal weight.

1732. Mr Scheurer provided a joint statement with Mr Divnich whose content we have taken into account above. He also provided evidence on a number of other topics from which we find the facts below.

1733. We find from Mr Scheurer's evidence that it was normal in publishing and development contracts to find:

(a) provision for the developer to have professional indemnity or E&O insurance;

(b) an escrow agreement permitting the assumption of the production of the game if the developer became insolvent;

(c) a third-party completion bond;

(d) provision for payment against milestones rather than against cash-flow needs. This would be a heavily negotiated section of a normal contract.

1734. We find that not all these elements were present in the DSA. Some of them could have enhanced to some extent IG's chances of success in particular circumstances.

APPENDIX 9

NRV CALCULATIONS

1735. This appendix examines the manner in which the LLPs calculated the figures which appeared in their accounts for the NRVs of their films. It addresses how the calculations were made, whether they were successful in producing estimates for NRV which reflected virtually certain income, and whether their effect or purpose was in fact to produce NRVs reflecting virtually certain income or whether it was to produce something else. It does not address whether the accounting policies of the LLPs complied with GAAP.

1736. Clearly it was never certain that the films would make any money at all. The qualifier "virtually" seems to us to be used to indicate a degree of realism in the appraisal and to invite the formulation, close to that which Mr Reid used in his oral evidence, of what realistically the minimum income would be. We have adopted this understanding of the test in our assessment of the LLP's calculations.

1737. We have not checked the detailed arithmetic which resulted in the figures used in the accounts, but no suggestion was made to us that it was faulty. The evidence to which we were taken related to the 5 April 2003 accounts for ITP, and the 5 April 2006 accounts of IFP2. We were not aware of different practices in relation to other years.

1738. This Appendix is ordered thus:

(a) Section 1: The method adopted by Ingenious

(b) Section 2: Our assessment of that method

(c) Section 3: Ingenious' approach: a tax loss purpose?

(d) Section 4: Conclusions

i) The Methods Adopted in Calculating the Accounts Figures for NRV

1739. As Mr Reid explained, the method of calculation used by IFP2 was slightly more complex than that used for ITP, and for each LLP the methods used differed between Independent and Studio films. We address in turn (a) ITP Independent and Studio films, (b) IFP2 Independent and Studio films.

(a) ITP: (i) Independent Films (5 April 2003 accounts)

1740. The method of estimating NRV was as follows:

(a) The sales agents' low estimates for each film were taken. The agents had not produced low estimates for *Blackball* and *Country of My Skull*. A low estimate for these two films was obtained by extrapolation from the high and mid estimates given by the agents.

(b) These amounts were taken as the gross income from the film and applied to the Collection and Management Agreement waterfall to determine the net income which would be attributed to the LLP under the terms of schedule 7 (i.e. including BR).

(c) A discount of 10% was applied to reflect the time value of money.

(d) A further 50% reduction was made.

(e) The resulting figure was compared with the income which would flow to the LLP from sales which had already been made. The higher of the two was taken as the NRV for the film. (In the case of *Blackball* the income resulting from sales which had already been made was in fact the higher.)

1741. For the period ending 5 April 2003 this process resulted in an aggregate NRV estimate of £4,083k for the six Independent films with which ITP was concerned (as against the reported cost of £35,498k).

1742. Mr Reid explained that for later LLPs (after ITP and before IFP2) the income which was fed into the schedule 7 waterfall was the sum of the contracted presales amounts in the territories where sales had been agreed plus 50% of sales agents' low estimates in other territories.

(a) ITP: (ii) Studio Films (year ending 5 April 2003).

1743. ITP was involved in only one Studio film, *Wimbledon*. The ITP internal report on NRV for 2003 shows that:

(a) Ingenious prepared high and low estimates for the WWBO of the film on the basis of an assessment of the film.

(b) 50% of WWBO was assumed to be deducted by the cinema (the formal report shows a deduction of 70% but we except Mr Reid's evidence that in fact the deduction was only 50%).

(c) It was assumed that the non-theatrical income (DVD, TV etc.) would be 200% of WWBO after the cinemas' deductions.

(d) 40% of WWBO was treated as being taken in recoupment of P&A.

