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SMALLWOOD: THE HIGH COURT DECISION

Philip Baker

On 8th April 2009 the High Court overturned the decision of the Special Commissioners in the case of *Smallwood and Others v Commissioners for Her Majesty's Revenue and Customs*[1]. The case raises some interesting and significant issues as to how tax treaties work, and as to the relationship between tax treaties and domestic anti-avoidance legislation.

Background

The background facts are quite simple to state. In 1989, Mr. Smallwood settled property on trust for the benefit of himself and his family. By the year 2000, the trustee of the trust was a corporation resident in Jersey and the principal asset of the trust was a holding of shares in FirstGroup plc, which was standing at a considerable gain to its acquisition value. If the shares were sold by the Jersey trustee, the chargeable gain would be attributed to Mr. Smallwood under s.86 TCGA 1992. To avoid this, Mr. Smallwood and his advisors implemented a scheme generally referred to as the "Round the World" scheme. This involved the Jersey trustee resigning in favour of trustees resident in a jurisdiction which had a suitable double taxation convention with the United Kingdom (in this case Mauritius), the new trustees in the treaty-protected jurisdiction disposing of the shares, and those trustees then resigning in favour of UK-resident trustees before the end of the year of assessment in which the disposal

took place. Pursuant to this scheme, the Jersey trustee resigned on the 19th December 2000 and a trust corporation resident in Mauritius was appointed in its place. On 10th January 2001 the shares in FirstGroup were sold. Finally on 2nd March 2001, the Mauritian trustee resigned in favour of Mr and Mrs Smallwood, who became the trustees and were resident in the United Kingdom.

This "Round the World" scheme was quite widely implemented, and it was not surprising that HM Revenue & Customs sought to challenge it. The *Smallwood* case was brought as a test case to challenge the scheme. HMRC sought to tax Mr. and Mrs. Smallwood as trustees of the settlement, and Mr. Smallwood as settlor under s.77 TCGA 1992.

As this section is the basis for the charge to tax, it is set out here:-

> "**77**. *Charge on settlor with interest in settlement.*
>
> (1) Where in a year of assessment—
>
> (a) chargeable gains accrue to the trustees of a settlement from the disposal of any or all of the settled property,
>
> (b) after making any deduction provided for by section 2(2) in respect of disposals of the settled property there remains an amount on which the trustees would, disregarding section 3, be chargeable to

> tax for the year in respect of those gains, and
>
> (c) at any time during the year the settlor has an interest in the settlement,
>
> the trustees shall not be chargeable to tax in respect of those but instead chargeable gains of an amount equal to that referred to in paragraph (b) shall be treated as accruing to the settlor in that year …"

The point should be made that s.86 TCGA 1992 – which attributes gains of non-resident trustees to a settlor who is interested in the settlement – did not apply as that legislation only applies where the trustees are not resident or ordinarily resident in the United Kingdom during any part of the year of assessment. By contrast, s.77 applies only if the trustees are "either resident in the United Kingdom during any part of the year or ordinarily resident in the United Kingdom during the year". Since the trustees are regarded as a continuing body of persons (see s.69 TCGA 1992), that body of person was resident during part of the year of assessment from 2nd March 2001 when Mr. and Mrs. Smallwood were appointed as trustees.

The argument for the taxpayers was that, as a result of Article 13(4) of the UK-Mauritius Tax Treaty, capital gains from the alienation of the shares "shall be taxable only in the Contracting State of which the alienator is a resident". As the alienator was the trustee, and the trustee was resident in Mauritius at the time of the disposal of the shares, this meant that the amount on which the

trustee would be chargeable to tax under s.77(1)(b) was nil. Hence, chargeable gains of nil should be treated as accruing to the settlor under s.77(1). The argument of HMRC was that Article 13(4) of the tax treaty did not operate in this way, and did not prevent the UK charge to tax.

The Special Commissioners' decision: treaty residence and the POEM Tie-breaker

The Special Commissioners' decision is unusual in having been decided on a basis that was contended for by neither of the parties. The central issue concerned residence for purposes of the tax treaty at the time of the disposal of the shares. It will be seen from the summary of facts that there were three periods of residence during the UK year of assessment 2000-01: the "Jersey period" up to the 19th December 2000, the "Mauritius period" from 19th December 2000 to 2nd March 2001, and the "UK period" from 2nd March 2001 to the end of the tax year on 5th April 2001.

The taxpayer contended that it was only necessary for purposes of the tax treaty to determine residence on the date when the disposal of shares took place. On that date, a "snapshot" was taken: the trustee was then resident only in Mauritius, and entitled to the protection of the tax treaty.

HMRC, on the other hand, argued that there were two consecutive periods of residence: the Mauritius period and the UK period at the end of the tax year. During the Mauritius period, Mauritius might tax the

capital gains realised by residents of that country (but, in practice did not do so here). During the UK period, however, the UK might tax gains of persons resident in the UK: the UK did that by virtue of s.77(1) which applied because the trustees were resident in the United Kingdom for part of the year of assessment.

Neither of the parties argued for a period of concurrent residence when the trustees were resident in both Mauritius and the United Kingdom. This was, however, the approach taken by the Special Commissioners. They considered that, for treaty purposes, during the Mauritius period the trustees were concurrently resident for treaty purposes in the United Kingdom. Periods of concurrent residence require application of the treaty tie-breaker provision in Article 4(3) which applied the concept of "Place Of Effective Management" (POEM). After a discussion of the meaning of that concept, and a thorough analysis of the facts, the Special Commissioners concluded that the place of effective management during the period of concurrent residence was in the United Kingdom, with the consequence that the trust was not regarded as resident in Mauritius for treaty purposes, and so did not get the protection of Article 13(4).

It is inherent in the decision of the Special Commissioners that residence for treaty purposes is not necessarily co-extensive with factual residence in the United Kingdom, and that one may use the benefit of hindsight and take account of subsequent events to determine whether a person is treaty resident at a time

prior to those events. Put another way, between 19th December 2000 and 2nd March 2001, the trustee was resident only in Mauritius. However, once trustees resident in the United Kingdom were appointed on 2nd March 2001, it was appropriate to take account of that fact and treat the trustees as having been resident in the United Kingdom for treaty purposes for the whole of the year of assessment 2000-01 starting from 6th April 2000. This is considered further below.

The Decision of the High Court

Before Mann J in the High Court, both parties maintained their previous position that there was no period of concurrent residence. The taxpayer maintained the "snapshot" approach, and HMRC maintained its argument based on consecutive periods of residence. Although they had won before the Special Commissioners, HMRC did not seek to support the Special Commissioners' decision on the grounds on which it was reached[2].

Mann J agreed with both parties that there was no period of concurrent residence in Mauritius and the UK: in his view, there was no warrant in the UK domestic legislation to extend the UK residence of the trustees back prior to 2nd March 2001 when they were appointed. The implication is that one could not take account of hindsight and subsequent events in determining whether a taxpayer became a resident for treaty purposes at an earlier date from the time that factual residence commenced: it also implies that the concept of residence for treaty purposes is closely linked to the meaning of

residence under domestic law. If this view were correct (which the author of this article considers is not the case) it would have very significant consequences for the application of tax treaties. To take an example cited by the Special Commissioners (at paragraph [102] of their decision) as follows: suppose an individual starts to visit a country, but it is not yet clear whether he will spend sufficient time there to become resident. Assuming that "sufficient time" is 183 days; until the taxpayer has spent 183 days it is not possible to say that he is resident. However, after he has spent 183 days, it must then become clear, with the benefit of hindsight, that he has been resident from the start of the year of assessment. No answer to this example is given in the judgement of Mann J.

Treaty Residence and Article 4(1)

It is important to remind oneself of two basic provisions of most tax treaties found in the OECD Model and in the UK-Mauritius treaty:

> "Article 1 – Personal Scope
>
> This Convention shall apply to persons who are residents of one or both of the Contracting States."
>
> "Article 4 – Residence
>
> (1) For the purposes of this Convention the term 'resident of a Contracting State' means, subject to the provisions of paragraph (2) and (3) of this Article, any person who, under the law of that State is liable to taxation therein by reason of his

> domicile, residence, place of management or any other criterion of a similar nature..."

Thus the UK-Mauritius treaty, like all treaties based on the OECD Model, uses the phrase "resident of a Contracting State". That is defined in the tax treaty in Article 4(1) in terms that relate its meaning to liability to taxation under the law of a particular state, and that liability has to arise by reason of domicile, residence, place of management or any other criterion of a similar nature.

