The First-Tier Tribunal has handed down its decision in Eclipse Film Partners No 35 LLP, a case concerning certain film rights exploitation transactions. The case concerned whether Eclipse Film Partners No 35 LLP ("Eclipse 35") was carrying on a trade for tax purposes. Even before judgment, this decision has been the subject of significant press coverage.

**THE FACTS**

Eclipse 35 licensed from Disney rights to exploit and distribute the films "Enchanted" and "Underdog" for a term of 20 years, for which Eclipse 35 agreed to pay Disney an annual licence fee (which was prepaid) and a variable royalty.

On the same day, Eclipse 35 sub-licensed the rights in the films to a Disney group distribution company also for 20 years. The Disney distribution company was required to exploit and distribute the films and pay Eclipse 35 fixed distributions and variable distributions over the 20 year term, plus contingent receipts equating to a 40% interest in the net receipts of the films. Payment of the fixed distributions was secured by the provision of a letter of credit issued by Barclays.

The Eclipse 35 members funded their capital contributions to the partnership principally (as to 94%) from loans advanced by a Barclays group company, Eagle Financial and Leasing Services. These loans had a term of 20 years, provided for a fixed rate of interest, and required members to pre-pay the first ten years’ of interest. The interest prepayment was effected by Eclipse 35 advancing funds to members on account of future profit distributions. The loans were secured by a charge given by Eclipse 35 to Eagle over the Barclays letter of credit.

Members sourced the remaining 6% of their capital contributions from their own resources.

Eclipse 35 engaged a member of the Disney group, WDMSP Ltd, to act as its agent with respect to the marketing and release of the films. As part of these arrangements, the services of certain Buena Vista personnel (Buena Vista being a Disney film distribution company) were made available to WDMSP.

Eclipse 35 members would be able to claim relief for interest on their loans from Eagle, when paid, against other taxable income. To do so, the money borrowed by members (once contributed to Eclipse 35 as capital) needed to be used for the purposes of "the trade…carried on by the partnership". HMRC argued that Eclipse 35 was not carrying on a trade, or if it was carrying on a trade, it was not doing so with a view to profit (such that the activities of Eclipse 35 could not be attributed to the members).
THE DECISION

The First-Tier Tribunal (Mr Edward Sadler and Mr John Walters QC) found in favour of HMRC. It held that Eclipse 35 was not carrying on a trade but instead a "non-trade business". This effectively denied members tax relief for interest payments on their Eagle loans, while the profits flowing to members via Eclipse 35 remained fully taxable.

The Tribunal considered that the transactions undertaken by Eclipse 35 were genuine transactions, rather than being shams as HMRC had effectively alleged. However, those transactions did not possess sufficient trading attributes. In particular, the Tribunal considered that Eclipse 35 was not at (sufficient) commercial risk; the fixed and variable annual distributions effectively ensured that Eclipse 35 turned a profit each year "without any reference to the success or otherwise" of the films. The risk of Barclays default under the letter of credit (which secured the fixed distributions) was considered too remote and too far removed from the activities of Eclipse 35 to render the profits of Eclipse 35 speculative. The Tribunal considered that the transactions failed to demonstrate, the provision of something "by way of business" and an identifiable "customer". The Tribunal highlighted that Eclipse 35 had acquired the film rights, and sub-licensed them, virtually simultaneously - Eclipse 35 did not enhance the rights in any way before they were sub-licensed to the Disney distribution company. And while Eclipse 35 did monitor the activities of the Disney distribution company with respect to the marketing and release of the films (via WDMSP, in its capacity as a service provider to (but not agent of) Eclipse 35), the Tribunal concluded that Eclipse 35 had no meaningful role in actually directing or influencing such marketing and release - in effect, the Disney distribution company did what it would have done regardless of the involvement of Eclipse 35. Both the strategic and day-to-day planning for the marketing and release of the films was, and remained at all times within, the Disney group - Eclipse 35 failing to overcome the "high credibility" hurdle that Disney would use its "vast resources and expertise to market and distribute the films to the best of their considerable ability". Hence on a realistic view of the facts, the Tribunal concluded that Eclipse 35 was not sufficiently involved in the film marketing and exploitation process to be trading.

COMMENT

The decision in Eclipse 35 is another example of the trend of the courts to find in favour of HMRC where transactions are seen to be tax-motivated. Tax-motivated transactions have been the subject of much public debate, aptly demonstrated by the media attention which this decision has attracted (even before its release) and the coverage of the recent arrests of certain employees of RBS in connection with their involvement in an unrelated film financing transaction.