(e) A further deduction of 40% of non-theatrical income was made for DVD/distribution expenses.

(f) The resultant elements were run through the schedule 7 waterfall to obtain the income which would accrue to the LLP.

1744. The result of these computations, on the basis of the low estimate of WWBO, was that no income would arise to the LLP from *Wimbledon*. As a result the NRV for *Wimbledon* was taken as being nil.

(b) IFP2: (i) Independent Films (there were 7 for the year to 5 April 2006)

1745. The method adopted was as follows:

(a) the gross income from the film was taken to be 100% of presales plus 50% of the sales agents' low estimates for unsold territories. (The difference between this and the ITP calculation was that in this calculation the sales agents' low estimates were replaced by actual contracted sales where relevant, so that there was no later comparison with actual sales).

(b) That gross income was applied to the Collection and Management Agreement waterfall (thus including BDR) to determine the net income which would be attributed to the LLP.

(c) No 10% deduction for the time value of money or further 50% reduction was made.

1746. The result was taken as the NRV of the film.

1747. It is to be noted that there may be a difference in the result obtained by putting 100% of the low estimates in at the top of the waterfall and reducing the waterfall result by 50% (as was done in the case of ITP), and the result obtained by putting 50% of low estimates in the top of the waterfall and making no later reduction (as was done in the case of IFP2). Because of the effects of expenses which do not vary with income (if any), and of stages in the waterfall which change with differing levels of income, we would generally expect the first method to yield a higher result than the second.

(b) IFP2: (ii) Studio Films (there were 15 of these for the period ending 5 April 2006).

1748. The method adopted was this:

(a) By reference to selected comparable films, a figure for the UK domestic gross box office was estimated. (Mr Reid described it as "skewed towards low performing films".) This was scaled by reference to budget but capped at twice the average budget.

(b) WWBO was then estimated from the estimate of UKBO by applying a multiple.

(c) WWBO was reduced by 55% to reflect the amount deducted by the cinemas. The result was the net Theatrical Revenue.

(d) DVD and TV income was estimated at 100% and 50% of net Theatrical Revenue respectively (50% less than that used for *Wimbledon*)

(e) An estimate was made of talent participations and residuals of 12% of gross receipts (i.e. receipts after the cinemas took their portion).

(f) P&A and DVD costs were estimated.

(g) The net Theatrical Revenue, the DVD and TV income, and the P&A/DVD estimate were applied to the schedule 7 waterfall to obtain the amount which would be attributed to the LLP (in the course of which the deduction was also made also for talent participation and residuals).

(h) It appears from the April 2006 paper that a deduction of 12.5% was made for the time value of money.

1749. The net allocation to the LLP deriving therefrom was treated as the NRV of the film.

ii) Our Assessment of the Approach Taken by the LLPs to the Determination of the Estimates in These Calculations

1750. We bear in mind in making this assessment that Deloitte gave a clean opinion on the accounts of the LLPs and will have had contemporaneous access to the calculations, to those who made them and to underlying data. It seems unlikely that they would not have checked the arithmetic and tested the basis of the calculations against the stated accounting policies of the LLPs.

1751. The LLPs' estimated NRV through the practice of equating NRV with the "virtually certain" income which would be realised from each film, or, as Mr Reid put it, "the minimum income that is going to come in from these films".

1752. For the reasons which follow, it seems to us that the LLPs took an extremely cautious approach to some of these questions.

1753. It will have been seen from the description in section 1 of this Appendix that many of the stages in the computations involved matters of judgement:

(a) Independent Films:

(i) which of the sales agents' estimates (low, medium or high) should be taken; whether any reduction should be applied to those estimates or whether a further reduction should be applied to the result obtained after the sales agents estimates' had been put through the waterfall;

(ii) whether any discount should be applied to reflect the time value of money.

(b) Studio Films:

(i) which other films were "comparable";

(ii) what the relationship was between UK domestic BO and WWBO;

(iii) what proportion of gross box office income would be deducted by cinemas etc.;

(iv) what DVD and TV income was likely to be as a percentage of WWBO or relevant box office figures;

(v) what P&A expenses would be;

(vi) what DVD costs would be;

(vii) how much should be deducted for talent participation and residuals;

(viii) whether any discount should be made for the time value of money.

