THE ENTERPRISE INVESTMENT SCHEME AFTER *BLACKBURN*

Patrick Way

Introduction

It's a funny old world, isn't it? I mean, it's odd where you end up when you are not looking.

I became interested in law because, ages ago, I bought, from an apparently prestigious garage in Birmingham, a 1965 Volkswagen Beetle for the grand sum of £250, only to find that the garage had put in a clapped-out 1955 engine such that the car was worth no more than £150. So, full of the joys of youth, I instructed a local firm of solicitors, Wragge & Co in Birmingham, to sue the garage and, God bless them, they recovered all my money and charged me the grand sum, I seem to remember, of £7 for the exercise. Wow, I thought, the law looks good to me .... where do I sign?

So, a few years later I found myself a fully-fledged lawyer in the tax department of the then West End firm of Nabarro Nathanson, now called Nabarro. Being in the West End was such fun especially because the tax department was at one end of Jermyn Street, one of the most stylish streets in London, and the main part of the firm was at the other end. So I used to thoroughly enjoy being summoned to a meeting in the "mother ship", as I could then saunter along Jermyn Street *comme flâneur*, past *Floris*, *Paxton & Whitfield* and *Jules Bar* before re-emerging into the harsher world of the main office.

One day I was summoned to do my walk, and, on arrival at HQ, I was told that the person who was to give a talk – with others – the next day to clients and others on venture capital (now called private equity – *who changes these things*?) had remembered that he had to see a man about a dog. Would I do his talk, on the Business Expansion Scheme ("BES") in his place?

It is wonderful being young and confident isn't it? "No worries at all", I said, "just let me have his notes and slides and I will step into the breach".

"Slight problemette there, mate ... No notes or slides. You're on your own".

Anyway, as luck would have it I "winged it" the next day, but the main point about this rather long-winded introduction was that there were three key people in the audience. First there was a chap who ran a conference company and he asked me to lecture for him on the BES; secondly, there was a publisher in the audience and he asked me to write a book on it; and finally there was an entrepreneur who wanted me to help set up the first BES. So the BES – from which came the EIS (Enterprise Investment Scheme) – and I became inextricably linked, and, from that introduction, twenty years later I came to meet Alan Blackburn and to represent him in his litigation with HMRC on the subject of the EIS.

Overview

Alan Blackburn's case involved consideration of two aspects of the EIS, a scheme which grew out of the BES already mentioned. It may be helpful, therefore, to give the following broad outline as to its rationale.[1]

The EIS was designed to encourage individuals (and, in relation to the deferral scheme, trustees as well) to invest in 'small' trading companies and to hold their shareholdings for at least three years. Income tax relief is given as a 'reward' on investments of up to £500,000 per year (ITA 2007, s 158(2) and FA 2008 s 31) by reducing, *broadly speaking*, 20% of the individual's income tax bill by reference to the amount subscribed in the EIS company. In addition, a full capital gains tax exemption is given to qualifying individuals who dispose of their EIS shares (*broadly speaking again*) after three years in circumstances where EIS relief has not been clawed back, and it is this capital gains tax exemption that makes the scheme so attractive (TCGA 1992, s 150A(2)). The exemption remains in place even if the company in question no longer carries out any form of qualifying trade at the time of its disposal (provided that it did not lose relief on the way) and even if the sale takes place many years subsequently. Finally, there is a separate capital gains tax deferral/reinvestment relief which is 'tacked on' to the EIS itself. It allows individuals and trustees to "rollover" gains in relation to any assets, the gain on which is invested in the EIS company, and thereby defer an immediate charge to capital gains tax, provided the individuals or trustees in question subscribe for EIS shares. As a *quid pro quo*, the base cost of the new shares is reduced to the base cost of the assets which were disposed of (TCGA 1992, Sch 5B para 2). It was this deferral relief which was at the heart of the *Blackburn* case.

Before going into detail about the case, it may be helpful to observe that for deferral relief to be available, a number of requirements must be satisfied, viz: *an individual (or trustees)* invests *cash* in a *qualifying company* which carries on a *qualifying trade* and does so within a *four-year period* which starts one year before and ends three years after the disposal which gave rise to the gain which is to be deferred. *Relevant Shares* are *issued* for *cash* in circumstances where the money is raised for the purpose of a *qualifying business activity* of that qualifying company or its qualifying 90% subsidiary. The expression '*relevant shares*' is a relatively new expression, but its meaning is the same as the old expression 'eligible shares': "plain vanilla" in modern parlance. (ITA 2007, ss.157(1)(*a*) and 173.) The shares must be *fully paid* and, in effect, the investor must *not get his money back* in breach of the rules but must genuinely pay away new money into the company for the company to spend, otherwise there will be a breach of the *value received rules*. If all these elements are in place then EIS deferral relief should be available.

