Appeal number FTC/43/2010
[2010]UKUT 417 (TCC)

Income tax – EIS relief – section 291B of ICTA - "Connected person" – condition concerning loan capital – whether loan capital and share capital to be aggregated - whether share capital to be taken at nominal value or subscribed value

UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS — **Appellants**

- and -

(1) MR NRJ TAYLOR
(2) MR N HAIMENDORF — **Respondents**

TRIBUNAL: THE HON MR JUSTICE ROTH

Sitting in public at The Royal Courts of Justice on 4 November 2010

Ms Aparna Nathan, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Appellant

Mr Ben Staveley, representative for the Respondents

DECISION

Introduction

1. The Enterprise Investment Scheme ("EIS") was introduced under tax legislation with effect from 1 January 1994, replacing the Business Expansion Scheme which had existed since 1981. The provisions dealing with EIS are designed to encourage investment by individuals in ordinary shares of unquoted companies. With that objective, relief from income tax is provided for investment in qualifying companies. In order for an individual to receive such relief, he must not be "connected" with the company in which he makes the investment. It is common ground in this appeal that the purpose of that condition is to preclude EIS relief from being used by individuals to fund their personal companies or companies over which they have significant influence.

2. This case raises a short, but far from easy, point of interpretation of one of the criteria whereby it is determined whether an individual is such a connected person. By its decision of 11 March 2010, the First-Tier Tribunal, Tax Chamber ("the FTT") rejected the interpretation of that criterion applied by the Commissioners for Her Majesty's Revenue and Customs ("HMRC"). With permission granted by the FTT, HMRC appeal.

The Facts

3. The facts in this case are not in dispute. Wrapit Ltd ("the Company") was a qualifying company for the EIS. It was incorporated on 15 February 2000 and traded as a website-based wedding list gift business until it went into administration in August 2008. The Company's authorised share capital was £100,000 divided into 10,000,000 shares of 1p each. Both Respondents were directors of the Company and the first Respondent, Mr Taylor, was the Company secretary.

4. The Company was funded by the issue of subscriptions for shares, bank lending and loans from the directors, several individuals and from another company, Strand Associates Ltd. This funding was required to cover trading losses and also to provide short-term seasonal loans to tide the Company over the winter period when the wedding gift business was slack.

5. Both Respondents held shares in the Company and extended loans to the Company. Although denominated in 1p shares, the issued share capital was subscribed for at a substantial premium. The proportions of the total shares issued by the Company held by the Respondents as at the end of 31 December 2004 and 2005 were as follows:

	No of 1p shares	Nominal value	Amount subscribed for shares
31.12.2004			
Total	3,568,201	£35,682	£1,432,161
Mr Taylor	149,667	£ 1,497 (4.2%)	£ 99,800.25 (7%)
Mr Haimendorf	247,000	£ 2,470 (6.9%)	£ 170,250 (11.9%)
31.12.2005			
Total	4,125,282	£41,253	£2,100,658
Mr Taylor	149,667	£ 1,497 (3.6%)	£ 99,800.25 (4.75%)
Mr Haimendorf	300,000	£ 3,000 (7.3%)	£ 233,850 (11%)

6. The loans which the Respondents provided to the Company were for fixed periods and were (with two exceptions) interest-bearing. There were no special terms in the short-form loan agreements and the loans were generally repaid within six months. The proportions of the total amount loaned to the Company contributed by the Respondents as at 31 December 2004 and 2005 were as follows:

	Amount loaned to the Company
31.12.2004	
Total	£400,000
Mr Taylor	£100,000 (25%)
Mr Haimendorf	£150,000 (37.5%)
31.12.2005	
Total	£450,000
Mr Taylor	£150,000 (33.3%)
Mr Haimendorf	£150,000 (33.3%)

The Legislation

7. The statutory framework governing EIS and the eligibility for relief is in Chapter III of Part VII the Income and Corporation Taxes Act 1988 ("ICTA").[1] Section 291(1) provides that an individual qualifies for relief in respect of eligible shares for which he subscribes on his own behalf if he is not connected with the company at any time in the period beginning two years before the issue of the shares and (by virtue of section 312) ending, in most cases, three years after the issue date. The succeeding provisions set out the circumstances in which the person is so connected ("a connected person"). An employee of the company or its subsidiary is a connected person: section 291(2)(a). A director who receives payment from the company is a connected

[1] All statutory references are to the ICTA

person: sections 291(2)(c), 291A. Section 291B sets out further categories of connected persons, described in the title as "persons interested in capital etc of company".