1754. We address each of these under the corresponding headings below.

(a) Independent Films: (i) Sales Estimates

1755. The calculations, both for ITP and IFP2, use sales agents' low estimates. This does not seem to us to be an unrealistic approach to the estimation of minimum income. But in both cases, though at different stages, the computation applies a 50% discount.

1756. Where sales had actually been made the only realistic method would have been to treat the receipt of the whole of the sale proceeds as virtually certain (unless there were real concerns about the credit of the purchasing distributor). That was the method adopted.

1757. Mr Olsberg told us that sales agents would seek to make their estimates as reliable as possible because their reputation was affected by the reliability of the estimates they gave. He said that it would be unusual for a film to be sold to a distributor for less than the low estimate.

1758. By contrast the reports prepared by Ingenious and approved by the LLPs' Boards (which appear to have been provided to the auditors) say that whilst sales agents' estimates are an indication of potential profitability "experience shows that they are speculative and often overstated". As a result the reduction of 50% was applied – either at the stage of assessing the income to be put into the top of the waterfall (IFP2) or after the waterfall computation (ITP).

1759. The speculative nature of any such estimate is obvious. The issue is its reliability. We prefer Mr Olsberg's evidence on this point.

1760. The board papers setting out the method of computation and the resulting figure also justify this 50% discount on the basis that a bank lending to a production company would typically lend only 50% of the low estimates. However, it seems to us that banks' lending criteria do not always indicate the value of the property against which the loan is made: a bank might not lend the full market value of a house on a mortgage for many reasons other than an expectation that it would not realise its market value, and will have borne in mind the costs of enforcement.

1761. In the light of Mr Olsberg's evidence the approach taken by the LLPs seemed to us to be an excessively cautious one. We concluded that the minimum income, or the virtually certain income, was understated to the extent of the effect of the 50% deduction.

(a) Independent Films: (ii) Discounts for the Time Value of Money

1762. These discounts were applied in the ITP calculations but not in the IFP2 calculations for Independent films. Mr Reid explained that this was because Ingenious had come later to the view that, given the assumption that the film would perform badly, income would arise relatively quickly and then stop, so that little time would elapse between the year-end and receipt.

1763. It seems to us therefore that the discount applied by ITP reduced the calculated NRV excessively.

(b) Studio Films: (i) The Selection of Comparable Films

1764. Ingenious did not employ someone like Mr Briggs to assist it with the determination of NRV, but relied on its internal resources. Members of its staff drew up lists of films they regarded as comparable to the film being valued, and calculated the average takings which arose from those chosen films.

1765. HMRC point to an exchange between Ingenious staff which took place as part of this process: on 6 April 2006 Mark Fielding e-mailed Paula Jalfon:

> "need bad films for FF2, DH4, NATM, GC, LOP".

At that stage Mr Fielding's calculations showed NRVs for the first four of these films, which were between 27.8% and 51.25% of budgeted cost.

1766. We were not able to assess the choice of films used as comparable in the process Ingenious undertook, but this request indicates to us that IFP2 sought to find comparable films that had performed badly in preference to those which had performed well. That is consistent with estimation of the minimum income which could be expected but not with a reasonable expectation.

(b) Studio Films: (ii) The Relationship between UK Domestic BPO and WWBO.

1767. We were not able to assess the approach taken to this relationship.

(b) Studio Films: (iii) The Proportion of WWBO which was Taken and Deducted by Cinemas Etc.

1768. The calculations for IFP2, Mr Reid told us, assumed that the cinema took 55% of the ticket sales leaving 45% as net Theatrical Receipts to go into the waterfall. The calculations for ITP assumed a deduction of 50% only.

1769. Mr Olsberg indicated that for Independent films the distributor would receive net Theatrical Receipts of between 40% and 55% of Box Office takings.

1770. In his more sophisticated computations for Studio films, Mr Briggs adopted ratios of retained net Theatrical Receipts to gross box office receipts which differed depending upon whether the ratios were being calculated for the North American market or other territories, and which also vary with the level of box office receipts. The ratios he used vary between 40% and 55%.

