[2017] UKFTT 0429 (TC)

TC05893

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

Income tax – whether expenditure on rights to income from films was capital.

FIRST-TIER TRIBUNAL
TAX CHAMBER

INGENIOUS GAMES LLP **Appellant**
INSIDE TRACK PRODUCTIONS LLP
INGENIOUS FILM PARTNERS 2 LLP
(CAPITAL OR REVENUE)

- and -

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

TRIBUNAL: JUDGE CHARLES HELLIER
JULIAN STAFFORD

A Decision following an earlier decision and hearing and made without a further oral hearing with the benefit written submission and replies by the parties

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

Malcolm Gammie QC, Jonathan Davey QC, Catherine Addy, 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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DECISION

1. This decision is supplemental to our decision in these appeals reported at [2016] UKFTT 521 (TC) and released on 2 August 2016. Terms used in that decision are used in this one and this decision should be read with that one. In that decision we gave our views on the issues raised by the parties and adjourned for the parties to agree the figures. They have unfortunately been unable to do so because there is a dispute as to whether the sums which we regarded as properly deductible for GAAP purposes as provisions for the impairment of the rights under the relevant agreements were not deductible in computing taxable profits as a result of section 33 ITTOIA (or its predecessor section 74(1) ICTA) on the basis that they were capital or of a capital nature.

2. In that decision we made, among others, the following findings:

(i) we held that the "relevant agreements" for any particular film or game were entered into at the same time as a single package and should be construed as a composite;

(ii) that under those agreements the LLPs acquired no meaningful interest in a film, and had limited involvement in its making;

(iii) that as a result of the relevant agreements and the payment made under them, the LLPs acquired as asset which was the right to payment of a portion of the proceeds of distribution of a film;

(iv) that an LLP's financial activity was the exchange of a sum of money paid to one party for a potential future financial reward from another;

(v) that an LLP did not intend to dispose of the right it acquired under the relevant agreements although the right was realised (so in effect consumed) as monies flowed from the right;

(vi) that these were speculative, organised, repeated transactions;

(vii) that for accounting purposes the rights were held "for use on a continuing basis in the business", and so were not current assets for those purposes. In substance (as "substance" is defined by the relevant accounting standards) the rights were not stock and should be treated as fixed intangible assets which should be accounted for at cost less any impairment (or onerous contract provision);

(vii) that generally the vast majority of the income from a right would arise in the first 5 years after the release of the film. (That would be somewhat more than 5 years after the contracts had been signed – to allow for the making of the film). Five years was a reasonable period over which to hope to make a profit from a film, and beyond that period the revenues became too uncertain to regard substantial future receipts as a realistic possibility.

Nevertheless it was possible that income would accrue after that time, although most films stopped earning after 30 years. Indeed ngenious' 2010 Ultimates

were prepared on the basis of significant future earnings for some films after the first 5 years. In a similar vein it was said that IFP2 would become profitable on the Ingenious basis when sequels to Avatar were produced.

5 Mr Briggs divided his calculation into a first cycle of 10 years and then the period thereafter. Whilst we considered that the likelihood of such second cycle income arising was too small to be taken into account in relation to some aspects of the decision, the receipt of such income was possible and, in the case of films such as *Gone With the Wind* and *The Sound of Music,* had been substantial and had lasted for many years after the first 10. Mr Sills and Mr

10 Briggs had agreed that it was possible that *Avatar* would fall into the same category.

(ix) that the Information Memoranda indicated that income payments received by an LLP would be distributed to members after deducting administration expenses.

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3. Section 33 ITTOIA provides that

"In calculating the profits of a trade, no deduction is allowed for items of a capital nature."

20 4. Section 74(1) ICTA provided that

"Subject to the provisions of the Tax Acts, in computing the amount of the profits or gains to be charged under Case I or Case II of Schedule D, no sum shall be deducted in respect of –

...

25 (f) any capital withdrawn from, or any sum employed or intended to be employed as capital in, the trade, profession or vocation, but so that this paragraph shall not be treated as disallowing the deduction of any interest."

5. No suggestion was made that the relevant meaning of the two prohibitions was

30 different or that authorities dealing with what was capital and what was not under the old legislation were not equally applicable under the new.

HMRC's argument

6. HMRC say that we found: that the LLP's activities were akin to buying an income stream in a complex way, exchanging a sum of money for a potential future

35 financial reward; that the commercial and legal reality was that the right the LLPs acquired under the relevant agreements was a right to income; that the LLPs did not, and did not intend to, dispose of that right although it was realised or consumed as monies flowed into the LLP from it; and that for GAAP purposes the rights under the relevant agreements were not current assets but fixed intangible assets held for use on

40 a continuing basis in the business. As a result they say that the rights were capital in

nature so that no deductions should be made in computing the LLPs' taxable profit or loss in respect of the impairment.