Government aims

Before we get more fully into the case it may be sensible to look at some of the political reasons for the BES and the EIS. When Sir Geoffrey Howe introduced the BES in his Budget speech on 15th March 1983 he said the following:-

> "These proposals will transform the position of unquoted trading companies seeking outside equity. It is a further move towards removing the bias in the tax system against the personal shareholder and a further measure to encourage wider share ownership. By concentrating help on those companies which do not have ready access to outside capital the scheme

will assist many more small or medium companies to realise their undoubted potential for growth."

Michael Portillo, the then Chief Secretary to the Treasury said this, on 22nd March 1994, following the introduction of the EIS, originally announced on 30th November 1993:-

> "The purpose of [the EIS] is to recognise that unquoted trading companies can often face considerable difficulties in realising relatively small amounts of share capital. The new scheme is intended to provide a well-targeted means for some of those problems to be overcome."

In fact the economic climate in 1983, and again in 1994, was quite similar to the current one, though for different reasons. It was difficult for entrepreneurs to access loan capital from banks, and the rationale behind the BES – and then the EIS – was to deal with this problem by giving a tax encouragement to investors to put money into small trading companies – which money would otherwise not have been available.

Mr. Blackburn's case

So now we turn to Mr. Blackburn's story.

As the case reports show, Mr. Blackburn had sold, on his retirement, some valuable shares realising a significant chargeable gain. At the same time, he was looking for a new venture to run and had come across a derelict sports club on the Isle of Wight, which seemed an ideal opportunity for him. Following discussions with his accountant, it was recommended that he should utilise the proceeds from his share sale as the capital of a new company which he would create, and this company would acquire and run the sports club. More especially, he was advised that this was the sort of situation that was tailor-made for the EIS deferral system.

Accordingly, Mr. Blackburn set up a company which he funded and which acquired the sports club. From time to time over the following year or so, whenever more money was needed for the purposes of the company's trading activity, Mr. Blackburn would invest further significant sums of money into the company. He did this by contacting his accountant, who ran the company's books, and telling him of his proposals and asking the accountant to write the books up. A constant pattern developed of Mr. Blackburn paying money into the company and receiving a £1 share for every £1 which he paid. In total Mr. Blackburn invested six tranches of money into the company producing six separate shares issues.

Sometimes the accountant would write the books up immediately, and then Mr. Blackburn might pay the money into the company a few days later; sometimes Mr. Blackburn would put the money in, and the accountant would write the books up a few days afterwards. On one occasion, he paid the money into the bank account the same day as the books were written up. Mr. Blackburn's records were by no means perfect but, on the face of it, you might think Mr. Blackburn should fall fairly and squarely within the ambit of the EIS: he had made an investment in the company, received shares, and all the money had been spent by the company on its trading activity.

HMRC's objections

In fact, HMRC objected to *all* of the six share issues which occurred.

Payment before registration

Where money was received into the company's bank account *before* the share register was written up, HMRC argued that the delay between payment and registration created a debt owed back to Mr. Blackburn, and – so the argument ran – this debt was then repaid by the company when the share issue took place. Accordingly, there was a breach of the value received rules, because – in effect – Mr. Blackburn was getting his money back. (As a matter of fact everyone accepted that he was not getting any money back, but – so it was argued – the law spelt out the problem clearly and however painful the result might be Mr. Blackburn was caught.) HMRC's objections were by reference to TCGA 1992 Schedule 13 para.1(2)(b) which read, as follows, at the relevant time:-

> "(2) ... an individual receives value from the company if the company –
>
> (b) repays, in pursuance of any arrangements for or in connection with the acquisition of the shares, any debt owed to the individual other than a debt which was incurred by the company –
>
> (i) on or after the date *on which he subscribed for the shares*."

I have italicised some of the words above because there is an important change to the legislation which has occurred subsequently.

Anyway, relief was lost.

Payment at same time as registration

HMRC also argued that where money was received into the company's bank account *on the same day* as, but a few hours before, the share register was written up, this produced a disqualifying debt as well.

So relief was lost here.

Payment after registration

Finally, it was contended that where money was received into the company's books *after* the share issue was written up, then although no problem in relation to the value received rules arose, there was another problem: the shares could not have been issued fully paid (TCGA 1992 Schedule 5B para.1(2)(c)).