1771. It seems to us that IFP2's use of 45% and ITP's use of 50% were realistic and not excessively conservative.

(b) Studio Films: (iv) DVD and TV Income

1772. IFP2 took these to be 100% and 50% respectively of the net Theatrical Receipts (so about 68% of WWBO); ITP took them to be in total 200% of such receipts (100% of WWBO).

1773. For Independent films Mr Olsberg indicated that combined DVD and TV gross revenue was about 155% of net Theatrical Receipts (varying between 120% and 170%).

1774. In Mr Briggs' calculations, DVD and TV income was subdivided into different classes and estimated as a percentage of the gross box office takings for each relevant territory (and sometimes capped). The ratios he used of DVD and TV revenue to gross box office in the two areas (North America and International) varied between 56% and 141% of gross box office, that is to say between about 112% and 280% of net Theatrical Revenues.

1775. We conclude that the LLPs, approach to this part of the calculations was realistic and not excessively cautious.

(b) Studio Films: (v) P&A.

1776. For ITP P&A was taken as 40% of WWBO.

1777. Mr Olsberg had suggested that on average P&A costs amounted to 50% of net Theatrical Rentals (for Independent films). Mr Briggs did not suggest that, as a rule of thumb, this was unreasonable, and in his detailed calculations took P&A costs to lie between 20% and 45% (with the exception of *Hot Fuzz* North American P&A for which he used 70%) of gross relevant box office receipts. Thus Mr Briggs' ratios represented between 40% and 90% of net Theatrical Revenue. This indicated to us that ITP's use of 40% WWBO (about 80% of theatrical revenue) was not unreasonable.

1778. Mr Reid explained that in April 2004 a Mr Stanford, who had been consulted in relation to some of the non-production activity of IFP2, had provided information on the relationship between box office results and P&A expenditure. He said that this information, together with information from external reports and from the distribution of the Inside Track films had informed IFP2's estimation of the level of P&A expenses.

1779. For IFP2 a spreadsheet which appears to have been produced close to the date of the Board Report (C2/10/5) document (because it shows carrying values which are the same in most cases as those in that report) shows that for each film P&A expense was calculated by aggregating estimates of domestic and international P&A, which in turn were derived from applying ratios of P&A to box office at differing box office levels to the Domestic and International box office figures derived from the comparable films exercise after eliminating outliers.

1780. The ratios of relevant P&A to relevant box office were estimated in bands depending on the level of box office. Generally as box office takings increased the percentage that P&A represented of box office takings reduced. The spreadsheet shows the movement from the ratios for each band which appear to have derived from, or from information provided by, Mr Stanford to the ratios used in the calculations, and also the ratios actually used in the later calculations. The ratios actually used for domestic P&A are on average 175.66% of those derived from the Stanford information, and those for International P&A about twice the Stanford figures. Thus for example:

Domestic BO	Stanford Domestic P&A%	Ingenious Domestic P&A%	Stanford International P&A%	Ingenious International P&A%
Up to £2,500k	188%	330%	100%	206%
…	…	…	…	…
£150m to £200m	36%	63%	23%	46%

1781. It appears that Ingenious' ratios were derived from information reported by ITP in relation to the 9 films with which it had been involved. The method adopted was to compare the reported P&A expenditure on these 9 films with that predicted by Mr Stanford's figures. On average it appeared that these films gave P&A expenditure which was 175.66% higher than that predicted by Mr Stanford's methodology.

1782. Thus, on the strength of actual information held by Ingenious and on 9 Inside Track films, the P&A expenditure on IFP2's portfolio of 22 films was increased by some 175.66%.

1783. It seems to us that the statistical significance of the performance of 9 films is little to go on, and that this method of estimating P&A expenditure was very cautious indeed.

1784. Given Mr Briggs' use of the ratios of P&A to WWBO of between 40% and 90%, and Mr Olsberg's rule of thumb 50%, the use of ratios[40] most of which exceeded 60% and varied between 54% and 270% was unrealistic and plainly excessive.

1785. We conclude that to the extent the ratios used by IFP2 exceeded 60% their effect gave rise to an NRV which fell below virtually certain or minimum income. The ratio of 40% used by ITP did not seem to be unreasonable.

(b) Studio Films: (vi) DVD Costs

[40] And also the figures in the Mosaic data – see the section on the Information Memoranda in Chapter VIII.