7. They say that, whilst there is no single test for determining whether expenditure is attributable to capital or revenue, the acquisition of an asset which is for the enduring benefit of a trade will be the acquisition of a capital asset unless thre are special circumstances tending to the contrary. They rely on Viscount Cave's well known and often quoted dictum in *British Insulated and Helsby Cables Ltd v Atherton* [1926] AC 205 at 213-4 that an expenditure made, "not only once and for all but with a view to bringing into existence an asset or advantage for the enduring benefit of a trade is likely to be capital."

8. They say our finding that the intangible fixed asset was held for use on a continuing basis must mean that the expenditure was to bring into existence an asset for the enduring benefit of the trade: the "continuing basis" test in Companies Act 2006 and the enduring benefit test they say are essentially the same. There were no special circumstances.

9. They rely on the distinction drawn between fixed and circulating (or floating) capital in *Anglo-Persion Oil Company v Dale (Inspector of Taxes)* [1932] 1 KB 124. They say that the rights under the agreements were not disposed of so cannot be circulating or floating capital. Equally they say they cannot be stock in trade for they were not dealt in.

The Appellants' arguments

10. The Appellants say that it would be absurd if the expenditure on the rights was disallowed as capital and the LLPs remained taxable on the gross amounts received without any deduction for the cost of acquiring those amounts.

11. They say that our decision that for accounting purposes the rights were not current assets does not inevitably lead to the conclusion that the expenditure on the rights was capital in nature, for, as Lord Upjohn said in *Strick v Regent Oil* (1965) 43 TC 1, it "is a question of fact and degree and above all judicial common sense in all the circumstances of the case".

12. In this they rely in particular on *Strick* and on *BP Australia v Commissioner of Taxation (Australia) [1966] 1 AC 224*, the judgement in which was delivered on the same day as *Strick* and by the same five law lords.

13. *Strick* and *BP Australia*, and the earlier case of *Bolam v Regent Oil*, concerned petrol ties in which the petrol company paid a lump sum to garage owners in return for an agreement to sell only the company's brand of petrol for a specified period. In *Bolam* the payment was an advance rebate which was repayable if actual gallonage fell below estimated gallonage for the period; in *BP* the payment was a fixed sum based on estimated gallonage for the period. In *Strick* the calculation of the payment was similar to that in *BP*, but the transaction was structured as a lease of the garage to the petrol company and a lease back for the same period less three days. In *BP* and

Bolam the payments were found to be revenue and deductible; in *Strick* they were found to be capital in nature.

14. The factor which tipped the scales in *Strick* was clearly the presence of the lease: all five members of the judicial committee referred to the difference made by the fact that the transaction took the form of a lease and sublease, and regarded it as not a mere matter of form, because it gave the petrol company interests in land which afforded greater security. So the quality of the company's asset was different from what it would have been under a simpler form of tie. This, they said, was a highly relevant factor. But the judgements also contained a discussion of the relevance of the nature of the trade and the period the asset would last. From this discussion the Appellants make three arguments:

(1) that one relevant feature pointing towards revenue rather than capital is that the contracts were ordinary commercial contracts;

(2) that the distinction between revenue and capital was based on accounting concepts which are outmoded and surpassed by the GAAP requirements of section 42 FA 1998; and

(3) that the judgements indicate that, whilst a payment for a 21 year tie would be capital in nature, a payment for a 5 year tie would not be and that the balance lies at about 10 years. The nature of the rights held by the LLPs they say were such that they had a realistic life of only 5 years and were not capital.

15. The Appellants also rely on the judgement in *BP Australia*. In particular they note the way in which the judgement was influenced by the accounting practice of 1965 (which appeared to permit the whole sum either to be held as an undepreciated asset in the balance, written off in the year against profit, or amortised), and the description given therein of the difference between circulating and fixed capital:

> "The test of whether these sums were payable out of fixed or circulating capital, referred to for example in *John Smith & Son v. Moore* tends in the present case in favour of regarding these payments as revenue expenditure. Fixed capital is prima facie that on which you look to get a return by your trading operations. Circulating capital is that which comes back in your trading operations. The sums in question were sums which had to *come back penny by penny* with every order during the period in order to reimburse and justify the particular outlay" (italics added)

16. Further they say that a parallel can be drawn with *Golden Horse Shoe Ltd v Thurgood* 18 TC 280 in which the price paid for dumps of gold mine tailings purchased for the extraction of gold for sale was held to be the purchase of the raw material for the taxpayer's business, rather than the means of obtaining that raw material, and accordingly of a revenue nature. They say that the rights under the relevant agreements were the raw materials of the LLPs' trades.

Discussion

17. We have not found this an easy decision, and are comforted by the fact that others have had similar difficulties with the concept of capital. Lord Edmund-Davies in *Tucker v Granada Motorway Services [*1979] STC 393 described decisions on the words of section 74(1) as having "created a morass of uncertainties, or as Templeman J put it-

> "an intellectual minefield in which the principles are elusive...analogies are treacherous...precedents appear to be vague signposts pointing in different directions...and the direction finder is said to be the 'judicial common sense'""

to which Templeman J had added: "The practice of judicial common sense is difficult in revenue cases".