It is important to note that, though the treaty definition is linked to liability under domestic law, the term "resident" is not simply defined as having the same meaning as under the domestic law of each Contracting State. That would have been possible and would have been the result under the general interpretation rule in Article 3(2) of the OECD Model, under which undefined terms take their meaning under the domestic law of the state applying the treaty. Article 4(1), to the contrary, does not base the meaning of the term "resident of a Contracting State" on the definition of the term "resident" under the domestic law of each state. There are good reasons why tax treaties do not adopt that approach. There are states which do not employ the term "resident" but nevertheless have the concept of a person who has general or unlimited liability to tax (that is liability to tax not restricted to tax only on income arising from sources in the Contracting State concerned), and attach that general or unlimited liability to a person whose residence, domicile or place of management (or other criterion) is in that state. Thus, it is fundamental to

tax treaties based upon the OECD Model that there is a concept of residence for treaty purposes, which may have a meaning different from the term "resident" under the law of one or both of the Contracting States.

It is clear that the domestic law of each Contracting State determines whether a person is resident: it must also be the case that this domestic law determines the period during which the person is liable to tax by reason by residence[3].

It is inherent in Mann J's judgement that there is no concept of residence for treaty purposes as such. Instead, the term "resident" appears to take its meaning from domestic law. Under UK domestic law, residence was not deemed to begin any earlier than the appointment of trustees resident in the UK. This approach fails to appreciate that there was liability to tax in the United Kingdom on disposals from 6th April 2000 onwards, by virtue of the appointment of trustees resident in the United Kingdom on 2nd March 2001 (before the end of that year of assessment).

What is somewhat surprising is that HMRC argued that residence for treaty purposes began only from the time that the UK-resident trustees were appointed. This seems simply wrong, and is inconsistent with statements in the OECD Commentary to which the UK government has made no objection or reservation (see the Special Commissioners' decision at paragraph [89]. The Commentary cites an example of an individual who becomes resident in a State, State B, on 1st April in a year, but is nevertheless regarded by domestic law as

resident from the 1st January: this example clearly supports the view that, with hindsight, an individual can be regarded as liable to tax - and, hence, resident - from a period prior to the factual commencement of residence.

How Article 13 Works

What is also particularly interesting in this case is how HMRC argued that Article 13 worked. Both parties, it will be recalled, contended that there were consecutive periods of residence, first in Mauritius and then in the United Kingdom, and no concurrent period of residence. The taxpayer argued that you applied Article 13 at the time the disposal took place and as the trustee was resident only in Mauritius, only Mauritius could tax the gain. HMRC argued, however, that Article 13 operated in a somewhat different way. It operated by allocating tax jurisdiction between the residence and the situs state. During the "Mauritius period" the trustee was resident only in Mauritius, so that state alone had jurisdiction to tax: Mauritius could, therefore, tax the gain on disposal of the shares, but Mauritius elected not to do so. During the "UK period", however, the UK was the state of residence and, as such, had jurisdiction to tax gains in accordance with its domestic law. Under UK domestic law, gains realised throughout the year of assessment were taxable in the UK as the country of residence of the trustees during the UK Period.

This approach has the potential for causing double taxation: if for example, Mauritius had taxed the gain and the United Kingdom had also done so. HMRC's solution to that lay not in the tie-breaker but in Article 24

of the UK-Mauritius treaty which provided for relief from double taxation by a credit. However, it is impossible in practice to apply Article 24 in a situation like this where there are, according to HMRC, two resident states, both of which is obliged to give relief from double taxation by credit for the other state's tax. Mauritius would be required to give credit for UK tax; and the UK would be required to give credit for Mauritius tax. In theory, this might be resolved by, for example, Mauritius taxing first and the UK giving credit and then possibly Mauritius giving credit for any UK tax charge in excess of the Mauritian tax. However, it would require a very strained interpretation to reach this result. Of course, HMRC might have pointed to the mutual agreement procedure and argued that that procedure could be prayed in aid where double taxation arises which is not relieved under Article 24.

HMRC's approach of identifying Article 13 as resolving conflicts between taxation based on residence and taxation based on situs, is not inaccurate. There may be rare circumstances where there are truly consecutive periods of residence and both states tax on a basis of residence. An example may be where State A regards a disposal as taking place at the time that a contract is entered into, while State B regards a disposal as taking place at the time of completion. Suppose that an individual is resident in State A at the time of entering into the contract of disposal, but ceases to be a resident of that state and becomes for the first time a resident of State B prior to completion of the contract. In that case, there is genuinely no period of concurrent residence,

both states taxing purely on a basis of liability by reason of residence in the jurisdiction. Double taxation would arise. It is best to regard that problem as one that requires to be relieved by the competent authority procedure and not by the elimination of double taxation article.

Mann J, however, accepted the taxpayer's argument which is a more straightforward one: it is necessary to apply Article 13(4) only as at the date when the disposal took place (ignoring the possibility – of which there was none here as Mauritius did not tax – that the two countries might have different concepts of the date at which the disposal took place). This simplistic approach may be appropriate where one is looking at a capital gain and at a disposal which takes place at a single point in time. However, how does one apply this approach to business profits, for example, where income and expenditure accrues and is incurred over a period of time, and one can only determine if there has been a profit when an account is struck? Equally, even in the case of capital gains a taxpayer in the United Kingdom is liable to tax on net capital gains, after setting off allowable losses. Thus, a "snapshot" approach may not always explain how different articles in tax treaties are to be applied.

The Temporal Application of Tax Treaties

The problem discussed in *Smallwood* is an example of the temporal application of tax treaties, where there are changes in the factual background over the period of time for which the treaty has to be applied. This issue has been little discussed in the literature, though there is

a short section in the author's book on *Double Taxation Conventions*. Mann J kindly cites from that book a section which, in full, is as follows:-

> *"The Temporal Application of the Residence Rule and the Tie-breakers*
>
> The Convention and the Commentary give little guidance to the temporal application of Article 4(1) and the tie-breaker tests in Article 4(2) and (3),[4] that is the scenario where a person changes residence during the relevant period of time. Suppose, for example, that a taxpayer resides in State A until 1st September 20X1, and then moves to reside in State B. Suppose that State A has a tax year which runs from 1st January to 31st December, while State B has a tax year which runs from 6th April to the subsequent 5th April. Suppose that both states consider that a person who is present for 180 days or more in a tax year is resident for tax purposes. And suppose, finally, that the taxpayer alienates an asset on 15th September 20X1.[5]
>
> The starting point to resolve this issue is Article 4(1). Domestic law determines whether a person is a resident of a Contracting State; it must also determine *the period* during which the person is a resident. Thus, for example, if both states adopt a split-year approach - dividing the tax year into a resident part and a non-resident part - there is no difficulty: the taxpayer is resident in State A until 1st September and in State B thereafter.
>
> However, if both states regard the person as resident throughout the respective tax year, then there is a period of dual residence - from 6th April to 31st December 20X1 - and the tie-breakers come

into play. The question which then arises is the period of time over which one applies the tie-breakers.

Take, for example, the first tie-breaker in Article 4(2)(a) - the availability of a permanent home. Does one ask in which state the taxpayer had a permanent home:

(a) only on the date when the alienation took place (i.e. on 15th September 20X1); or

(b) throughout the period of dual residence (i.e. from 6th April to 31st December 20X1); or

(c) throughout the two states' tax years which overlap (i.e. from 1st January 20X1 to 5th April 20X2)?

If the answer is either (b) or (c), it is far more likely that a taxpayer who moves residence will have permanent homes in both states during the period (and may have a centre of vital interests which cannot be determined). If the answer is (a), then where an event such as alienation is concerned, the availability of permanent homes on just one day in the year might determine taxation rights.

The issue is particularly acute for the tie-breaker in Article 4(2)(b) - habitual abode - which refers to the state in which the longer period of residence occurs. Paragraph 19 of the Commentary explains that the comparison must be made over a sufficient period of time for it to be possible to determine where the residence is habitual.