And so here also – you guessed it, relief was lost too.

Yorkshire cricket joke

As Mr. Blackburn observed, given that he had lost relief when he had paid the money into the company '*before, during and after share registration*', it was difficult to conceive how he could ever have obtained relief in the circumstances. Indeed, this reminds me of the joke about the cricket match between two Yorkshire villages.

The fast bowler (usually a blacksmith for poetic reasons) comes charging down the hill and bowls a fabulous out-swinger which takes a nick off the opponent's bat and flies reassuringly into the wicket keeper's large padded gloves – a definite catch, and, therefore, a wicket.

"Howzat?" cries the blacksmith. "Not out," replies the umpire, a resident of the other village. "Came off the pad not the bat, lad. Bad luck."

The blacksmith then bowls down the next ball and it hits the batsmen's pad plum in front of the wicket for a clear leg before wicket ("LBW") – and out.

"Howzat?" cries the blacksmith. "Not even close, lad" replies the umpire. "Not out".

Finally the blacksmith sets off for a third time. This time, for dramatic effect, he begins his run all the way back behind the boundary rope, and by now – also for dramatic effect – dusk is falling. He then delivers the perfect unplayable ball which sends all three stumps cartwheeling back to the boundary for a majestic clean bowled. The blacksmith turns to the umpire and says, sardonically, "Phew, nearly had him there."

Well that's just how Mr. Blackburn felt.

The events in tabular form

It may be helpful to set out in tabular form the details of each of the six share issues in question.

Issue number	Number of shares	Payment before or after issue	HMRC's contentions
(1)	149,998	Before	Value received – failed
(2)	140,000	After	Not fully paid – failed
(3)	210,000	Before but same day	Value received – failed
(4)	100,000	After	Not fully paid – failed
(5)	350,000	Before	Value received – failed
(6)	250,000	Before	Value received – failed

Special Commissioners[2]

The case came first before the Special Commissioner, who held that, in relation to issue number (3), where the share register had been written up the same day as the money was received, that there could be no mischief: the value received rules could not apply because there was no time, in effect, for a debt to come into existence.

In relation to issues numbers (2) and (4) where HMRC argued the shares were not fully paid, the Special Commissioner held, pursuant to the ratio of the case of *Spitzel v. Chinese Corp Ltd* (1899) 6 Mans 355, that it was clear that the understanding between Mr. Blackburn and the company was that he was not to become a member until the money had been paid, because he agreed to become a member only *conditionally* on payment. From this it followed that the shares were not issued nil paid but were fully paid up at the time the issue was *completed* by satisfaction of the relevant condition. So Mr. Blackburn won on issues (2), (3) and (4).

So far as issues (1), (5) and (6) were concerned (all of which were concerned with the value received rules) the Special Commissioner was of the view that the situation fell fairly and squarely within the value received provisions. This was on the basis that any payment which did not amount to a share subscription would create a debt from the company which was repaid on issue thus invoking value received rules. (Given the change in legislation described subsequently, if a debt *does* come into existence on subscription, this will cause major problems for the reasons which follow in due course.)

So, Mr. Blackburn lost in relation to issues (1), (5) and (6), but won issues (2), (3) and (4).

The High Court[3]

Mr. Blackburn appealed in relation to issues (1), (5) and (6) and HMRC did not cross-appeal in relation to issues (2), (3) and (4). In the High Court it was held, by reference to the Privy Council decision of *Kellar v. Williams* [2000] 2 BCLC 390, [2000] 4 LRC 211, that where a shareholder, such as Mr. Blackburn, agreed to increase the share capital, without a formal allocation of shares, that capital became part of the equity. There was no formal gift nor any debt; just a contribution to capital. Absent a debt, the value received rules had no application and Mr. Blackburn’s share issues (1), (5) and (6) were valid.