18. What is clear is that there is "no single rule or touchstone has been devised for distinguishing between capital and revenue payments" (Lord Fraser in *Granada*). Instead there are many factors, and many approaches, to be considered some or all of which may be relevant. We consider below what appear to us to be the more important tests or indicators by reference to which this question was evaluated in the cases cited to us.

Absurdity or unfairness

19. To the eye of an accountant practising in the last 40 years the idea that profit should be struck without taking account of the depreciation of capital assets is absurd. If the winning of receipts diminishes the capital value of the asset by which they are won no one would say that it was 'common sense' that profit should be struck without taking into account that reduction.

20. Further, in contrast to what appears to have been the understanding of accounting practice at the time of most of the judgements relating to this problem, accounting practice over the last half century has recognised the accruals concept under which only that part of the cost of an asset which has been expended should be matched against the income generated so that the profit and loss account is not distorted by deductions in one year which relate to income earned over more than one year.

21. The unfairness of a rule which allows no deduction for a wasting capital asset is recognised in the authorities. As Lord Reid said in *Strick:* "If a trader acquires a rapidly wasting asset not covered by these statutory provisions he would not generally strike his balance of profits and gains without taking account of the annual wasting or diminution of value of that asset. But if his expenditure in acquiring it has to be regarded as capital expenditure he cannot do that for income tax purposes."

22. As Lord Reid says this practice is required by the statute. We see no warrant for reading the words of the statute differently because accounting practice has changed. In some situations the legislation mitigates its effect by giving capital allowances or like deductions. The van owner who rents out her van is denied deductions for the depreciation on her van but may be given capital allowances (or the like) calculated by reference to the cost of the van which she may set against the adjusted income.

From time to time the legislation has provided similar, often generous, allowances for the owners of films (see for example *Ensign*). There are specific reliefs for R&D expenditure and IP rights. The very fact of those allowances indicates that the meaning of "capital" in the prohibition in section 33 remains as it was understood more than half a century ago.

23. Thus it seems to us that we must resolve this question by reference to the understanding of "capital" in, and the reasoning of, the authorities without regard to whether or not the result might seem absurd or unfair.

24. Nor do we consider that the move to GAAP in section 42 FA 1998 requires a revision of previous understanding. That provision is subject to any rule of law, and the rule in section 33 is such.

Fixed or circulating capital –raw material

25. Some cases appear to rest on an accounting distinction between "fixed capital" and "circulating capital". Vinelott J in *Patterson v Marine Midland* ascribes the phrase "circulating capital" to Adam Smith, and cites Scrutton LJ in *Ammonia Soda Co v Chamberlain* "you cannot take the gross receipts of the year without taking into account in finding the profits the part of the capital which you have parted with – circulated, sold - in order to obtain this profit", by contrast he says you cannot deduct a loss of fixed capital in ascertaining a company's trading profit. That states the rule but does not help decide what is circulating and what is fixed.

26. Tiley & Collinson's UK Tax Guide 8.110 provides a useful summary of the distinction: Fixed capital is that retained in the shape of assets which either produce income without further action eg shares…or are made use of to produce income eg machinery…Circulating capital is that which the [business] intends should be used by being temporarily parted with and circulated in the [business] to return with, it is hoped, profit". That of course leaves unresolved what is "temporary".

27. In *Golden Horse Shoe*, Romer LJ rested his judgement on whether the tailings dumps were to be regarded a fixed or circulating capital. He explained the distinction thus:

> The reason for this distinction being drawn between fixed and floating or circulating capital is not far to seek. In assessing a trader to income tax under Sch. D, Case I, the revenue authorities are only concerned with his annual gains and profits; that is, gains and profits in the year of assessment or whatever may be the other material interval of time. They are not in the least concerned with his financial position as a whole at the end of the time as compared with his financial position at the beginning. Changes in the value of his fixed capital are therefore disregarded except where it is otherwise expressly provided in the Act. On the other hand, changes in his floating or circulating capital must be taken into consideration in ascertaining his annual gains and profits. For the profits or losses in a year of trading cannot be ascertained unless a comparison be made of

the circulating capital as it existed at the beginning of the year with the circulating capital as it exists at the end of the year.

28. This is not, for an accountant brought up in the last 40 years, easy to understand. Accountants have recognised fixed and current assets but for a long time have regarded annual profit as representing changes in balance sheet values across a year and as struck after deducting items such as depreciation which represent changes in fixed assets. Nevertheless it represents the context in which the "capital" must be understood in the Act.

29. Romer LJ emphasises the annual nature of profit computation and by inference the annual root of the meaning of circulating capital. Whilst other judgements, such as that of Lord Reid in *Strick* show a move away from an emphasis on the "annual" period indicated by Romer LJ, the approach is to our minds an unavoidable part of the understanding of "capital": as Lord Reid said, "the more closely the period of endurance is related to an accounting period the easier it is to argue for a revenue character, but no doubt there is a penumbra the width of which may vary according to the nature of the trade".