1786. IFP2's calculation estimated DVD costs as 35% of WWBO.

1787. This is consistent with: (a) the ratio Mr Bowers said he usually observed, (b) Mr Olsberg's Independent film rule of thumb; and (c) the ratios of 30% (North America) and 40% (International) used by Mr Briggs (although not with the figures used in LS202).

1788. We conclude that the estimate for DVD costs was fair.

(b) Studio Films: (vii) Participations and Residuals

1789. A cost of 12% of gross income was used for all IFP2 films; no deduction was made for ITP's film.

1790. In Mr Olsberg's rule of thumb waterfall for Independent films no deduction is made for these items.

1791. In Mr Briggs' Studio film calculations he makes deductions of between 10% and 15% of gross revenue for these costs.

1792. Mr Briggs said that such payments are often contingent upon, as well as varying with, certain performance statistics. Thus a poorly performing film might not incur such costs (and the calculations were not based on films which performed well). It seems to us that the 12% estimate applied by IFP2 was unrealistically cautious but given that an LLP should have had access to the films' contractual documentation, it should have determined the precise level of participation cost at the levels of income used in the calculations, rather than adopting an estimate. When exactitude is reasonably possible an estimate cannot be a reasonable estimate.

(b) Studio Films: (viii) Discount for Time Value of Money

1793. A discount of 12.5% was applied to the waterfall result to reflect the time value of money.

1794. Considering that: (i) Mr McKenna accepted that most of a film's income arose in the first five years, (ii) the (pessimistic) forecasts suggested that the films would not be successful and so would be unlikely to have a long run; (iii) the witnesses' acceptance that almost 98% of the theatrical income arose in the first 6 months, (iv) the fact that the LLPs distributed income received and so did not have a cost of capital, and (v) interest rates at that time, it seems to us that no discount should have been applied.

1795. *Summary Assessment*

1796. Taking together all the elements discussed in (a) and (b) above, we find that the calculations of NRV were excessively cautious and to that extent resulted in values which were less than those which realistically reflected the virtually certain or minimum income from each film.

iii) Ingenious' Approach to NRV Calculations: The Purpose?

1797. There is a difference between a very cautious application of a policy whose aim is to estimate virtually certain or minimum income, and one whose aim is to achieve a first year NRV of about 20% of cost, even if they happen in particular circumstances to produce the same result.

1798. HMRC infer that the second was the policy actually adopted by the LLPs. HMRC suggest, as Mr Gammie put it to Mr Reid, that the approach to the calculations had been motivated by an intention to achieve NRVs which in aggregate gave a first period loss of the same order as that suggested in the Information Memorandum. In other words that the accounting policy actually adopted was not to estimate virtually certain income, but to produce a first year NRV of about 20% of recorded cost.

(a) ITP

1799. The ITP Information Memorandum contains illustrations which assume that each Independent film will be written down at the end of the first accounting period to the LLP's share of contracted presales. These are assumed in that memorandum to be 30% of budget. The illustrations show that this would result in tax repayments to investors of 84% of their investment.

1800. For Studio films the ITP Information Memorandum contains illustrations which assume a write-down of the film in the first period to nil.

1801. In April 2003 Ingenious' personnel commenced the process of estimating NRV for the year to 5 April 2003. It appears that initially it was expected that NRV for an Independent film at the end of the first year should be determined by reference only to the monies which would come to the LLP from contracted presales: so without the inclusion of anything in respect of territories in which there had not been presales. The early draft reports produced show write-downs of the film portfolio to £1,863k or £953k and contain explanations that this represented the LLP's share of contracted presales (against a budgeted cost of around £66m). Earlier discussions in February 2003 with Deloitte appeared to indicate that Deloitte would have been happy with this approach.

1802. However, later versions of the reports and the spreadsheets referred to 100% of, and the final version incorporates 50% of, the sales agents' estimates for territories which had not been sold, giving rise to an increase in calculated NRV of £4,084,000. (The spreadsheet attached to the 25 April 2003 e-mail shows both presales values and lower, medium and high estimates income; similar figures were sent to Deloitte on 24 April 2003. Sales agents' estimates appear in spreadsheets after 14 April 2003.)