8. The particular provision at issue in this case is section 291B(1)(b), to which I shall refer, like the FTT, as "paragraph (b)". But as that paragraph has to be considered in its context, it is appropriate to set out most of the section:

> "(1) An individual is connected with the issuing company if he directly or indirectly possesses or is entitled to acquire more than 30 per cent of—
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> (a) the issued ordinary share capital of the company or any subsidiary,
>
> (b) the loan capital and issued share capital of the company or any subsidiary, or
>
> (c) the voting power in the company or any subsidiary.
>
> (2) An individual is connected with the issuing company if he directly or indirectly possesses or is entitled to acquire such rights as would, in the event of the winding up of the company or any subsidiary or in any other circumstances, entitle him to receive more than 30 per cent of the assets of the company or subsidiary (the "company in question") which would then be available for distribution to equity holders of the company in question.
>
> (3) For the purposes of subsection (2) above—
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> (a) the persons who are equity holders of the company in question, and
>
> (b) the percentage of the assets of the company in question to which the individual would be entitled,
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> shall be determined in accordance with paragraphs 1 and 3 of Schedule 18, taking references in paragraph 3 to the first company as references to an equity holder and references to a winding up as including references to any other circumstances in which assets of the company in question are available for distribution to its equity holders.
>
> (4) An individual is connected with a company if he has control of it or of any subsidiary.
>
> …

> (7) For the purposes of this section the loan capital of a company shall be treated as including any debt incurred by the company—
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> (a) for any money borrowed or capital assets acquired by the company,
>
> (b) for any right to receive income created in favour of the company, or
>
> (c) for consideration the value of which to the company was (at the time when the debt was incurred) substantially less than the amount of the debt (including any premium on it).
>
> …
>
> (9) In determining for the purposes of this section whether an individual is connected with a company, no debt incurred by the company or any subsidiary by overdrawing an account with a person carrying on a business of banking shall be treated as loan capital of the company or subsidiary if the debt arose in the ordinary course of that business."

9. HMRC contend that paragraph (b) sets out a composite category such that the amounts of loan capital and issued share capital are to be aggregated and an individual who holds more that 30% of that aggregation is accordingly "a connected person". Further, HMRC apply the nominal value of the share capital for the purpose of that calculation. The FTT decided, upholding the argument of the Respondents, that on a purposive construction, paragraph (b) sets out a double category such that the 30% threshold is applied both to the loan capital and to the issued share capital. Accordingly, if an individual holds more than 30% of the loan capital but less than 30% of the issued share capital, the paragraph (b) threshold is not crossed and he is not a connected person. Hence on the interpretation adopted by the FTT, the Respondents were not connected persons, whereas on HMRC's interpretation, save for Mr Taylor in 2004, the Respondents were connected persons and thus ineligible for EIS relief.

Discussion

10. HMRC submitted that on its natural meaning, the wording of paragraph (b) clearly expresses a composite, aggregated category. Hence, it was argued, the interpretation adopted by the FTT ignored the natural meaning of the words and applied the 30% threshold in a different way to paragraph (b) from the way in which it clearly applies to paragraphs (a) and (c). I do not accept that

argument. The problem caused by the two elements in paragraph (b) simply does not arise as regards the other two paragraphs in sub-section 291B(1) so there is no question of any inconsistency in approach. Moreover, the FTT expressly acknowledged that HMRC's reading of paragraph (b) works better grammatically but held that the alternative reading is not impossible. I respectfully agree. However, I would add that if it had been the intention of Parliament for the 30% threshold to apply both to loan capital and to issued share capital, I would have expected the draftsman to use a different formulation (for example, by insertion of the words "each of" at the start of paragraph (b)). But although that is a valuable pointer, I do not regard it as decisive.

11. As with all statutory construction, one must consider not just the literal expression employed but the objective of the provision and the consequences of the alternative interpretations. There is no difference of approach in that regard because this is a tax statute or because in this case it is the taxpayer who seeks to rely on a purposive construction. As Sir Richard Scott V-C observed in *Bibby v Prudential Assurance* [2000] STC 459, commenting on the House of Lords' landmark decision in *WT Ramsay Ltd v IRC:*

> "The case signalled an end to some of the excesses that a literal approach to construction had appeared to invite. The warning against literal construction that would permit the use of a taxing provision for a purpose never intended or contemplated by Parliament was directed as taxpayers, or their tax advisers, but must, in my judgment, be heeded also by the Revenue."