30. Romer LJ continues:

> "Unfortunately, however, it is not always easy to determine whether a particular asset belongs to the one category or the other. It depends in no way upon what may be the nature of the asset in fact or in law. Land may in certain circumstances be circulating capital. A chattel or a chose in action may be fixed capital. The determining factor must be the nature of the trade in which the asset is employed.",

and then gives examples showing that a particular asset may be for one business an item of fixed capital and for another an item of circulating capital.

(This "determining factor" is echoed in Lord Pearce's citation of Dixon J in *BP Autralia*:

> "The answer "depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process".)

31. In the same case Lord Hanworth MR placed a similar emphasis on the nature of the trade. He said:

> "The question in this case which we have to consider is what is the nature of the adventure or concern which this particular company is carrying on. If it is merely a manufacturing business, then the procuring of the raw material would not be a capital expenditure. But if it is like the working of a particular mine or bed of brick earth, and converting the stuff worked into a marketable commodity, then the money paid for the prime cost of the stuff so dealt with is just as much capital as the money sunk in machinery or buildings."

32. Romer LJ then goes on to distinguish between a coal gas producer who buys a coal mine (capital) and one who buys a quantity of extracted coal (revenue). As to the reason for distinction he says

> "The reason for this distinction is not at first sight very easy to discover. It must, as it seems to me, be found in this: that in the former case the purchase of the mine is not a purchase of coal but a purchase of land with the right of extracting coal from it. The land is regarded merely as one of the means provided by the manufacturer for causing coal to be brought to his gas works, and therefore as much part of his fixed capital as would be any railway trucks or lorries provided by him for the same purpose."

33. It seemed difficult to reconcile the "determining factor" - that the answer does not depend on the nature of the asset but on the nature of the trade - with this explanation, given its reliance on one of the transactions being a purchase of land. But it seems to us that the answer is that Romer LJ addressed it in the following way: if 'the nature of the trade' is described as 'using coal to produce gas', then the mine would be merely one of the means for obtaining coal. This requires a degree of finesse in the description of a trade.

34. It was from these considerations that Romer LJ concluded that the question to be decided was whether the tailings dumps were "the raw material of the appellant's business or ...merely... the means of obtaining that raw material." He viewed the nature of the business as producing gold as a finished product from the tailings just as the coal gas producer's business was producing coal gas from coal, and so was able to conclude that the tailings were raw material

35. HMRC say that the analogy the LLPs draw between the rights under the relevant agreements and raw material is inapposite. They say raw material is something acquired and processed or sold whereas the rights were not processed, were not modified in any way, and were not sold or incorporated into anything sold.

36. The LLPs say that the rights are not merely the means of obtaining raw materials but are exhausted as they are exploited and are the raw materials of the trade.

37. We do not consider the analogy helps. The rights did not play the role of raw materials since they were not used. Nor however did they play the role of a mine from which a mineral was extracted and sold, or an orchard whose fruit was sold: the money went out on the rights and came in from the rights. There was no material intermediate stage. The rights were the direct source of the money, more like the loans made by a bank.

38. But the underlying principle remains to be considered, namely what is the nature of the LLPs' business and what role do the rights have in that business?

39. We found that the nature of the LLPS' trade was financial: it was the speculative activity of choosing and laying out money on rights in the hope of monetary receipts from them. If the contrast of circulating and fixed capital is

considered then from a practical business point of view the monies deployed on the rights could be regarded as circulating over the period the rights remained in existence. That could indicate that over the economic cycle of the LLPs' trade the rights were revenue in nature. But the following two matters weigh against that
5 conclusion.

40. First that the nature of the LLPs' business as originally advertised did not involve the recycling of monies received. There was a separate LLP for each year; the monies which came in were to be distributed to the members. The nature of the business was to engage in number of speculative transactions, to await (and monitor)
10 their outcome and distribute the income arising: there was no circulation of capital.

41. Second, the emphasis on annual profit in the judgements, although tempered by other dicta, indicates that there is a length of business cycle which is so long that the business cycle cannot displace the attraction to the annual nature of profit. We discuss this under How Long is Sufficient? below.

15 42. Finally, in relation to the dichotomy between fixed and circulating capital the Appellants drew our attention to the Privy Council's decision in *BP Australia* in which it was said of the petrol ties:

> "The test of whether these sums were payable out of fixed or circulating capital, referred to for example in *John Smith & Son v. Moore* tends in the present case
> 20 in favour of regarding these payments as revenue expenditure. Fixed capital is prima facie that on which you look to get a return by your trading operations. Circulating capital is that which comes back in your trading operations. The sums in question were sums which had to come *back penny by penny* with every order during the period in order to reimburse and justify the particular outlay"
> 25 (italics added).