The Court of Appeal[4]

HMRC appealed against the judgment of the High Court such that the question again was as to the meaning of the value received rules in relation to issues (1), (5) and (6) and whether, in particular, a debt comes into existence in the circumstances. The Court of Appeal looked at share issues (5) and (6) first before finally turning to share issue (1). Lord Neuberger, sitting in the Court of Appeal, doubted why payments should be characterised as loans or debts as a matter of law simply because they were paid to a limited company. He said:

> “I severely doubt that there is any reason in terms of principle, authority or practice for accepting that suggestion. In practical terms, I find it impossible to see, for instance, why a company

> should not be able to treat a gift as a contribution to its capital. As to authority, far from there being any case which confirms the suggestion [that a debt arises], the Privy Council in *Keller v. Williams* ... indicated precisely the opposite. Lord Mackay of Clashfern, giving the judgment of the Committee (which included Lord Browne-Wilkinson and Lord Millett) said that "there was nothing in ... the company law of England" which prevented giving effect to an agreement between "the shareholders of the company ... to increase its capital without a formal allocation of shares. In such an event, he said, such capital would "become ... part of the owner's equity" [Not debt] ... So far as principle is concerned, I do not see why the fact that accountancy convention may make it difficult to decide how to record a particular type of payment and capital accounts means that, as a matter of law, the payment cannot be characterised as being of that type. While accountancy convention has an important part to play in some areas of tax law and company law, this will I think, be a case of the tail wagging the dog."

So it was that the Court of Appeal dismissed HMRC's appeal in relation to issues (5) and (6).

So far as the first issue was concerned, however, Lord Neuberger observed that it had not been possible to point to any prior course of dealing or any understanding as the need for Mr. Blackburn to be allotted shares in order to obtain EIS relief before paying the monies in relation to the first issue and consequently he decided that the appeal should be allowed in relation to the first issue.

Eventual outcome

Issue number	Number of shares	Payment before or after issue	Eventual outcome for Mr. Blackburn
(1)	149,998	Before	Lost – value received
(2)	140,000	After	Won – conditional share issue
(3)	210,000	Before but same day	Won – produces no objections
(4)	100,000	After	Won – conditional share issue
(5)	350,000	Before	Won – not value received because there was no debt
(6)	250,000	Before	Won – not value received because there was no debt

Practical issues

So where does this leave us? The short answer is that it is extremely important to make sure when an investor is paying money into an EIS company that there is full paperwork. In particular, practitioners must make sure there is a proper share subscription agreement, even where there is a one-man company. In addition, this agreement should be supported by resolutions and minutes making it clear that the payment of the money into the company is by way of share subscription and is in relation to an issue of shares and for no other reason, and that no debt is to be created.

Change of legislation

As already mentioned, it is also worth observing that the legislation which was the subject matter of the *Blackburn* case has changed significantly since that which was at issue before the courts. The relevant wording now reads that there will be value received where a company:-

> "repays, in pursuance of any arrangements for or in connection with the acquisition of the shares, any debt owed to the individual other than a debt which was incurred by the company –
>
> (i) on or after the date *of issue of the shares*."

Previously it said, as already mentioned, -

> "(i) on or after the date *on which he subscribed for the shares*"

This is an important change because it means, as mentioned, that practitioners must definitely ensure that there is some form of contract in place before the issue, under the new rules, since if money is simply paid in to a company and there is not the appropriate evidence that it was not intended to be a debt then there is a risk that this very fact, coupled with the change in the legislation, will produce a debt. After all, the Special Commissioner said the following by reference to the old wording:

> "Accordingly, if a person applies for shares and at the same time (or later) pays cash to a company, although a debt is created in his favour because the other directors have not reserved to allot the shares, there is no value received from the company resulting in those shares not being eligible shares, *because the debt is incurred on or after the subscription for shares*. This is the answer to [the] contention that without a contract to subscribe for shares one could never satisfy the EIS conditions because paying money in advance of the issue always results in value received."

So there is a risk, taking account of the new statutory wording to which the Special Commissioner, it should be emphasised, was not referred, that:-

(a) even where a *formal application* is made by subscription;

(b) a debt *still* arises at *that* time; and

(c) when the later share issue occurs, it triggers the value received rules, because the debt arose beforehand, on subscription.

The answer to this is to spell out in the subscription agreement that the parties decree that no debt arises between them, and to have full minutes of record.

Overview

It is unfortunate, to say the least, that HMRC ever argued that money paid by an owner into his own company for shares issued later – including *later the same day* – could cause EIS deferral to be denied merely because a delay occurred between payment and issue giving rise, in HMRC's eyes, to a disqualifying debt. Indeed, HMRC's stance runs the risk of making the scheme unworkable for all but those who are properly advised by experts, especially given the new wording just described. For my own part, I do not consider that a debt *does* automatically come into existence when an owner pays money into his or her company and then writes the books up later; nor do I consider that a debt comes into existence when a contract, such as a share subscription, is entered into pursuant to which shares are subsequently issued. But it is unlikely that this matter will be tested again; so caution must be exercised.