12. The first ground on which the FTT rejected HMRC's interpretation was the impracticability or uncertainty as to the manner in which the aggregation of the share capital and loan capital should be carried out. HMRC submitted that this reasoning was misplaced and that once it is determined on what basis the share capital should be valued, the aggregation can be calculated without difficulty. However, I do not think that the FTT was suggesting that there is any mathematical difficulty and, clearly, HMRC have been performing the calculation, applying their interpretation of the provision, for many years. The point made by the FTT, as I understand it, was rather that if the two elements are to be aggregated before calculating the percentage threshold, then the decision as to whether the nominal value or the subscribed value of the share capital is to be used can make a very substantial difference, especially when the nominal value is small (eg, 1p shares) compared to the amount actually subscribed for each share. Therefore, if HMRC were correct that the two elements are to be aggregated, the legislation might have been expected to indicate on which basis the valuation of the share capital should be carried out.

13. It was a subsidiary ground of the Respondents' case that, if the two elements are to be aggregated, then "issued share capital" should mean the amount subscribed for the shares since that would more realistically represent the financial interest advanced to the company by the individual, and it would preclude the loan capital from disproportionately outweighing the share capital in a case where the shares had a very low nominal value compared to the amount subscribed. Although the Respondents' primary argument was that there should be no such aggregation, I think that the analysis is assisted by considering, first, the meaning to be given to issued share capital. Even on their primary contention, the point could be significant since successive issues of shares may well be subscribed at a different premium.

14. The meaning of "issued share capital" received a clear and careful analysis by Megarry J in *Canada Safeway Ltd v IRC* [1973] 1 Ch 374. The statutory context in that case was the provision providing relief from stamp duty on the transfer of a beneficial interest between two "associated" companies, in the sense that the one company owns not less that 90% of the issued share capital of the other. An American company made a large transfer of shares in an English company to the taxpayer. The American company owned all of the ordinary shares in the transferee but none of the cumulative redeemable preference shares. As a result, on the nominal value, the American company owned less than one-third of the issued share capital and thus was far short of the requisite 90% for exemption; however, if the actual value of the shares owned by the American company was taken it easily satisfied the 90% requirement. The critical question, therefore, was whether the percentage of "the issued share capital", as specified in the statutory test, was to be based on actual value or on nominal value.

15. Megarry J held that the nominal value of the issued share capital was to be applied. The language "share capital" pointed clearly to the nominal or face value of the issued share capital rather than the market value. The judge stated (at 380E):

> "The word "capital" seems to me to be a word which in this context is inept if it is intended to convey the idea of actual value. The capital of a company may remain wholly unchanged while estimates of the value of the company's assets or its undertaking or its shares fluctuate greatly on the stock exchange and elsewhere. To proffer a percentage of the value of the issued share capital is no compliance with a statutory demand for a percentage of the issued share capital itself."

He proceeded to observe that the phrase actual value is itself capable of a variety of meanings and therefore to adopt that definition would introduce considerable uncertainty. He concluded (at 381B):

"The test of nominal value is simple, workable and, above all, related to the words "share capital"."

16. For the Respondents it was submitted that the *Canada Safeway* case was distinguishable since the alternative there considered was the market value, which was obviously prone to fluctuation, not the subscribed value that was fixed and readily ascertainable. That is so, but the reasoning of Megarry J was largely based on close attention to the statutory language. He recognised that there would be some marginal cases where this would produce a result that seemed at odds with the statutory purpose but on the whole the adoption of this meaning gave "substantial effect" to the general purpose of the provision.

17. Although the *Canada Safeway* case was therefore not addressing directly the issue of subscribed value, its reasoning appears to me to apply equally in the present case. Moreover, the expression "issued share capital" is used frequently throughout the ICTA. As the Respondents were constrained to recognise, it would be a striking result if the same form of words were to receive a very different interpretation within the same statute. In my judgment, if that result was intended, the draftsman would have made express provision for this by including a distinct definition of issued share capital specifically for the purpose of this part of the legislation in section 312. In the absence of such special definition, I consider that the phrase must receive the same meaning throughout the ICTA. That meaning has been well-established since the *Canada Safeway* judgment that has been applied for almost 40 years. Accordingly, I consider that it is clear that issued share capital in paragraph (b) refers to the nominal value of the shares. Once that is determined as the correct interpretation, the potential practical difficulty of aggregating the two elements in paragraph (b) falls away: the actual calculation is straightforward.