43. The Appellants say that precisely the same may be said about the sums laid out by the LLPs – they came back "penny by penny" with every ticket and DVD sale.

44. But the same is true of the van which the van hire company buys. The money laid out in its purchase comes back in the rental payments. We do not find this a
30 strong indicator of revenue nature.

45. A similar argument was rebutted thus by Lord Wilberforce in *Strick:*

> "A more elaborate form of the argument was that the sums were circulating capital because Regent expected to get its money back out of current profits as sales, gallon by gallon, day by day, were made. Of course they did; many
> 35 traders who lay out capital expect to get both a return on the capital and the amortisation of the capital expenditure out of the profits of the periodical sales and, whether consciously or not, they calculate the amount they are willing to lay out accordingly; but the fact that they have this expectation and so calculate their expenditure does not enable them to claim that the expenditure is of a
> 40 revenue character."

46. Our conclusion is that the nature of the trade weighs in favour of the rights being of a revenue nature but that this is balanced by the lack of circulation. The balance appears to us to lie in the question of whether the rights in context have too long a life to be revenue.

5 An enduring benefit

47. In *British Insulated and Helsby Cables* a company's contribution of a substantial sum to form the nucleus of a fund and provide the amount then necessary to provide pensions for its staff was held by Viscount Cave to be a capital payment on the
10 ground that:

> "when an expenditure is made, not only once and for all but with a view to bringing into existence an asset or advantage for the enduring benefit of a trade ... there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable
> 15 not to revenue but to capital."

This is not a conclusive bright line formula. Lord Pearce, giving the judgment of the Privy Council in *BP Australia,* said: "Those words are useful as an expression of general principle on prima facie indications, but the benefit in the particular case was the foundation of a fund that would endure for the whole life of the company and
20 provides no analogy to the present case. The solution to the problem is not to be found by any rigid test or description."

48. In *Strick,* three of their Lordships commented on Lord Cave's formulation. Lord Upjohn acknowledged that this test would in many cases be a valuable criterion but it did not help him in that case because it invited the further question "how long does it
25 take to be an 'enduring benefit' if you are dealing with a purely long term trading agreement?". There is an echo of that sentiment in these appeals where the trade of LLP relates to long term trade agreements.

49. Lord Reid thought that so much had been built on Lord Cave's words that he must try to see how they could be applied in that case. He saw nothing in the words to
30 indicate that a lump sum paid for an asset which would last only three years could necessarily be said to have been paid "once for all". He thought that in using "enduring" Lord Cave intended to link it with "once for all" and was thinking of an advantage which would last for an indefinite time. He declined to accept the argument that "enduring" had to be interpreted so as to include any benefit which lasted for
35 more than one year.

50. If "enduring" is meant to indicate an indefinite time, then the LLPs' rights technically satisfy that criterion. Although normally they will have little value after five or 10 years, they carried the possibility of receipts over a much longer period. That would point to capital.

51. That analysis, however, focuses on the juristic legal nature of the rights rather than what they are calculated to "effect from a practical and business perspective". In *Strick* Lord Wilberforce said this:

> This brings me to consideration of the durability of the advantage acquired. As Dixon J. said, when considering the nature of the advantage sought, "its lasting qualities may play a part." In English law the term most commonly employed in this part of the argument is "enduring" - ever since Viscount Cave L.C. in the *Atherton* case spoke, without intending to lay down a test, of "the enduring benefit of a trade." It might be enough to decide this case in favour of the Revenue to say that in relation to an "asset" of so concrete a character as a lease, or as a lease accompanied by a sublease, at any rate when the term of the lease amounts to five years or more, the test of durability is satisfied, but I do not wish to rest on this narrow ground; indeed, I do not think that it is sound reasoning to do so. I agree entirely with Lord Denning M.R., that if one considers the business reality here or, in the words of Dixon J., what the expenditure is calculated to effect from a practical and business point of view, the payments were made for rights (reinforced by the lease-sublease method) of exclusive supply of petrol to certain filling stations for periods varying from five years to 21 years. It is the endurability of this complex right which has to be considered, and we must squarely face the question whether such an advantage is sufficiently enduring in the context of Regent's trade to qualify as a capital asset or whether it has such transient qualities that it ought properly to be regarded as "day to day" or "current" and, so, revenue expenditure.

52. He then asked whether there was any line which could be drawn. After considering the authorities he concluded:

> The principle seems to emerge that if, on a consideration of the nature of the asset in the context of the trade in question, it is seen to be appropriate to classify it as fixed rather than as circulating capital, the brevity of its life is an irrelevant circumstance. But it would still be correct, in my opinion, where the nature of the asset, taken together with other relevant factors, leaves the matter in doubt, to have regard, amongst other things, to its transient character. No rule can be laid down as to a minimum period of endurance for a capital asset or a maximum permissible period for an item of stock or circulating capital, though obviously the more closely the period of endurance is related to an accounting period the easier it is to argue for a revenue character, but no doubt there is a penumbra the width of which may vary according to the nature of the trade.
>
> I return, then, to the expenditure in this case. Here the nature of the payments - lump sums - the nature of the advantages obtained - security in respect of the placing of orders for a period - the substantial periods involved, the shortest being a period of five years, more than adequately establish the expenditure as made for the acquisition of capital assets.