> Alienation of a capital asset takes place at a point of time (even though any gain may have accrued over a lengthy period of time). However, other income may be harder to attach to a point in time: business profits, for example. For business profits, presumably, residence in a Contracting State and the application of the tie-breakers must be determined over the period during which the profits accrued (e.g. the accounting period).
>
> Even for the alienation of a capital asset there may be differences in identifying the time of alienation. Suppose State A's domestic law identifies alienation with the conclusion of a binding contract, and State B's law with completion of the contract. If the taxpayer enters into a binding contract before he leaves State A, and completes the contract after arrival in State B, each state will regard the alienation as occurring during the period of residence in that state (even where both operate a split-year approach). This may be a problem which will have to be resolved by Mutual Agreement.[6]"

Mann J very kindly answered the question of the period of time over which one applies the tie-breakers. In his view (see paragraph [43] of the judgment) the answer is (a) – only on the date when the alienation took place. With respect, however, there are, perhaps, different issues that need to be considered. One needs to apply the tie-breaker with regard to the period of time or the point of time when there is concurrent residence, and it is necessary to know whether a person is resident in which Contracting State to apply the substantive article of the treaty. That much is agreed. However, the question raised in my book is whether, in applying the tiebreaker

at that point of time or for that period, one looks at the factual background only as at that date, or over a broader period. Take, for example, the third leg of the tie-breaker for individuals, which refers to the place of *habitual abode*. This is explained in the Commentary as the place where the taxpayer spends the greater part of his time. How can one assess an individual's "habitual abode" by reference to only one point in time, or one day? The factual pattern over a longer period of time has to be taken into account in order to determine the application of the tie-breaker as at that particular date. This is, with respect a different issue from the one to which Mann J addressed himself.

Vicarious exemption under tax treaties: the dog that didn't bark

One of the many puzzling things about this case is that HMRC does not appear to have argued that Mr. Smallwood was not entitled to the protection of the UK-Mauritius tax treaty. It should be remembered that Mr Smallwood was never resident in Mauritius: he could only rely upon the exemption in the tax treaty, therefore, vicariously. The argument would be that the Mauritius-resident trustee was exempt from tax in the United Kingdom by virtue of Article 13(4) of the treaty. That exemption also extended to the UK-resident trustees, as the trustees are regarded as a single and continuing body of persons. The next step would be that, as the liability of the trustees to tax was nil, the "amount equal to that referred to in paragraph (b)" in section 77(1) TCGA 1992 was also nil. Thus, vicariously, Mr. Smallwood

enjoyed the benefit of its tax treaty while never going anywhere near Mauritius.

Logically, this argument is unimpeachable. However, it seems to run against the decision of the Court of Appeal in *Bricom Holdings Ltd v IRC*[7] and the decision of the Special Commissioner in *IRC v Willoughby*[8].

Following the decision in *Bricom*, there appears to be a distinction made between situations such as s.13 TCGA 1992, where a UK resident is treated as if the chargeable gain accruing to a non-resident had accrued to him. In that situation, if the non-resident was protected by a tax treaty, so was the UK resident. This may be contrasted with the charge to tax under the controlled foreign companies legislation which was at issue in *Bricom*, where the chargeable profits of a non-resident were apportioned to a UK-resident company and a sum equal to corporation tax charged on the apportioned amount of profits. It is very hard to see this as a tenable distinction. Assuming that HMRC accepted that Mr. Smallwood could enjoy the vicarious exemption under the tax treaty, then it would appear that HMRC places the charge to tax under s.77(1) in the same category as s.13 TCGA 1992.

In the circumstances here, the Mauritian trustee resigned in favour of the UK-resident trustees before the end of the UK year of assessment to ensure that s.77 TCGA applied and not s.86 TCGA. By doing so, the whole issue of concurrent or consecutive periods of residence arose. It was sometimes said that the vicarious

exemption under a tax treaty was easier to argue under s.77 than under s.86, though s.86(4)(e) provided that "chargeable gains of an amount equal to that referred to in subsection (1)(e) above shall be treated as accruing to the settlor in the year…". That appears to be a similar formulation to that of s.77(1). The author of this article, for one, has never understood why it was thought that section 77 was more likely to give rise to a vicarious exemption from tax: if the author is right, then HMRC should also accept (and subsequent legislation suggests that is the case) that a settlor may also enjoy a vicarious exemption from a charge to tax under s.86 TCGA 1992. If that is right, then it was unnecessary for the Mauritian trustees to resign in favour of UK-resident trustees (which gave rise to the issue of concurrent or consecutive periods of residence).

Concluding comments

It is understood that the decision of Mann J is to be taken on appeal. If HMRC were now to abandon its position of arguing for consecutive and not concurrent periods of residence then it seems that they should win. If there was a period of concurrent residence when the trustees were resident (under domestic law) in Mauritius and also liable to tax in the United Kingdom by virtue of their subsequent residence in the UK, then the place of effective management tie-breaker would, on the basis of the facts as found by the Special Commissioners, result in no exemption under the treaty. Since the finding of place of effective management is a finding of fact, the taxpayer would either have to argue that the Special

Commissioners had misdirected themselves as to the meaning of the phrase "place of effective management", or that they had reached a decision on the facts that no reasonable tribunal could have reached.

If, on the other hand, HMRC continues to maintain that there were periods of consecutive residence only, then their chances of success must be lower. They would need to point out that it is rare that one determines tax liability based upon a single event such as the disposal of an asset, and that liability is usually determined over a period of time. They may also wish to abandon their argument based upon Article 24 in favour of the possibility of resolving conflicts between two resident states where there is no concurrent period of residence through the competent authority procedure. Alternatively, they may wish to revisit whether, in accordance with *Bricom* Mr. Smallwood really enjoyed vicarious exemption from tax under the UK-Mauritius treaty.

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[1] The High Court decision is [2009] EWHC 777 (Ch) and the decision of the Special Commissioners is reported at [2008] STC (SCD) 629. (Noted in Vol VII No.2 of this *Review* at page 27.)

[2] It is a little surprising that HMRC did not support the decision of the Special Commissioners, particularly in the light of the rather surprising nature of HMRC's own argument on the application of Article 13. It may possibly be that HMRC was concerned that this was a test case, and that if the decision turned on the factual place of effective management, then all other cases would need to be examined on their facts. On the other hand if HMRC's position on

Article 13 was sustained, the Round the World scheme failed for everyone, as least everyone where the trustees subsequently became resident in the United Kingdom during the year of assessment.

[3] This view is expressed in the author's book on Double Taxation Conventions at paragraph 4B.19. Mann J cited this at paragraph [42] of his judgement. However, he considered that under domestic law there were consecutive periods of residence and no concurrent period. Thus he considered that it was unnecessary to apply the tie-breaker.

[4] Other than a rather un-illuminating example in Para. 10 of the Commentary, and some guidance in Para. 19.

[5] The application of Art. 13 (Capital Gains) is perhaps easier than some other Articles because alienation takes place at a specific point in time - though see further below.

[6] Some of these issues concerning change of residence were discussed in IFA; The tax treatment of transfer of residence by individuals (2002) 87B Cahiers DFI.

[7] [1997] STC 1179.

[8] [1995] STC 143 at page 168

SUB-FUNDS – DEEM, DEEM, DEEM?

by Felicity Cullen

Many trustees hold settled property on trust for several beneficiaries or several groups of beneficiaries. In a large proportion of cases where there are several beneficiaries or groups of beneficiaries, the trust instrument (and instruments which are supplemental to it) will provide for assets attributable to specific beneficiaries or specific groups of beneficiaries to be held on discrete funds or sub-funds within the settlement. This sort of division of assets within a trust fund was not, until recently, addressed by the income tax and capital gains tax ("CGT") regimes; and this led to a number of difficulties or irregularities which are not discussed in this note, but which included matters such as utilisation of allowable losses for CGT purposes and the application of the share identification rules.

In 2006, legislation was introduced which permits trustees of a settlement to elect for a fund or specified portion of settled property to be treated as a separate settlement for income tax and CGT (but not one or other) purposes. In essence, a sub-fund election may be made if (and only if) the four conditions set out below are satisfied on the specified date (i.e. the date on which the election is specified to take effect), and if conditions 2 to 4 are satisfied throughout the period from the specified date to the date the election is made. The conditions are as follows:

1. The principal settlement must not itself be a sub-fund settlement.

2. There must be some property comprised in the principal settlement.

3. Property must not be co-owned by the trustees of the principal settlement and the trustees of the sub-fund settlement.

4. Subject to certain exceptions, a person must not be a beneficiary under both the principal settlement and the sub-fund settlement.

The CGT legislation relating to sub-fund elections is in s.69A and Schedule 4ZA Taxation of Chargeable Gains Act 1992 ("TCGA 1992") and the income tax legislation is in s.477 Income Tax Act 2007 (which, in essence, gives effect to Schedule 4ZA TCGA 1992 for income tax purposes).