1803. HMRC also point to the speedy notification to investors of the losses that they might claim which followed the year-end and (by 13 May 2003) subsequent communications with investors.

1804. HMRC point to a draft document prepared by Mark Fielding on 28 July 2003, after the finalisation of the 5 April 2003 accounts which appears to relate to income

projections for the next slate of ITP films. The attached spreadsheet contains very detailed, territory-by-territory and expense-by-expense, calculations including overages based on an extensive set of assumptions. In his e-mail he says:

> "The initial calculations seem to be showing final income figures that are too high, and not accounting for the poor performance of some of the films. I have re-worked the calculation (on the sheet entitled "Box Office") and this appears to give a pattern of film performance closer to what was expected, and closer to the box office information we have. If the revised calculation is deemed to be more realistic, then some assumptions will have to be made regarding getting from the Revenue figures calculated to Distribution Income."

1805. On the spreadsheet there is a comment that the total level of Distribution Income appears too high.

1806. It was not clear to us what was the purpose of the exercise Mr Fielding was conducting. Clearly it did not relate to the 2003 accounts. It seemed to take into account actual box office results, and therefore to relate to a period after the year-end. He spoke of Distribution Income, which suggested that it was either concerned with what might be distributed to members or with what might be the eventual – ultimate – result for certain films. It was unlikely to have been an attempt to calculate NRV. We were not clear that all the films to which he referred had been financed by ITP.

1807. Although it is not wholly clear (since "Revenue figures" in the closing words of his e-mail may refer to revenue to the LLP rather than to figures produced for HMRC) it seems that there may be an acknowledgement here that the figures he has produced are or would be better than those for NRV and that some explanation for the difference may be required. That difference might, however, be that between the estimation of a realistic minimum and the estimation of what was reasonably likely.

1808. We did not feel able to conclude from this e-mail that the policy adopted in the 2003 accounts was to produce figures which gave life to the Information Memorandum's assumptions.

1809. HMRC also point to an e-mail of 20 April 2004 (so just after the end of the 2004 accounting period) which attached an NRV calculation. This seems clearly therefore to relate to the NRV calculations for the accounts for that year. The NRV spreadsheet was not available to us. In the e-mail Mr Crossley (who must have in mind the accounts for the year to 5 April 2004) tells Mr Jaggon that he has:

> "added *Wimbledon* to his backing spreadsheet (only six comparisons so far – could dig out some lesser performing Working Title Films)".

1810. Mr Jaggon replies by sending him details of Working Title films box office results provided by Deloitte. When Mr Crossley uses these he gets an even higher number and Mr Jaggon responds to this news by saying that the discount factor should be higher as the list of films included super hits like *Notting Hill* and *Four Weddings and a Funeral* (which would have increased the average obtained) which probably should be discounted altogether.

1811. In seeking to estimate realistic minimum receipts or virtually certain income it does not seem to us to be unreasonable to exclude comparator films which were super hits. Nor does it seem unreasonable to be surprised at an NRV which may be considerably higher than the nil value in the previous year's accounts for *Wimbledon*. But the common understanding appears evident that what is expected is low values for NRVs. There is not, however, any indication that that value is linked to any expectation in the Information Memoranda.

1812. We did not conclude that ITP in fact adopted a policy of writing down to conform with the Information Memorandum illustrations.

(b) IFP2

1813. The IFP2 Information Memorandum (for the 2006 fundraising) contained financial illustrations which showed a loss (arising from the writing down the films to NRV) to be allocated to individual investors in the first period of some 90% of individual investors' capital contributions. The Information Memorandum did not expressly state the percentage of cost which would be represented by NRV but it was implicit in the projections that NRV would be about 19.7% of cost (since 56% of an assumed £200m investment is taken as film cost, i.e. £112m, and the cost of sales as £89.9m – indicating an NRV of £112m - £89.9m = £22.1 million or 19.7% of stated cost).

1814. On 29 March 2006 Mark Fielding e-mailed Jane Moore and Paula Jalfon with his "current list" of NRV's. He said:

> "Here's the current list. Think I'm going to have to increase P&As significantly as at the moment I'm not showing any write-down on NATM, FF2 & GC."