53. Thus whether there is an enduring benefit is to be considered by asking what is the nature of the asset in the context of the trade: "what the expenditure is calculated to effect from a practical and business point of view". Regent's trade was the supply

of petrol; the LLPs' trade was about longer term financial contracts. In a trade whose success or failure is illustrated over a period of 5 years, and the majority of whose returns are expected over such a period, we would not regard an asset which lasted for only five years as a capital asset. But, in the case of the rights some (or all) of which were hoped to produce money after 5 years, we are taken back to the question of how long is the shadow cast by the longer term nature of the rights in the context of the trade.

Once and for all - recurrence

54. Lord Reid regarded the "once and for all" criterion as part of Lord Cave's enduring benefit test, but it has been considered separately. It was stated in *Vallambrosa Rubber Co Ltd v Farmer*: "capital expenditure which is... once for all, and income expenditure which is a thing that is going to recur every year" ("every year" being later interpreted as meaning in continuous demand in the business).

55. In *BP Australia* Lord Pearce quoted Dixon J: "the expenditure is to be considered of a revenue nature if its purpose brings it within the very wide class of things which in the aggregate form the constant demand which must be answered out of the returns of a trade or its circulating capital and that actual recurrence of the specific thing need not take place or be expected as likely."

56. In *BP Australia* the Privy Council applied that test having regard to the "whole picture" and thought that the expenditure was recurrent and thus not "once for all".

57. The whole picture for the LLPs includes (i) their intent to return monies to the members (underpinned by the fact that they did so) (ii) their intent generally to operate so that only one LLP was open for subscription in any year, but (iii) the fact that the LLPs could become involved in other films in years after the first, either on seeking further subscriptions (as was the case for *Avatar)* or redeploying monies which had been expended on films which did not go ahead. Taking "recurrence" to be flavoured by the idea of continuous demand, and taking these considerations together, whilst the LLPs entered into many film contracts, the recurrence of the expenditure or a continuous or constant demand for such expenditure was not part of the business model. That points away from revenue.

Ordinary Commercial Contracts.

58. In *Van den Berg's* case Viscount Radcliffe recorded a demarcation between the permanent structure of a business (capital) and the cost of earning the income (revenue). In that case receipts derived from three agreements were held to be capital because they were not ordinary commercial contracts for the trade's products or agreements as to trading profits, but contracts which regulated the trader's activities. In *Strick,* in discussing the guidance afforded by Viscount Radcliffe, Lord Reid said that he found the test unhelpful, but:

> "I would think that the two most important of these considerations were that the contracts were not ordinary commercial contracts made in the course of carrying on the trade, and that, by defining what the company might do and might not do,

they affected the whole conduct of the business. I think that in some later cases the metaphor of structure has been used with far less justification."

59. The rights under the relevant agreements were the ordinary commercial contracts of the LLPs' trade; they did not regulate the LLPs' activities. The nature of
5 the *contracts in the context of the trade* points to a revenue nature.

Accounting Practice

60. In *Strick* Lord Wilberforce said:

"... I know of no reason why a short-term lease, for which a sum has been paid, or the benefit of a short-term covenant, should not rank as a capital asset. Of
10 course, its value ought in prudence to be writtten off over its life out of revenue, and it is no doubt fiscally unpleasant for the trader that (the income tax code allowing no depreciation of such assets to be charged) he must do so out of taxed income. But this taxable disadvantage cannot be used as an argument against the insertion of the item in the balance-sheet rather than the profit and
15 loss account: it is merely an argument against resorting to this type of transaction."

61. In 1933 Lord Hanworth MR in *Golden Horseshoe* recognised this difficulty recalling that the Courts had approved prudent accounting provision for the wasting character of their assets, but: "Yet that principle is not, except to a limited, though in
20 recent years, to an increasing extent, recognized in the method of the computation of profits and gains to the income tax.".

62. In *BP Australia* the Privy Council considered how the sums should be dealt with in accordance with the ordinary principles of commercial accounting, The evidence was that they would be written off in the year of payment; if they had been
25 "put in the balance sheet" they would have to be written down each year by the appropriate fraction if the balance sheet "was to be honest". The judgement concluded:

"The most apt way of dealing with these sums might seem to be to debit the profit and loss account with the whole payments and credit it with their
30 unexpired value, thus treating them as a revenue item; but *this is not the practice of accountants.* If, therefore, one must allocate these payments either wholly to one year's revenue or to capital it would seem that either course presents difficulties but that an allocation to revenue is slightly preferable." [added italics]

35 63. The accountancy evidence before us was different, and what we regarded as GGAP was more in line with what this passage indicates as preferable. The passage is thus an indication that the impairment of the rights was a revenue item not one in respect of capital.