The four conditions referred to above are derived from paras. 4 to 7 inclusive of Schedule 4ZA TCGA 1992. Paragraph 1 Schedule 4ZA TCGA 1992 provides as follows:

> "The trustees of a settlement (the "principal settlement") may elect that a fund or other specified portion of the settled property (the "sub-fund") be treated, unless the context otherwise requires, as a separate settlement (the "sub-fund settlement") for the purposes of this Act, and the election shall have effect."

Paragraph 13 Schedule 4ZA TCGA 1992 provides that a sub-fund election may not be revoked, and paragraph 17 Schedule 4ZA TCGA 1992 provides as follows:

> "The sub-fund settlement shall be treated, for the purposes of this Act, as having been created at the time when the sub-fund election is treated as having taken effect."

Paragraphs 18-22 Schedule 4ZA TCGA 1992 - under the heading "Consequence of a sub-fund election" (under which para.17 also sits) - provide for the following matters.

1. Paragraph 18 contains rules for the purposes of identification of the trustees of the principal settlement and of the sub-fund settlement from the time at which the sub-fund election takes effect.

2. Paragraphs 19 provides that the sub-fund trustees shall be treated for the purposes of the Act as having become absolutely entitled, at the time when the sub-fund election is treated as having taken effect, to the property comprised in that settlement as against the trustees of the principal settlement. This creates (or possibly confirms) a deemed disposal under s.71(4) TCGA 1992 (or under s.80(2) TCGA 1992) on the date on which the sub-fund election is treated as having taken effect: para.20 Schedule 4ZA TCGA 1992.

3. If the trustees of the sub-fund settlement are treated, by virtue of para.19 Schedule 4ZA

TCGA 1992, as having become absolutely entitled to money expressed in sterling, the trustees of the principal settlement are treated as having disposed of that money, and the trustees of the sub-fund settlement are treated as having acquired that money, for the purposes of the Act on the date on which the sub-fund election takes effect.

4. Paragraph 22 provides for the attribution of trust gains between the principal settlement and the sub-fund in accordance with s.90 TCGA 1992. It will be apparent that paragraphs 1 and 17 Schedule 4ZA TCGA 1992 have the effect that, for the purposes of TCGA 1992 a sub-fund is to be treated as a separate settlement, created at the time when the sub-fund election is treated as having taken effect. The consequences of this may, conceivably, go beyond those that are specifically provided for in paragraphs 18-22 Schedule 4ZA TCGA 1992. In particular, where – as is likely to be typical – the sub-fund election is made as regards a part of the assets in the original settlement in which an individual had an interest such as an interest in possession, the effect of the election must be that for the purposes of TCGA 1992, that individual's interest in possession becomes an interest in possession in the funds comprised in the sub-fund settlement.

Does it then follow first, that the beneficiary concerned has disposed of his interest in the principal settlement and acquired an interest in the sub-fund settlement and, secondly, that the application of the provisions of s.76 TCGA 1992 (Disposal of interests in settled property) and s.76A (Disposals of interest in settled property: deemed disposal of underlying assets) needs to be considered? For the purposes of analysis, the first question will initially be assumed to be answered positively, and the application of the specific provisions will be considered accordingly. The first question will then be addressed.

Section 76 TCGA 1992

It is clear that, in the circumstances postulated, there is not an actual disposal by the beneficiary concerned. Any disposal must, accordingly be a deemed disposal. On the assumption that there is a deemed disposal of an interest under a settlement, s.76(1) TCGA 1992 will not, in most cases, cause chargeable gains to accrue on the occasion of that disposal because the deemed disposal will be made by a person for whose benefit the interest was created or by another person who has not acquired nor derived his title from one who has acquired the interest for relevant consideration in money or money's worth.

Non Resident Trustees

The protection of s.76(1) TCGA 1991 will not, however, be available in cases where the trustees of the settlement have, at any time (including at the time of the

deemed disposal) been neither resident nor ordinarily resident in the United Kingdom (s.76(1A) and (1B) and s.85(1) TCGA 1992).

Interests in Sub Fund Settlements

Nor will the protection of s.76(1) TCGA 1992 will be available as regards a disposal of the interest in the sub-fund settlement, if the beneficiary of the sub-fund settlement should, on analysis, be considered as having acquired that interest for a consideration in money or money's worth other than consideration consisting of another interest under the settlement. Given the separate settlement treatment applied to the sub-fund it is not considered possible to argue that any consideration consists of another interest under the *same* settlement. More fundamentally, however, it is considered that, even if there is a deemed acquisition of an interest in the sub-fund settlement for the purposes of s.76(1) TCGA 1992, there is no basis[1] for deeming[2] that the interest was acquired *for consideration in money or money's worth* (which consideration could consist only of the interest under the principal settlement). The legislative silence on this point may be contrasted with, for example, para.9(1) of Schedule 4A TCGA 1992[3] in which the character of a deemed disposal is spelt out in terms which include treating that deemed disposal as having taken place for a consideration specified as described in that provision. Reference may also be made to para.3 of Schedule 4A TCGA 1992 which is referred to below.

Section 76A TCGA 1992

Section 76A TCGA 1992 applies Schedule 4A TCGA 1992 in cases where there is a disposal of an interest in settled property. Schedule 4A applies, in essence, where there is a disposal of an interest in settled property for consideration; then, if various conditions are met, there is a deemed disposal of the relevant underlying assets (as defined) comprised in the relevant settlement. Where the relevant conditions are met on creation of a sub-fund settlement, Schedule 4A TCGA 1992 could apply to create a deemed disposal of the relevant underlying assets provided that there is a disposal of an interest in settled property for consideration.[4]

Paragraph 3 of Schedule 4A specifically determines whether a disposal is "for consideration". It provides as follows:

> "3(1) For the purposes of this Schedule a disposal is "for consideration" if consideration is given or received by any person for, or otherwise in connection with, any transaction by virtue of which the disposal is effected.
>
> (2) In determining for the purposes of this Schedule whether a disposal is for consideration there shall be disregarded any consideration consisting of another interest under the same settlement that has not previously been disposed of by any person for consideration.
>
> (3) In this Schedule "consideration" means actual consideration, as opposed to consideration

> deemed to be given by any provision of this Act."

In the light of this definition there are at least two clear reasons for concluding that, even if a sub-fund election causes there to be a deemed disposal of an interest in the principal settlement and an acquisition of an interest in the sub-fund settlement, that cannot be a disposal "for consideration" as defined in Schedule 4A TCGA 1992. First, as regards para.3(1) Schedule 4A TCGA 1992, there is no "transaction" by which the disposal of an interest in settled property is effected: it is not considered that a unilateral election can properly be characterised as a "transaction". Secondly, as regards para 3(3) Schedule 4A TCGA 1992, no relevant consideration is deemed to be given on the making of a sub-fund election by any provision of TCGA 1992 (which would not, in any event, be material); nor is there any actual consideration because, in actuality, there is no change to the beneficiary's interest as a matter of fact or general law. A third reason is provided by the application of the principles in *Marshall v. Kerr* [1993] STC 360 which are considered below.

The Assumed Disposal

For the purposes of the above consideration of ss.71 and 76A (together with Schedule 4A) TCGA 1992, it has been assumed that it must follow from the making of the sub-fund election and the rules deeming the sub-fund to be a separate settlement that a beneficiary will be deemed to have disposed of his or her interest in the principal settlement and to have acquired an interest in

the sub-fund settlement. A fundamental issue is whether, notwithstanding the separate settlement treatment for the purposes of the Act (TCGA 1992), this is a necessary inference.

There may be at least two reasons for concluding that this is not a necessary inference. The first reason derives from the correct approach to deeming provisions as described by Peter Gibson J in *Marshall v. Kerr* [1993] STC 360 at p.366 (and approved by Lord Brown-Wilkinson at [1974] STC 638 at p.648-649):

> "... I take the correct approach in construing a deeming provisions to be to give the words used their ordinary and natural meaning, consistent so far as possible with the policy of the Act and the purposes of the provisions so far as such policy and purposes can be ascertained; but if such construction would lead to injustice or absurdity, the application of the statutory fiction should be limited to the extent needed to avoid such injustice or absurdity, unless such application would clearly be within the purposes of the fiction. I further bear in mind that because one must treat as real that which is only deemed to be so, one would treat as real the consequences and incidents inevitably flowing from or accompanying that deemed state of affairs, unless prohibited from do so."