1815. The spreadsheet attached shows total NRV at 57.84% of cost and appears to use the Stanford information for calculating P&A costs.

1816. Ms Jalfon replied:

> "Have you included gross participation and residuals which would come off the top? At the level of box office we are projecting for Night and Fantastic 4 I would imagine these would be pretty hefty".

1817. Ms Jalfon later sent Mr Fielding a link to a genre index apparently to help him estimate these figures.

1818. The next iteration of the spreadsheet we understand to have been completed to 6 April 2006. It appears to use the adjusted (175.6% uplift from the Stanford figures) amounts for P&A and significantly smaller figures for many of the expected box office results. Mr Fielding has also added a deduction of 12% for "gross participations and residuals". It shows total NRV at 23.4% of cost with some, including *Night at the Museum*, *Famous Four 2*, *Die Hard 4* and *The Golden Compass*, with significantly higher percentages.

1819. On 6 April Mr Fielding sent the e-mail noted above to Paula Jalfon saying that he needed "bad films" as comparators for these four films.

1820. In the final board report on NRV dated 5 April 2006 (C 2/10/7) aggregate NRV is shown at 18.46% of cost and the NRVs of three of the films mentioned by Mr Fielding (NATM, FF 4, and GC) have been significantly reduced.

1821. HMRC say that the progression of these amounts and calculations shows, not the honing of a meticulous approach to the estimation of virtually certain income, but an attempt to reach a write-down to 20% of cost.

1822. When Mr Gammie asked Mr Reid about the correspondence between Mr Fielding and Ms Jalfon recited above he could not provide any light. He could only suggest that Mr Fielding would have been justifiably worried if his results showed an NRV in excess of budget. In fact the results did not show that but it seems to us that Mr Fielding was likely to have been aware that previous first year NRVs had been in the order of 20% of cost, and would be concerned if his results were different. It is well known that scientists have the same reaction when their experiments produce results which defy expectation; they will often repeat them as a result; the history of the Michelson-Morley measurement of the speed of light is an example. But the tone of Mr Fielding's e-mails is different: he is not seeking to extend his sample, but to worsen it. That indicates an analysis whose purpose is to get a low result rather than to get a realistic result.

1823. In the same vein HMRC drew our attention to an e-mail to Mr Reid from Emily Ng, Ingenious' management accountant, of 7 April 2008 attaching NRV reports to send to the auditors. Mr Reid replied asking that people sign off internally before the reports were sent to the auditors and saying "Do the NRVs give the trading result the investors expect?" This e-mail did not relate to the LLPs, but its content is redolent of the desire which may be felt in many enterprises not to surprise investors, and indicates that that desire was not absent at Ingenious. It is likely that a similar question would have been in the minds of Ingenious personnel assessing NRVs for the LLPs.

1824. An e-mail from Mr Sandler to Mr Clayton in 2009 which may not relate to NRV calculations conveys a similar impression when he talks about looking at the numbers and then making further assumptions or adjustments "depending on how we think they should look".

1825. We conclude that at the least there was an unconscious desire not to deliver an NRV which would surprise investors and that this led to a less critical acceptance of calculations which delivered NRVs in the 20% range.

iv) Conclusions

1826. In relation to the NRV calculations our conclusions are in summary these:

(a) Minimum income or virtually certain income was understated by the effect of:

(i) the reduction of 50% applied to sales agents' low estimates;

(ii) the discount for the time value of money applied in the ITP estimates for Independent films and in the IFP2 estimates for Studio films;

(iii) the application of a ratio of P&A expenditure to box office exceeding 60%.

(b) The deduction for Participations should have been calculated using the actual rates applicable in the film documentation. 12% was excessive.

(c) Neither ITP not IFP2 operated a policy of determining NRVs at about 20% of budget, but in practice the decisions taken by both entities were biased in favour of elements of the calculations which would deliver NRV closer to 20%.

(d) This practice resulted in the understatement of NRVs when measured against a policy of calculating NRV as minimum income or virtually certain income.

CHARLES HELLIER
TRIBUNAL JUDGE

RELEASE DATE: 14 OCTOBER 2016

This decision has been amended and reissued under Rule 37 correcting accidental typographical slips