"Upon assets" or "with" assets: part of the structure or part of the money making
40 machinery?

64. In *Commissioner of Taxes v Nchanga Consolidated Copper Mines [1964] AC 945* Viscount Radcliffe spoke of the demarcation between creating the permanent structure of a business and the cost of earning the income itself. He said it lead to distinctions of some subtlety between a profit made "upon" assets or "with assets".

5 65. In *Van den Berghs'* case contracts which related to the "whole structure of the profit making apparatus" were classified as capital.

66. Overall consideration of these formulae weighs towards treating the cost of the LLPs' rights as of a revenue rather than capital nature. The contracts made by the LLPs were long term, but they are the substance rather than the structure of the LLPs'
10 businesses: monies flowed from the contracts, not by deploying them.

<u>How Long is Sufficient?</u>

67. In *Strick* Lord Reid said:

> In two of the four arrangements with which the present case is concerned (including much the largest transaction) the ties were for 21 years: in one the tie
> 15 was for 10 years; and in the fourth it was for five years. I would have no doubt that the lump sums paid for the 21-year ties could not be treated as revenue outgoings even if there were no lease and sublease. These ties were not obtained in order to facilitate planned marketing or because the appellants thought it desirable to have them. The lump sums paid for them were only paid because
> 20 garage owners were in a strong bargaining position: they wanted and were able to get large sums paid immediately and they were willing to grant long ties in return.

68. But in relation to *Bolam's* case, where the longest ties were for 5 or 6 years, Lord Reid accepted that a business could not be managed on a day to day basis and
25 that it may not be unreasonable to look forward 5 or 6 years. On that basis arrangements for 5 or 6 years could generally be regarded as an ordinary incident of trading and part of revenue running costs especially where the payment was repeated.

69. The projections in the LLPs' Information Memoranda ran for 5 years, but that we think was for the purpose of giving investors an idea of what might happen over
30 that time frame, rather then as a tool for managing the business. The majority of the income was expected to come in over 5 years, but that did not indicate management by reference to a perpetually moving 5 year horizon. The management of the business did not seem to us to have the kind of 5 year cycle which would justify the application of Lord Reid's approach to *Bolam*.

35 70. Lord Morris said:

> Aided by the word pictures or descriptions of a capital asset which the decided cases contain I consider that a tie of the kind now being examined is a capital asset. If a lump sum is paid for such a tie for five years (or for a lesser number of years) it would give a false and unreal picture if the
> 40 whole sum were debited to the profit and loss account for the first year or

> for the year in which the payment was made. If it is said to be hard that no part of the lump sum can be a debit in the profit and loss account that is merely to voice a regret that there is no statutory provision which enables periodic allowances to be made. That however is not a matter for the courts.

In other words even if the ties had been for five years he would (unlike the others) have held that they were capital. But this was a minority view based on what seems to be antiquated accounting practice.

71. Lord Upjohn said:

> "I certainly approach the problem with this in mind, that in modern conditions trading contracts become more and more complicated, and those responsible for the affairs of large companies have to look much further into the future and to plan for the future in a way unthought of years ago. A company may reasonably require and be prepared to pay for secured outlets for its products for some years ahead especially when dealing with a product like oil which costs so much to extract, transport and refine...
>
> "Such payments are not lightly to be held to be capital.
>
> "But the amount of the payment and the length of the tie are important elements among all the other relevant facts. I part company at once with the submissions of counsel ...that ... the length of the tie is utterly immaterial save as a factor in calculating the anticipated gallonage and so the amount of the lump sum payment. ...So I approach this matter as one of judicial common sense and I start with the case of Murphy; it seems to me that to pay substantial sums for a tie for as long as 21 years is quite plainly, as a matter of common sense, a tie which must be described as of a capital nature,"
>
> On the other hand, one has the agreement for the payment of a sum for 5 years...I would think that the length of the tie plainly put it into the character of merely a long term trading contract...[and deductible]. The interesting case, of course is...where the tie was for 10 years...This is a borderline case and I shall say no more about it..."

72. We set out at [83] the comments of Lord Pearce in *BP Australia,* in which he viewed a 5 year payment in the case of a "durable" company as not having the once for all quality it would have if it were for a 20 year asset; later he says "considerations pointing towards a revenue expenditure would ...have prevailed on balance in the transaction where only a 5 year period is involved. But they would probably have failed to do so in the transactions which relate to periods of 21 years, and which therefore acquire a more enduring and structural quality.

73. The Appellants say that these dicta show that something lasting under about 10 years can be revenue but something of 20 year will be and something for 5 years is likely to be deductible.