In any event, I find it hard to believe that the value received rules should ever apply in this sort of situation for the reasons which follow. First, based on the discussions which I had with the Treasury at the time the EIS came into existence the position in which we now find ourselves is, in relation to the value received rules, a million miles away from anything which anybody ever thought would arise or indeed wanted. The scheme was meant to enable people put money into their companies and be rewarded with EIS deferral relief. Secondly, the value received rules are part of the checks and balances to stop abuse of the system. The mischief which the legislation is focusing on is where an individual has his cake and eats it by "not really" putting money into a company. In particular, it addresses a situation where an individual, let us say, has *already lent* the company money and then sees an opportunity for accessing relief which should not be properly available to him, given that he does not propose to *leave the company with new money*. Assume an individual has previously lent a company £250,000, and then assume that – in due course – he subscribes £250,000 of share capital, hoping to obtain EIS relief. When his original debt of £250,000 is paid back relief is clearly lost. This must be the real mischief that the legislation is really focusing on, because here the investor *does* get value back; by contrast, Mr. Blackburn was out of pocket in relation to every pound that he put into the company, and nothing was returned to him.

Caveat

I should perhaps mention that it is only in relation to EIS *deferral relief* that an individual may own 100% of the shares as Mr. Blackburn did. For the 20% *income tax relief* and the capital gains tax *exemption*, no individual seeking relief may be *connected* with the company, meaning – broadly speaking – that no more than a 30% interest can be held.

Finance Bill changes

Finally, this is an appropriate time to draw attention to the proposed changes announced in this year's Budget and these apply to the EIS *as a whole* and not just in relation to the EIS deferral system with which the Blackburn case was exclusively concerned.

First change

The EIS currently requires that 80% of the money which is raised must be employed, for the purposes of a qualifying activity, within twelve months, with the balance being so employed within a further twelve months. These rules are now replaced with a single requirement that *all* of the money raised by the issue of shares is to be wholly employed within *two* years of the issue of shares or, if later, within two years of the commencement of a qualifying activity.

Second change

Further, there was a trap under the old rules where an EIS company issued shares some of which were EIS shares and some of which were not. Here *all* of the money raised (not just that relating to the EIS issue) had to comply with the rules. Thankfully, this requirement has now gone: only the EIS issue must satisfy the rules.

Third change

There is a rule allowing an investor to "carry back income tax relief" to the previous year by claiming that qualifying shares which are issued to him in a later tax year, before the 6th April, can be treated as having been issued in the earlier tax year, subject to a limit of half the subscriptions in that period and up to an overall limit of £50,000 subscribed. The Finance Bill 2009 removes these restrictions.

Fourth change

Finally, there is an important change which has application to the EIS deferral scheme. Currently it is possible that a charge to capital gains tax can occur on a share-for-share exchange where a gain would not normally arise. The Finance Bill change removes the rules that prevent the normal share-for-share exchange capital gains tax rules from applying to the gain on a disposal of the shares when deferral relief has been recovered. The position will be (under TCGA 1992 ss.135 and 136) that on the occasion of a qualifying share-for-share exchange, any deferral relief which has been previously given will be recovered, but there will no longer be a gain or loss to be brought into charge in respect of the disposal of the shares that form the subject matter of the exchange itself.

Conclusion

When the BES was introduced it was said by the Government (in a curiously non-PC way) that the scheme was something that even "Aunt Agatha" could invest in, it was so simple. Well now, Aunt Agatha would need the help of lawyers and accountants well-experienced in the scheme to make sure that full paperwork is involved and every 'i' is dotted and every 't' is crossed. Given the outcome of the case, and the change in legislation, by virtue of which any debt which comes into existence before *issue*, rather than before *subscription*, will disqualify a share issue, it is critical that any payment into a company before the issue, including a payment of subscription monies themselves, does not create a debt. So, in the case of subscription monies, it is imperative that these are paid pursuant to a formal document which spells out that payment is in consideration of an issue of shares. and there should be a provision which specifies that no debt comes into existence by virtue of the (inevitable) fact that the payment will precede the issue.

Aunt Agatha must be spinning in her grave.

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[1] Patrick Way represented Alan Blackburn in all the court hearings with the assistance of Michael Jones before the Court of Appeal.
[2] *Blackburn and anor v. Revenue & Customs Comrs*, SpC 606, [2007] STC (SCD) 519.
[3] As before, ([2008] EWHC 266 (Ch), [2008] STC 842).
[4] As before, ([2008] EWCA Cir 1454, [2009] STC 188).