The reasoning might run as follows. Giving paras 1 and 17 Schedule 4ZA TCGA 1992 their natural meaning, and consistent with the policy of the Act and provisions of Schedule 4ZA, as ascertained from the provisions of Schedule 4ZA, to treat a sub-fund election as creating a

disposal of an interest in the principal settlement and an acquisition of an interest in the sub-fund settlement would lead to injustice and absurdity: it would mean (for example) that no settlement which had at any time had non-resident trustees could elect for sub-fund treatment without exposing the beneficiaries to the crystallisation of potentially chargeable gains on disposals of their interests (in addition to the crystallisation of trust gains on the trustees of the sub-fund settlement becoming absolutely entitled as against the trustees of the principal settlement). Although one must treat as real the division of the original settlement into a principal settlement and a sub-fund settlement for CGT purposes, a beneficiary's interest can simply be regarded as switching from an interest in one settlement to an interest in another, or the original interest can be regarded as terminating and a new one as commencing; disposals and acquisitions by beneficiaries are not incidents or consequences which inevitably flow from or accompany the division of the settlement for tax purposes.

The second reason (which also supports the first reason in terms of the policy behind Schedule 4ZA TCGA 1992) is that Schedule 4ZA TCGA 1992 contains the heading "Consequences of a sub-fund election"; and the express consequences listed in paras.17 to 22 inclusive TCGA 1992 are clearly intended to be exclusive so that no other (implicit) consequences follow or are deemed to follow.

It is considered that this reasoning is correct and that the contrary conclusion would be unsustainable in the Tax Tribunal.

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[1] See the principles from *Marshall v. Kerr* [1993] STC 360 set out below.

[2] Deeming is necessary as there is, in fact, (as for general law purposes) no change in the beneficiary's interest.

[3] "(1) The deemed disposal shall be taken –

(a) to be for a consideration equal to... market value; and

(b) to be a disposal under a bargain at arm's length..."

[4] It might be observed that this deemed disposal of underlying assets would give rise to gains which are potentially identical to those which arise on the occasion of the trustees of the sub-fund becoming absolutely entitled as against the trustees of the principal settlement, (and there would be points regarding sequence and priority to be considered). It is considered inconceivable that there could be a double charge under Schedule 4A and s.71 TCGA 1992 despite the circumstances that this scenario would not fall within the express provisions of para.10 Schedule 4A TCGA 1992 (avoidance of double-counting).

THOUGHTS ON CORPORATE RESIDENCE

by David Goldberg

According to Google's on line etymology dictionary, the phrase "get real" originated, in American college slang, in the 1960s – which was, of course, the era of hippie culture and flower power.

Apparently, the apogee of usage of this phrase was reached in 1987, since when it has been in relative decline as a matter of popular speech, being largely replaced by the, perhaps more useful, exhortation to wake up and smell the coffee.

In the world of tax, however, the requirement to get real has been growing since about 2003, when Ribeiro PJ told us, in his judgment in the *Arrowtown* case, that it was necessary, in tax cases, to apply the statute, construed purposively, to the facts viewed realistically.

A difficulty with this sort of elegant formulation is that the words "viewed realistically" are clearly meant to add something to the words "the facts".

Are the facts one thing when just viewed, and another when viewed realistically; and, if so, what is the difference?

I ask the question because the word "real" quite often crops up in Special Commissioners' decisions on residence, although higher courts on appeal seem to avoid it and go along with the proposition that what

happens is what happens and does not change if you ask what really happened.

I shall try, a bit later, to see if I can demonstrate what I mean about how the Special Commissioners seem to treat what really happened as different from what happened, by reference to the recently decided cases about residence.

However, before I do that, I should make some general points about corporate residence.

As every reader will know, any company incorporated in the United Kingdom since 1988 is automatically resident here for tax purposes, unless it can show that its place of effective management is in a country with which we have a relevant double tax treaty – see FA 1994 s.249.

And any company which is not incorporated here (or which was incorporated here before 1988 and which has been resident outside the United Kingdom since then) will be resident here if the central management and control of the company abides here, so that its real business is carried on here.

That is the well known common law test laid down by Lord Loreburn in 1906 in the *De Beers* case.

Now no doubt all sorts of tests could have been chosen for residence, but incorporation and central management and control seem just as good to me as any other test of residence: indeed, in the case of a body

corporate, it seems quite hard to think of another more sensible test of residence.

In what follows, I shall speak essentially about companies not incorporated in the United Kingdom, though I shall also make some comments relevant to UK-incorporated companies seeking to say that they are Treaty non-resident.

I should begin by making four points about the company law or treaty test of residence.

First, the central management and control test relates to the business of the company and not to the company itself.

The enquiry is not into where the company is controlled, but into where the business of the company is controlled.

Thus we do not look to see where the shareholders of a company meet: we look to see where the controlling mind of the company's business is to be found.

Now a point quite often overlooked here is that, in looking for the place of the controlling mind, something – not everything, but something – will turn on what the company's constitution says.

The case law shows that the usual thing to do when looking to find the place of central management and control is to look to where the directors meet.

I accept, of course, that there are *dicta* in some of the cases that you do not just look to see where the board meets to determine residence, but I assert that, in general, the authorities show that the first thing to do in deciding residence is to see where the board meets and that that will determine residence in the absence of some other feature.

I shall come in a moment to discuss what that other feature might be.

However, before I do that I should say that it will only be right to look to where the board meets if the company's constitution gives the directors of the company the power to manage its business (which it usually does do, but may not), and the directors are actually acting as directors and have not been usurped.

The case law makes a huge distinction between cases where the directors act, albeit only slightly, and cases where control has been wrenched away from them and they do not act.

Thus the case law shows that , in a case where the constitution of the company in question gives power to the directors to manage its affairs, central management and control is to be found where the board of directors meets, unless the functions of the board have been usurped.

Case law around the common law world is unanimous on this point, perhaps surprisingly

unanimous; and the test is applied not just in tax cases, but in other areas of law too.

Accordingly, the feature which makes it wrong to look to the place where the board meets to find the place of residence – and the only feature which makes it wrong to do that – is usurpation.

Without usurpation, the decisions in the cases show that the place of residence is the place the board meets and, accordingly, I do not entirely agree with those who say that location of formal board meetings is not determinative of tax residence.

In my view, it is, on the authorities, determinative of tax residence, unless it can somehow be said that the functions of the board have been usurped.

I understand people have said that the location of the directors' meetings is not determinative.

The *dicta* in the cases give some encouragement for that view, by referring to the place of actual management.

However, there is an important point to make here about the way in which judges decide cases, about what I might call the case law experience.

It is a commonplace of many areas of the law that judges, in certain parts of their judgments, make very high-flown comments: in the field of judicial review, for example, there are passages which make you believe that

the courts will give a distressed litigant the waters of the moon.

It is, nonetheless, necessary not only to look at these high-flown passages, but also to what actually happens when the case is decided.

Never mind what the judge says: what does he actually do, what does he decide?

It is only the decision which is binding authority, not the commentary.

It is true that in residence cases, the judges emphasise that we are looking for the real place of control.

But the really important point to note – the thing which, like coca cola, is the *real thing* – is that the judges have always decided that a company is resident where its board of directors meets and that that is the place of real control with only one exception, the exception being a quite extraordinary case in which the directors had stood aside, had abandoned their role so that their position had been usurped.

It is only when you can find that feature that residence is not where the board meets; and experience, not all of it bitter, has taught me that, in using case law, it is essential to look to what is decided and not to the promises made in the commentary which are virtually never fulfilled in the actual decisions.

Moreover, case law in the higher courts is unanimous about the need to distinguish between the exercise of control on the one hand and the exercise of influence on the other: control makes a company resident; influence does not.

Furthermore, the exercise of influence over a board does not amount to a usurpation of its functions: on the contrary, the board usually has to act to implement the influence and it is that acting which is the exercise of central management and control, not the influence leading to that action.

I have limited what I have just said about case law to decisions of the higher courts because, as I shall show shortly, the Special Commissioners here seem somewhat wedded to the proposition that influence is important; a proposition for which (leaving aside the Special Commissioners themselves) there is no case law authority at all anywhere in the common law world.

However, again leaving the Special Commissioners aside for the moment, the general proposition can be safely stated: control of the kind which makes a company resident is found where the directors of the company meet, so long as they are meeting and acting in a way no matter how formal.