74. We found that the LLPs were marketed as 5 year vehicles and that generally the vast majority of the income from the relevant agreements arose in the first five years. But it was also the case that the LLPs hoped that they had chosen at least some films which would be real successes. For those films income would continue to come in for many more than 5 years. It is true that the LLPs may have been able to assign the benefit of the contracts after 5 years or even earlier, but there was no indication that this was the nature of the business being conducted. In the context of the nature of their businesses, it seems to us that these rights should be regarded as having a life of more than 5 years. They would last as long as the business lasted since they were the substance of that business.

75. The role these rights played in the business seems to us to extend over too large a tract of time to escape from the magnetic attraction of the idea that profits are "annual", or the idea that things which last a long time must be capital.

The Approach in *BP Australia*

76. The Appellants said that they relied upon the whole of this judgement. The approach adopted in it provides a way of pulling together the factors already discussed.

77. Lord Pearce, who gave the judgment said:

> A valuable guide to the traveller in these regions is to be found in the well-known judgment of Dixon J. in Sun Newspapers Ltd. v. Federal Commissioner of Taxation, where he discussed the nature of certain sums spent in buying up the competition of a rival and concluded that they were capital. "There are, I think," he said,
>
> > "three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment."

78. The judgment then considers each of those matters. Under (a), the character of the advantage, he considers (i) Lord Cave's enduring benefit test, (ii) whether the payments were "once and for all" or had the quality of recurrence, (iii)the length of the agreements, (iv) their treatment in accordance with ordinary commercial accounting principles, and (v) whether the payments were expended on the structure of the business as opposed to being part of the money making process. He concludes

that consideration of the nature of the benefit in that case pointed to the expenditure being revenue rather than capital.

79. We have considered these tests separately in the sections above. We considered that:

5 (i) the advantage sought by the LLPs from the rights under the relevant agreements was the receipt of future income, and whether or not this was an enduring benefit depended upon how long a shadow the nature of the business cast;

(ii) the payments did not have recurrent nature in the sense of being
10 continuously demanded by the business;

(iii) the rights had a length which could not escape from the primitive concept that revenue items had an annual or at least a short term nature;

(iv) ordinary commercial accounting principles would nowadays require deduction of part of the cost from the profit and loss account, and

15 (v) the monies were not expended on, and the rights were not part of the structure of the business.

80. These considerations were finely balanced but overall weighed in favour of a capital nature.

81. In relation to (b), the manner in which the benefit was to be used, Lord Pearce
20 says that the tie agreements were to be used in the continuous struggle to sell petrol and became part of the ordinary process of selling. Those facts pointed in that case towards the expenditure being a revenue item.

82. In the case of the LLPs the rights were a result rather than a part of the ordinary process of selling (any "selling" – the exchange of money for a future right to money -
25 had been done when the rights were entered into), and they were not used or turned over as part of any continuous struggle. This is not a pointer to revenue.

83. Were the rights part of the class of things which formed the "constant demand" to be answered out of returns of the trade or its circulating capital? The nature of the LLPs' trades could not in our view be regarded as creating a "constant" demand in
30 this sense, There was an initial demand, but the intention to distribute receipts as drawings meant that it could not be said that there was, in the nature of the trade, a constant demand for new film rights contracts. This does not point to revenue.

84. Under heading (c), the method of payment, Lord Pearce noted that the payments in that case were not annual but of a one off nature. He said:

35 "These payments were not current payments made annually over the period of benefit but on the other hand it was clear that they would have to be made again at intervals of a few years. In a durable company of this nature recurrent five yearly payments certainly cannot be said to have a "once for all" quality. Had

the payments been for one or two years they would point towards revenue; had they been for 20 years they would point towards capital."

85. Like the payments for the ties, the payment made by the LLPs for the rights were not made periodically, but, in contrast to the payment for the ties there was nothing to suggest that they would be repeated at intervals.

86. We also find some help in this passage, not so much in relation to the precise periods Lord Pearce mentions, but in relation to the way they are viewed against the business of the company. He describes BP Australia as a "durable" company. We take this in contrast to an enterprise which is only intended or likely to last for a few years. The LLPs' business was not durable in this sense: the LLPs might well continue to become involved in new films but monies which came from the films rights were intended to be distributed to the members not retained for future use. There was some uncertainty as to the long term future of the business; nevertheless the rights would exist, and the monies could be paid under them for a long period.

87. Taking those considerations together we regard this aspect of the three pronged test advocated in *BP Australia* as pointing towards capital rather than revenue.

Conclusion

88. It is with misgivings and reluctance that we conclude that the rights were capital in nature. The period over which the rights were to play a part in the business of the company is the factor which has weighed most heavily in reaching this conclusion despite the fact that the rights were ordinary commercial contracts and were the source of income rather than the setting in which it was generated.

89. We therefore find that the impairment amounts (or onerous contract provisions), which related to the capital expenditure on the rights, were not allowable deductions.

Rights of Appeal

90. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

CHARLES HELLIER
TRIBUNAL JUDGE

RELEASE DATE: 17 MAY 2017