18. I do not think that this conclusion is affected by the judgments of the Hong Kong Court of Final Appeal in *Collector of Stamp Revenue v Arrowtown Assets Ltd* [2003] HKCFA 46. That case also concerned the test of 90% "of issued share capital" for the purpose of stamp duty. But the issue there was whether in applying this test the issued share capital should include a separate class of non-voting shares that had been specially created for a tax avoidance arrangement. The Court held, on a *Ramsay* approach, that these shares were to be disregarded, but that is a very different question from how the shares are to be valued. Indeed, the judgment of Lord Millett NPJ in that case expressly referred with approval to *Canada Safeway* for the meaning of issued share capital (see at para 102). There is nothing artificial or contrived about the application of that meaning in the context of paragraph (b).

19. The primary ground on which the FTT upheld the appeals against the tax assessments was that the combination of the two ingredients involved in

HMRC's construction of paragraph (b) could lead to capricious results. The FTT observed that when the nominal value of each share is small while the actual amount subscribed for each share is much higher, a temporary loan to the issuing company can lead an individual holding a small minority of the shares to become the holder of a disproportionately large part of the issued share capital plus loan capital. That indeed was the position of the Respondents in the present case. To take the year 2005 by way of example, Mr Taylor and Mr Haimendorf held, respectively, only 3.6% and 7.3% of the nominal share capital but their short-term loans of £150,000 each to the Company took their percentages of the aggregated total to 30.8% and 31.1%. The disproportion results from the fact that these were 1p shares, so that in terms of the total capital actually contributed to the Company of some £2.55 million (i.e., £2.1 million subscribed for shares and £0.45 million in loans), Mr Taylor had contributed only 9.8% and Mr Haimendorf only 15%.

20. The FTT gave a hypothetical example of the kind of anomaly that could result at para 10 of the Decision: if four shareholders who had subscribed at premiums for 5% of the shares then agreed to advance to the company equal amounts by way of loan, the late provision of the loan capital by one of them could temporarily place the other three in the position of being over the 30% threshold, thereby losing their EIS relief whereas the late payer would retain it. Further examples of potential anomalies were suggested in argument.

21. In his attractively presented submissions, Mr Staveley for the Respondents relied on the purposive approach to statutory construction to contend that where the statutory language permitted an interpretation that avoided such anomalous results, that interpretation should be adopted. Looking at sub-section 291B(1) as a whole, its purpose is to preclude individuals from claiming relief if they have significant influence over the company. Hence paragraph (a) is concerned with ownership and paragraph (c) with voting power, whereas paragraph (b) is addressing financial or economic influence. Debt funding generally gives less influence over a company than equity funding, especially bearing in mind that by virtue of section 291B(7) and (9) "loan capital" is given a very wide definition: any money advanced, even on the simplest terms, is included other than a regular bank overdraft. It is therefore not appropriate, the Respondents submitted, to give them equal weight, still less to allow the loan capital completely to outweigh the share capital in calculating the 30% threshold when the company's share capital is denominated in 1p shares.

22. The difficulty with these submissions is that the legislature has manifestly viewed loan capital as relevant in this context. On either construction, loan capital is therefore to be regarded as bringing influence when combined with some holding of the issued share capital. If an individual owns more than 30% of the issued ordinary share capital of the company, he will be a

connected person by virtue of paragraph (a). Paragraph (b) therefore becomes relevant only for an individual holding 30% or less of the issued ordinary share capital. And in that eventuality, even on HMRC's construction he will not be caught by paragraph (b) unless he has contributed over 30% of the loan capital. Put another way, the minority shareholder postulated by the FTT would only fall within paragraph (b) once he provides over 30% of the company's borrowing, whereas on the alternative construction adopted by the FTT a small minority shareholder who provides a very high proportion, or even the entirety, of the company's loan capital would never be regarded as having the significant influence envisaged by the concept of a connected person. In my view, that result does not indicate a sensible or reasonable construction of the provision, having regard to its overall purpose.

23. I do not derive much assistance from consideration of sub-sections (2) and (3), which relate to the rights on winding up and which, Mr Staveley pointed out, include only a lender in respect of a non-commercial loan: see Schedule 18, para. 1. The focus of those provisions on rights on winding-up is manifestly different from that of the sub-section (1). But far from the broad definition of loan capital under sub-sections (7) and (9) that applies for the purpose of sub-section (1) weakening HMRC's case, I consider that it supports it. Since commercial bank lending (save only by way of ordinary overdraft) is included in the total of loan capital – and thus is counted in the denominator – it is understandable that an individual whose lending nonetheless accounts for over 30% of that total should be regarded as having significant influence although he holds less than 30% of the issued ordinary shares.

