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A domino effect?

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Bill Dodwell considers recent cases in which one relief has been contingent on another

What’s going wrong with the Enterprise Investment Scheme? EIS and its little cousin Seed EIS have both been the subject of recent tax cases. In both instances, the taxpayer has won.

EIS was introduced in 1994 and SEIS in 2012. Investors in qualifying companies, which use the money for a qualifying trade, get upfront income tax relief on their share subscription. There is a capital gains tax exemption on sales after three years – but only on the proviso that income tax relief was given and not withdrawn. Investors can also defer capital gains realised up to a year before or three years’ later and may qualify for inheritance tax exemption too.

The capital gains tax reliefs were at issue in both cases.

Robert Ames’ case is a perfect example of a quite unnecessary restriction in the law – which provides that an individual may only claim exemption from capital gains tax on the sale of shares where income tax relief has previously been claimed on the share subscription. Fortunately, the Upper Tribunal has opened the door for Mr Ames’ late claim for EIS relief. Mr Ames hadn’t claimed income tax relief on his share subscription, as his income that year was only £42. This was well below the personal allowance, which was given automatically in HMRC’s online Self Assessment system, as his counsel, Keith Gordon, pointed out. HMRC thus refused Mr Ames capital gains tax relief on his later sale of the shares. There’s no good economic or policy reason for linking the claims, but the Upper Tribunal found it was the law.

It was suggested at the First Tier Tribunal hearing that Mr Ames could have submitted a late claim for income tax relief – so he did. HMRC turned him down, though. As well as arguing (and losing) on the technical element, Mr Ames sought judicial review of HMRC’s refusal to allow a late claim for income tax relief. Mr Justice Fancourt and Judge Greg Sinfield decided to quash the original decision.

HMRC’s care and management powers under section 5(1) of the Commissioners for Revenue and Customs Act 2005 allow it to accept late claims. The HMRC officer who refused the late claim did not consider whether this was one of those '…exceptional cases that do not meet these conditions and are not covered by guidance concerning the particular claim or election, where it may still be unreasonable for HMRC to refuse a late claim or election.'

The judges ordered HMRC to remake its decision, with a broad hint that this case was likely to be sufficiently exceptional to allow a late claim for income tax relief – thus permitting capital gains tax exemption.

In the second case, *Oxbotica*, the First Tier Tribunal ruled in favour of the taxpayers. This is a case about the Seed EIS scheme, designed to help smaller start-ups. Oxbotica was founded to acquire and develop spin out technology from Oxford University, developed by two academics. Four individuals and Oxford University subscribed £1,000 for shares in the company and the university made a loan to the company of £110,000. The company sought authority to issue an SEIS compliance certificate to three individuals, who had subscribed £316 for shares. HMRC turned down the application, asserting that the Department did not consider Parliament would have intended granting relief where the share subscription was just £316. HMRC also said that 'in circumstances where the company had already secured funding from the University, HMRC considered that the purpose of the share issue was an attempt to secure capital gains tax relief.'

The Tribunal faced little difficulty in dismissing HMRC's arguments. The SEIS legislation did not set out a minimum subscription level and there was no basis to add one in. On the facts, it was clear that the money raised had been spent on the company's qualifying business activity. HMRC's argument about the purpose being to obtain capital gains tax relief also failed, not least because HMRC had not claimed there was a tax avoidance purpose. It would surely have been impossible to show there was a tax avoidance purpose here, where the shares were subscribed for by the people working on the project and the company's chairman. Given that the legislation clearly provides for a range of tax reliefs, it must be very hard for individuals contributing to a qualifying company through their work to have a tax avoidance purpose.

Although it's disappointing to find this case (and *Ames*) going before the Tribunal, the real problem lies with the way in which the law was originally drafted. There seems little doubt that Parliament intended offering income tax, capital gains tax and inheritance tax advantages to EIS and SEIS investors. The odd way in which the capital gains tax benefit is available only where income tax relief has been granted and not withdrawn seems to have more to do with HMRC's administration than Parliament's intention. Surely if we'd asked the governments of the day whether they intended that one relief should be contingent on obtaining another, they would have responded in the negative. Each relief is perfectly capable of standing on its own. Let's hope HMRC reconsider their overall approach to the reliefs.