A recurring theme of what I want to say is that, for something to be actual management or control or to be the real place of control, it must be something that is, somewhere where management or control is.

Finding something to be real and then describing it as management does not make it control.

The position is likely to be different if the company's constitution does not give the directors of the company power to manage its business; but this point has not yet actually arisen for decision, no doubt because advisers are, on the whole, sensible enough to ensure that it does not arise.

The second point to make is that the case law does recognise the possibility of a company being resident in two or more places at once.

Although the concept is central management and control, the centre is apparently capable of being geographically diverse.

Recent case law has tended to shy away from this idea, but the possibility of multiple residence should not be overlooked.

Good planning, of which more later, will ensure that the possibility of multiple residences does not arise.

The third point is that, as I have mentioned, sometimes, where a treaty is relevant, we need to find the "place of effective management" of a company.

I should have thought it completely obvious that the phrase "effective management" refers to a wholly different concept from that to which the phrase "central management and control" refers.

Central management and control consists in the giving of directions and effective management is not control, but putting the decisions of central management into effect.

It turns out, however, that even English language versions of DTCs contain French words and that "effective" is one of them and should, accordingly, be pronounced "effectif" – which means something different from effective.

At any rate, current authority and commentary both now strongly equate the concepts of effective management and central management and control.

Another point here is that you do not really want to be in this position.

The fourth point I should make before turning to the recent cases is that litigation about corporate residence is really no different from litigation about anything else, though it is a bit unusual in tax terms, because it is unusually fact-centric: there is no issue here as to what the statute means; the case is all about finding the place where central management and control is to be found.

One point to note here is that, in terms of tax litigation, cases about residence might be one-shot cases, in the sense that, if the Special Commissioners make unhelpful findings of fact, an appeal from them, which is, of course, only on a point of law, may be quite difficult.

In fact-centric litigation, there is often a danger of the wood getting lost in the trees (that happened, appropriately enough, in the *Holden* case) and because that is so it is necessary for the advocate to ensure that the enquiry made by the court is focussed on the proper question.

As I have said, the proper question is about central management and control, and it is, "Where did the acts of central management and control take place?"

We are looking for management and control, not hopes, dreams and wishes.

The failure properly to distinguish between management and control on the one hand and hopes, dreams and wishes on the other has, in recent cases, led the Special Commissioners into error; and anybody litigating about corporate residence needs to make sure that the court understands that hopes, dreams and wishes do not decisions make.

The Special Commissioners do not presently seem to have a firm grip on that point; and, indeed, the way they have been coping with hopes, dreams and wishes and treating them as management and control is what led me to begin this talk with some musings about the requirement to get real.

As we shall see, the Commissioners, in an endeavour to make resident in the United Kingdom certain entities the residence of which is in doubt, have been trying to develop a concept of effective or real

management in relation to things which are not management at all.

Indeed, it was the endeavour of the Special Commissioners to develop that sort of point which led them into error in *Wood* v *Holden*.

The question in that case was about a company called Eulalia, which had directors in Amsterdam.

It was the subsidiary of another foreign company, CIL, which, in turn, was owned by a foreign trust, the beneficiaries of which were in the United Kingdom.

It was accepted that the other company, CIL, and the trust were non-resident but, even so, the Special Commissioners held that they were not satisfied that Eulalia was non-resident.

That was an odd conclusion, related to the burden of proof, which is on the taxpayer in a tax appeal: it was not a finding that Eulalia was resident in the United Kingdom, and it was, accordingly, a somewhat fence-sitting decision.

In reaching that conclusion, the Special Commissioners made a number of errors.

First, they failed to recognise that all sorts of people – shareholders perhaps, beneficiaries of trusts holding shares perhaps – can huff and puff about what they want done, but nothing can actually happen in the corporate sphere unless the people who actually run the

company do something: in a typical case, unless the directors make a company do something, nothing can happen.

That seems to me to be a rather telling point: influence does not make – has no power to make – things happen.

Secondly, the Special Commissioners failed to recognise that, if the people who actually run the company – the directors – do make the company act, what they do must be an effective decision, must be an act of central management and control.

What happened, of course, in *Wood* v *Holden* was that the Special Commissioners saw a tax plan thought up in the United Kingdom and implemented because Mr Wood, who lived here, wanted it to be implemented.

So they seem to have adopted the slogan with which I began – get real – and said the real control of the relevant company was here in the United Kingdom.

But so called "real control" can only be central management and control if you can make the company actually do something, can only be central management and control if you can actually control the business of the company.

On the facts of *Wood* v *Holden*, there were many, many people in the United Kingdom exercising influence over what happened in Holland, but none of them could make anything happen there: the only people who could

do that were the directors of Eulalia, and so they were the only people with any form of control over what Eulalia did.

There is a difference between just deciding on the one hand and deciding coupled with the ability to do, on the other.

I realised the difference most strongly on Black Whatever-day-of-the-week-it-was.

I had decided, just before, to sell all my shares, not that I had many, but the decision to sell them availed me nothing when the markets tumbled. I had not actually sold them.

In order to have central management and control of a company in a particular place, it is necessary for there to be, in that place, decisions taken by persons who can put them or cause them to be put into effect.

In *Wood* v *Holden*, there was no place in the United Kingdom where that was being done: the only place where that could happen was in the Netherlands; and the Courts so held.

The Special Commissioners did not realise that, because they confused influence with control and, happily for the taxpayers, made an important mistake in their reasoning here.

In particular, they said, in that case, that the only acts of management took place in Amsterdam; and they

then implied that the acts of management taken there were not effective acts.

They then went on to imply that effective control was in the United Kingdom, but did not say that precisely.

They did not, in that case, themselves use the language of reality, but rather that of "effective control" and, as I say, they implied it was in the United Kingdom.

They did not ask themselves how influence could be effective control if there was no way of forcing it into effect and so, as is often the case, in a search for reality found only an illusion they believed in.

The mistake in their reasoning – the contradiction between the finding that all the acts of management were in Amsterdam and the holding that residence in Holland had not been established – enabled us to say that there was an error of law here and so to get the decision reversed.

The High Court and the Court of Appeal both decisively rejected the idea that actions taken by a board could be ignored because they were formal actions or because they were not fully informed actions.

The Court of Appeal in particular made it clear that, if the board of a company acted, its actions and nobody else's were the acts of control, and the Company was resident where it acted and nowhere else: the only exception was usurpation. Sir Christopher Staughton in

particular was scathing about the use of the word "real" to ignore or disguise the effect of what happened: the actuality remained the actuality even if something else was said to be real.

I should, however, repeat that questions of residence do, usually, in the end turn on findings of fact, and the scope for reversing a decision of the Commissioners is quite limited: that point, by the way, is true not only of cases of corporate residence, but also of individual residence.

The taxpayers were very lucky in *Wood* v *Holden*, because the reasoning of the Special Commissioners was distinctly odd: once they had found that the only acts of management were in Amsterdam, the only logical possible conclusion – the only conclusion that was correct in law – was that the company was resident there.

I might also add here that it is sometimes said by the Commissioners that the question in a tax appeal about residence is not where the company was resident, but whether it was resident in the United Kingdom.

That is, of course, in a certain sense true, because the tax question will usually be dependent on residence here, and, since dual residence is at least a theoretical possibility, the relevant issue is usually whether residence here has been established.

However, the older case law, which is, of course, decided in the House of Lords, clearly contemplates that a company can have a residence in a particular place

which is not in the United Kingdom, and it must, inevitably, be helpful in a case where a claim of non-residence is being pursued, to point to a place outside the United Kingdom where the company is resident.

News Datacom is an interesting case.

The putative taxpayer was a Hong Kong incorporated company, which had held a board meeting in the United Kingdom, a thing which is not to be recommended if you are seeking to say that the company is not UK resident.

However, the Special Commissioners in that case (who were different from those in *Wood* v *Holden* and from those in the next case I shall consider) incisively recognised that not everything done by directors constitutes central management and control; and found that what had happened in the United Kingdom did not, in that particular case, make the company resident here, because it represented mere administration and not control.

That was an important point, not previously expressly recognised in our case law, and so the case represents a material advance in the thinking about corporate residence.

However, as I have indicated, it is not a good idea to hold any board meetings in the United Kingdom at all.

The most recent case about residence is *Smallwood*. The decision of the Commissioners was

reversed by the High Court (which Philip Baker discusses elsewhere in this issue), but here I want to look simply at the way the facts were found by the Commissioners.