24. Moreover, there is a further difficulty in the FTT's approach. Paragraph (a) refers to "issued ordinary share capital" and paragraph (b) to "issued share capital". The distinction in effect relates to preference shares which do not form part of the ordinary share capital: section 832(1). But for smaller companies of the kind that qualify for the EIS, as in the present case, the issued ordinary share capital and issued share capital are generally the same. In the light of that, if paragraph (b) applied only if an individual held more than 30% of the issued share capital, it would add almost nothing to paragraph (a). Only in the rare case of an individual holding more than 30% of the issued share capital but 30% or less of the ordinary share capital would paragraph (b) be other than superfluous – and then it would apply only if he also held a sufficient proportion of loan capital. I can see no logic in such a distinction, nor in giving paragraph (b) such a restricted role in the statutory scheme.

25. The rules on eligibility for EIS relief require clarity. The selection of a single, uniform boundary based on a percentage proportion is generally somewhat arbitrary. Such rules may often give rise to anomalous cases. The FTT, in its focus on such potentially anomalous results of HMRC's interpretation, paid

insufficient regard, in my judgment, to the consequences of the alternative interpretation which it adopted. An individual who provides a company with over 30% of its aggregate loan capital and share capital, where his contribution to loan capital alone is well over 30% although his holding of share capital is below 30%, may reasonably be considered to have potential influence in the company's affairs, even if there are no formal restrictions in the loan terms. He would often not be a purely outside investor of the kind that EIS relief is designed to benefit.

26. The real anomaly, and it seems to me the thrust of the Respondents' underlying grievance, arises not from the aggregation of loan capital and share capital for application of the threshold, but from the fact that the share capital is counted for this purpose at its nominal value and not the value actually subscribed. To express the matter in specific terms by reference to the facts of this case, if Mr Haimendorf had acquired not 300,000 but 550,000 shares by the end of 2005 he would have held on their nominal value less than 14% of the shares in the Company but (assuming that his shares were all acquired at an equivalent premium) together with his lending of £150,000 the aggregate amount of his contribution would constitute more than 30% of the Company's actual funding. It would be entirely consonant with the purpose of section 291B(1) then to regard him as a connected person. Indeed, given that the legislature has adopted 30% as the threshold for significance and considered financial interest to be a relevant criterion, in my view it would be somewhat bizarre if he then was *not* regarded as connected for these purposes.

27. I recognise that in some cases the degree of divergence between nominal and subscribed share values and the particular ratio of lending to share investment may combine to produce a result that seems harsh. But that is the result of the use of the nominal value in the computation of share capital. That this value is the correct one to use is well-established, as I have held. In my judgment, it would be wrong to distort paragraph (b) into a bifurcated category so as to counter-balance the use of nominal share values that produces anomalous results in some cases. Having regard to the statutory context and purpose, I consider that paragraph (b) should therefore be interpreted, in accordance with the more natural meaning of the words, to refer to a single, composite category to which the 30% threshold is applied.

28. I do not think that this interpretation, as opposed to the alternative, causes particular problems of uncertainty for an individual seeking to claim EIS relief. Depending upon the nominal value of his shareholding, an investor will have to take care as to the proportion that he advances of the company's total borrowing. The fact that this is not within his sole control, and that the amount of the company's total loan capital may fluctuate, is inherent in the use in the eligibility criterion of the concept of a proportion of total loan capital. Contrary to the FTT, it seems to me that a similar problem of monitoring

would arise if the individual had to ensure that his lending did not at any time exceed 30% of the loan capital on its own.

29. Finally, I should mention that towards the end of the reply on behalf of HMRC at the hearing of this appeal, it emerged that exactly the same criteria as are set out in section 291B(1) are used to determine a "connected person" in section 228 for the purpose of the tax treatment of a company repurchasing its own shares. It is unfortunate that this was not mentioned anywhere in HMRC's skeleton argument or, it seems, drawn to the attention of the FTT. Clearly, the same meaning must be given to the identical wording in section 228(2) as in section 291B(1). No submissions were made as to the context and purpose of the former provision but it appears that similar considerations would militate in favour of interpreting the wording as the expression of a single, composite category in section 228(2)(b).

30. Accordingly, this appeal is allowed and tax assessments on the Respondents are restored.

THE HON MR JUSTICE ROTH
TRIBUNAL JUDGE

RELEASE DATE: 23 November 2010