Film is a fertile area for challenge by HMRC, and they have seen recent success, notably in Samarkand Film Partnership No.3 and Others v HMRC where it was held that neither of the relevant film sale and leaseback partnerships were trading. Parallels can be drawn from the decision in Samarkand to this decision in that the economics in both cases were found to be driven by the availability of tax relief rather than an interest in commercial profit. In both cases the returns were found to have been pre-determined at the outset and in particular, in the case of Eclipse 35, the fixed distributions had been reduced by reference to the interest prepayment (albeit the contingent receipts entitlement had been increased). Both cases had also included a right to contingent receipts which the Tribunal had disregarded as too remote, referring to them as "gravy" or "pixie dust" (in Samarkand) and a "bonus" (in Eclipse 35). The Tribunal was also of the view that the financial projections given to potential members did not have sufficient regard to the right to contingent receipts in calculating the expected internal rate of return to render such entitlement meaningful.

The Tribunal rejected the argument that the licensing and sub-licensing arrangements could be regarded as trading transactions on the analogy of a sale and leaseback transaction. The reasoning of the Tribunal in this regard was that finance leasing was really a financial trade rather than a leasing trade, and that in this case Eclipse 35 had not provided any finance nor could any financial activity be imputed on a group basis. Moreover, the Tribunal held that Eclipse 35 had not retained any "residual film rights having commercial reality" - the agreements had been entered into concurrently, were co-terminus (such that neither agreement could have an effective life beyond the other) and interdependent. In addition, Eclipse 35 never received actual physical delivery of a copy of the films (albeit delivery was effected in the same way as other commercial film transactions where a copy of the film is held at a laboratory with access being granted).

Whilst film transactions are a fertile area of challenge, it has not all gone HMRC’s way; the taxpayer succeeded in
Micro Fusion 2004-1 LLP v HMRC. What seems to be clear in comparing the recent decisions in this area (such as Micro Fusion, the Supreme Court decision in HMRC v Tower MCashback LLP 1 and Another and the Upper Tier Tribunal decision in Icebreaker 1 LLP v HMRC) is that a key differentiator between success and failure for the taxpayer is implementation and evidence of implementation, rather than strict legal form. Indeed, the Tribunal in Eclipse 35 held that the licence and sub-licence had effect according to their terms and the film rights were real and meaningful. One wonders whether the decision may have been different if Eclipse 35 had implemented its transactions in a different way. For example, what if it had negotiated a more probable right to contingent receipts? Or if it had retained a meaningful interest in the film rights? Or if it had been able to demonstrate that the personnel made available to WDMSP were acting for Eclipse 35 providing meaningful direction and influence over the marketing and release of the films? Taxpayers considering similar types of arrangements would be well advised to deal with these matters upfront and retain contemporaneous evidence of so doing.

It will be a welcome confirmation for taxpayers that the Tribunal found that the manner in which the Eclipse 35 members had financed their capital contributions and the related banking and security arrangements were strictly extraneous to the question of whether Eclipse 35 was conducting a trade, albeit they "were part of the context" and could inform as to the motivation for the transactions entered into. Another welcome clarification was that the inclusion of language in the licensing agreements that for the purposes of US tax law and US GAAP, the transactions would be treated as the purchase of a revenue stream (so called "Danielson" language) should not prejudice a taxpayer’s case and could in fact assist the taxpayer in highlighting that the legal effect of the transactions in the UK may well differ from the interpretation for other purposes (and indeed, from the UK GAAP interpretation).

We understand from the press, that Eclipse 35 is likely to appeal the decision; aspects of the decision could give grounds for such an appeal. In particular, the determination that commercial risk or speculation is a required attribute for trading fails to appreciate the reality that any business will seek to reduce, as far as possible, commercial risk. There are many examples of trades with pre-determined levels of profit, such as utility companies. Also the Tribunal relied upon older case law on the "badges of trade" which does not translate well into the modern business environment. The Tribunal found that Eclipse 35 did not have a customer; surely the Disney distribution company answered that description? And the basis for distinguishing Eclipse 35 from sale and leaseback transactions is questionable.

With the cap on income tax reliefs for individuals (expected to include interest reliefs) at the greater of £50,000 or 25% of income to have effect from 6 April 2013 and the prospect of a general anti avoidance rule (GAAR) on the horizon, unrestricted income tax reliefs now appear to have a very short shelf life. And given the current attitude of the courts, those wishing to access such reliefs and stay on the right side of the line, would be well advised to focus on commercial motives and implementation.

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