This was a case about the residence of a trust, not about a company and there are, I think, important differences, not least that the constitutional documents are different.

The question in the case was where the place of effective management of the trust was in a period when the trustee itself was in Mauritius and there was influence flowing from the United Kingdom: in that period, the trustee sold certain shares at an enormous gain.

There was no doubt that people in the United Kingdom wanted the shares sold; and equally no doubt that people in the United Kingdom had decided that they should be sold.

There was also no doubt, however, that the only person with the right to sell the shares was the trustee in Mauritius.

The question which arose under the terms of the UK/Mauritius DTC (so that no question of purely domestic law arose) was whether the gain which arose on the disposal of the shares was exempt from capital gains tax in the United Kingdom.

The Commissioners found that the degree of influence emanating from the United Kingdom was such as to constitute effective management of the Trust here; and it is, perhaps, relevant to note that one of the Commissioners was Dr Brice who did not sit in the *News Datacom* case but who did sit in *Wood* v *Holden* case at first instance; and that, in this case, the Commissioners again attempt to get real, referring this time to "real control".

I can well understand how the Special Commissioners felt that the influence flowing from the United Kingdom was effective.

I have more difficulty in seeing how the effective influence was management of the trust: before you can have effective management, you must have management, and I cannot see any actual management of the trust in the United Kingdom in the relevant period; calling what happened in the United Kingdom "real" management does not actually make what happened here management.

What happened in *Smallwood* involved the carrying out of a relatively unattractive tax avoidance scheme of the too good to be true kind, and the residence issue (because it relates to a trust and not a company) does not benefit from the fact (as the residence issue in *Wood* v *Holden* did) that the decision of the Court could impact on wholly commercial arrangements which had no tax avoidance aspects whatever.

I am not sure that the case should be of too much concern in the corporate context.

In particular, the Court of Appeal in *Wood* v *Holden*, has made it absolutely clear that, if a non-UK incorporated company has directors acting outside the United Kingdom, their actions cannot be ignored and influence emanating from the United Kingdom will not make the company resident here.

I am not sure that the Special Commissioners who decided *Smallwood* fully recognise that point.

Let me now turn to some practical points.

If you want to make a company non-resident, these are the rules to observe if you want to avoid the opportunity of contributing to the Law Reports at the highest level:

(i) hold at least six board meetings a year; (I say this because anyone receiving this advice might hold three or four which is enough to make me feel comfortable, but if I said three or four, they might only hold one, which would not make me feel comfortable.)

(ii) keep full minutes which show the directors exercising central management and control;

(iii) hold the meetings in a fixed place or at least usually in a fixed place. This is a practical

point, not a legal one: if there is a peripatetic board, meeting at different places outside the United Kingdom, the company will still be non-resident; but it is easier, if a challenge to residence arises, to be able to say "this company is resident in X" rather than "this company is not resident in any particular place and, in particular, is not resident in the UK".

In law, it does not matter where a directors' meeting is held, so long as it is not in the United Kingdom: it can be on a ship or a plane outside the United Kingdom, and the relevant company will still be non-resident.

Again, however, the practical issue of proving non-residence needs to be borne in mind.

Do not hold any board meetings in the United Kingdom.

Do not have a quorum of directors resident in the United Kingdom (to avoid accidental meetings) and, similarly, do not have a quorum present temporarily in the United Kingdom and deciding things.

(iv) do not allow directors to participate in directors' meetings by telephone or video conferencing facilities or by using e-mail from within the United Kingdom.

There is no law on this and the probability is that, so long as the majority of the board are outside the United Kingdom, this is all right.

But the chief thing you do by trying this is to give yourself the opportunity to be a leading case, which is an opportunity which should be avoided if possible.

Similarly, where directors' resolutions are passed in writing, don't sign them here;

(v) there is, however, no harm in thinking about things in the bath here: thinking is not doing and doing is needed before there can be any management and control;

(vi) if the board wants things done in the United Kingdom it needs to delegate the functions to be performed here to people here and then supervise what they do at their regular board meetings: the acts of delegation and supervision are then the acts of central management and control, and what is done here is of a lower order, in the administrative category.

Overall, the general message in this: if you want a foreign incorporated company to be non-resident, you need an active board which meets and takes decisions.

If that is inconvenient to highly important board members, they need to remember that tax mitigation requires some effort and that nothing which comes easy is worth having. Or at any rate that is my view of reality.

TAX PLANNING IN PRE-PACKAGED ADMINISTRATIONS

Michael Jones*

Pre-packaged administrations,[1] or "pre-packs" as they are commonly known, are a phenomenon on the rise. Their prevalence has been well documented,[2] but what has yet to be considered is whether they present any restrictions on, or opportunities for, tax planning in and around corporate insolvency. This note focuses on one important aspect of such planning, namely the use of tax losses, which is a subject that highlights the way in which pre-packs can impact on taxation in insolvency.

Background

Broadly speaking, a pre-pack works as follows. The troubled company, X Ltd, recognises that either it is, or will presently be, insolvent. It has a valuable business, or at least valuable assets, for which a prospective purchaser has been found. At this point a licensed insolvency practitioner, the administrator-in-waiting, is brought in to advise on the whether the terms of any proposed sale would be acceptable to him in his capacity as administrator of X Ltd. Against this background the purchaser and the company negotiate, but do not execute, an agreement for sale. The contract will usually contain only very limited warranties from the prospective administrator,[3] who will be the one executing the sale once the company is in administration.

After the terms of the sale have been agreed by the parties the company is placed into administration, usually using the "out of court" appointment procedure.[4] Once in office the insolvency practitioner, now acting as administrator, will execute the sale as agent for X Ltd. The advantage of having the sale executed in administration is that it provides an element of cover for the management of X Ltd, particularly where they are the ones buying the business from the administrator. Were the management themselves to execute a quick sale of X Ltd's business at a price less than market they would run a high risk of being challenged on the basis of being in breach of their fiduciary duties, especially where that sale was to themselves. By having the sale blessed and then executed by the administrator, however, the risk of challenge is lower. Another benefit of the pre-pack is that the time during which the company is subject to a formal insolvency procedure is kept to a minimum. This is particularly important where the main asset of the business is goodwill or where it is crucial to the survival of the business that disruption to its employees and clients is minimised.

After the sale is completed the administrator will wind down the company, making what distributions he can.

Tax Planning and Accumulated Losses

By the time a company reaches the stage where it might need to consider a pre-pack sale it will very often have already accumulated a considerable amount of trading losses. If it carries on trading after that point then

it may well amass more. From a tax perspective there is value to be extracted from these losses and this can be done in one of two ways. First, the company might utilise them directly against its own tax liabilities; alternatively, the company could transfer its trade, together with the associated losses, to another company in return for consideration. Both options are discussed in more detail below.

On a more general note, it will be seen from what follows that the rules governing the use of losses in this context are relatively restrictive. This leads one to question whether tax law hinders the aims of insolvency law in this area, particularly in light of the Enterprise Act 2002 reforms and the focus on rescue.[5]

Direct Use of Losses

If our insolvent company, X Ltd, has any trading losses it can use them itself. The asset sale by the administrator may give rise to corporation tax on any chargeable gains, against which the accumulated losses might be set. However, the company's entry into administration triggers a new corporation tax accounting period (s.10(1)(i), Corporation Tax Act 2009 (formerly s.12(7ZA) ICTA 1988)), with the result that the range of losses that can be used for such a purpose is substantially reduced. Under section 393A trading losses can only be set-off against chargeable gains in the same accounting period in which the losses arose or an earlier one. Once that period expires, trading losses can only be carried forward against future profits of the same trade.

So, if trading losses have been accumulated in the accounting period prior to the company's entry into administration then, purely from a tax-planning point of view, it would be better to complete the asset sale before the company enters administration because losses will be available to set-off against any gains. After entry into administration the trading losses can only be used if the company continues to trade,[6] but, of course, if the administrator has sold the business assets within days of entry into administration there will not be any future profits of the trade arising to the company. The losses will, therefore, go unused.

This problem is not exclusive to pre-packs, it is a feature of all administrations, but it is perhaps most pronounced where pre-packs are involved because the sale is negotiated at a point when losses would potentially be available but it is executed perhaps only days later at a point when those losses can no longer be used. What is more, had the sale been executed outside of administration any resulting tax would have ranked as an unsecured claim; once inside the administration procedure, however, any corporation tax on chargeable gains will rank as an expense of the administration[7] to the benefit of HMRC and to the prejudice of the other creditors.

Using Losses Directly in a Pre-packaged Insolvency

One option to get around these restrictions would be to have the pre-pack effected by an administrative receiver rather than an administrator, if that option is open to the charge holder.[8] The appointment of an

administrative receiver does not cause a change in accounting period of the company and so the pre-negotiated sale can be executed and trading losses used against any resulting gain without the same restrictions.

Another option, subject to obtaining the necessary insolvency/company law advice, would be to have the company execute the sale of any assets standing at a capital gain before it enters administration. This would have the effect that the chargeable gain would arise in the accounting period during which trading losses are available for set-off.

A third option would be for the administrator to effect a hive down and then a sale to a third party. Alternatively, where the ownership of the transferor and the transferee companies will be the same there will be the possibility of using section 343 ICTA 1988 to pass the trading losses of the transferor to the transferee company for use in the carrying on of the trade. Hive downs and section 343 are discussed in the next part.

Indirect Use - Hive Downs

As just mentioned, one way around the restrictions on the direct use of trading losses is to make indirect use of them by transferring them to someone who is able to use of them going forward. This can be achieved by the administrator effecting a transfer, or hive down, of the trade and the assets into a “clean” subsidiary, which can then be sold to a purchaser.

This form of indirect asset-sale allows for the administrator to cherry-pick the valuable and profitable assets of the company, leaving behind any onerous or valueless assets. A further benefit that a hive down has over a straight assets sale is that the potentially valuable tax losses and capital allowances can be transferred to the subsidiary by virtue of section 343 ICTA 1988, which, in fact, began life as an anti-avoidance section.

Section 343 applies where one company ceases to carry on a trade, and another company begins to carry it on and, on or at any time within two years after that change, the trade, or at least a 75% interest in it, belongs to the same person as it did at some point within a year before the change. There is a further requirement that within the two year time frame the successor company carries on the trade within the charge to corporation tax. If these conditions are met then the successor company is entitled to the capital allowances and the unclaimed trading losses available for carry forward relief under section 393 ICTA 1988.

Looking at those requirements in turn, first, it is crucial that, on or within two years after the transfer, the trade or at least a 75% interest in it must be owned by the same person as it belonged to at some time within a year before the transfer. Under section 344(2), a trade or an interest in a trade belonging to a company can be treated as belonging to the persons owning the ordinary share capital of the company and as belonging to those persons in proportion to the amount of their holding of that capital. Alternatively, where it is a subsidiary company

that carries on the trade, it can be treated as belonging to its parent or to those persons that own the share capital of the parent, and again, in proportion to the size of their respective holdings. For these purposes, as is common in taxing statutes, ownership means beneficial ownership. In essence, therefore, this provision ensures that the focus is upon economic, rather than pure legal, ownership of the trade.

To put this into the context of a hive down in an administration, it means that, within two years of the hive down, X Ltd, our insolvent company, must beneficially own, directly or indirectly, at least three-quarters of the share capital of the subsidiary in order to meet the first condition in section 343. Care must be taken to ensure that beneficial ownership of those shares has not been lost, for example, as a result of the administrator having contracted to sell the shares in the subsidiary to a third party purchaser before the requirement has been met.

Secondly, the section does not stipulate any minimum period during which the common ownership condition must be fulfilled; all that is required is that the requirement is met on or at any time within two years after the point of transfer. On a literal reading the section is brought into play where the condition is met for only a *scintilla temporis* on or after transfer. Ideally, however, in order to give the reconstruction some substance, it is suggested that X Ltd should beneficially own the shares for at least a week, during which Newco can carry on the trade, before any subsequent sale. It may be possible to

trim down this period, and we will return to this point later, but the risk of HMRC attack is likely to be increased as a result. This is particularly the case in a pre-pack, where a prospective purchaser has already been lined up and is waiting in the wings. The further question of the impact of the *Ramsay* line of jurisprudence on pre-arranged hive downs is also considered below.

The timing of the commencement of trading is key. The successor subsidiary must begin to carry on the trade before X Ltd loses beneficial ownership of its subsidiary. If commencement by the subsidiary takes place after the share sale then section 343 will not apply.[9]

Thirdly, there is an important restriction on the use of losses where the transferor is insolvent, i.e. it has an excess of liabilities over assets and the successor company fails to take over all the liabilities. Broadly speaking, section 343(4) provides that a successor company is only entitled to the carry-forward trading losses to the extent that the amount of unrelieved losses exceeds the level of the transferor's insolvency.

The restriction operates by reference to "relevant assets" and "relevant liabilities". "Relevant assets" are defined in section 344(5) as the assets vested in the predecessor company immediately before cessation which were not transferred to the successor company and which were not apportioned to a successor company on any previous application of section 343. Also included is the consideration given to the predecessor company by the successor in respect of the transfer, although the

assumption of the predecessor's liabilities by the successor is not treated as consideration. "Relevant liabilities" are liabilities which were outstanding and vested in the predecessor immediately before it ceased to trade, which were not transferred to the successor company and which were not apportioned to a trade carried on by a successor company on any previous application of section 343. "Relevant liability" does not include any liability representing the predecessor's share capital, share premium account, reserves or relevant loan stock.

The way in which this restriction works is best demonstrated by way of an example:

> Suppose X Ltd is in financial difficulty but it still has a valuable business. At this stage X Ltd has accumulated trading losses of £1m. It sets up a subsidiary, Newco, and transfers to Newco its lease, plant, machinery, stock, goodwill and employees. The sale consideration of £400k is left outstanding. Newco trades for a week before its shares are sold to Purchaser Ltd for £1. Purchaser Ltd ensures that Newco satisfies the £400k debt it owes to X Ltd. X Ltd has "relevant assets" of £800k and "relevant liabilities" of £1.5m:
>
> | | |
> |---|---|
> | Relevant liabilities: | £1,500,000 |
> | Less Relevant assets: | £ 800,000 |
> | Less Consideration: | £ 400,000 |
> | | £ 300,000 |

> For the purposes of section 343 ICTA 1988 X Ltd is insolvent to the tune of £300,000. Accordingly, there are £700,000 (£1,000,000 minus £300,000) worth of losses for use by Newco.

For this reason, where the company is heavily insolvent there may be no tax benefit in effecting a hive down.

The final restriction is on the way in which the trade is carried on within three years of the change of ownership of the trade. If, within three years of the transfer there is a major change in the nature or conduct of its trade then any relief will be lost.[10] Simply trading more efficiently should not be considered to be a major change in the conduct of the trade.

When the subsidiary is sold a tax degrouping charge will arise on the assets hived down to the extent that any chargeable gains would have arisen if the trade and assets had been transferred to a third party at that time;[11] however, under section 179A TCGA 1992 it is possible to re-allocate the charge to another member of the disposing group.[12]

There is a potential VAT charge on the transfer of assets from the seller to a buyer unless the sale is a transfer of a business as a going concern or both companies selling and buying are in the same VAT group.

One disadvantage of a hive down is that there is likely to be an SDLT or Stamp Duty on the transfer of

some types of asset into Newco and accordingly such assets are commonly left out of the transfer.[13]

Hive Downs and Pre-packs

The next question is whether hive downs can be used in conjunction with pre-packaged administration. As explained, one of the defining features of a pre-pack is speed, and this factor may preclude the use of hive downs after entry into administration. With the appropriate planning and advice in place, however, it may be possible to arrange a hive down before the predecessor company enters administration. If that were done, and all of the necessary requirements satisfied, then the sale of the subsidiary could be pre-packed and executed once the predecessor company goes into administration. The difficulty is that this planning would require a transfer of the insolvent company's assets into Newco prior to entry into administration, which is arguably inconsistent with one of the main purposes of pre-packing, namely protection of the management of the insolvent company. Since the transfer of the business will take place in the twilight period before administration, the management might be left more exposed to creditor redress and the sale itself may be open to challenge, for example, as being at an undervalue. Appropriate insolvency and company law advice would, therefore, be required.

An alternative method of employing a hive down would be for both the transfer to Newco and the sale of Newco to take place once X Ltd has gone into administration. The downside of this approach is that

Newco would, ideally, carry on the trade for at least a week before being sold on whereas pre-packed sales tend to be executed more quickly than that. As noted above, however, there is no period stipulated in the legislation during which Newco must carry on the trade within the same ownership. It is, therefore, open to argue (with caution) that provided it can be shown that Newco has in fact carried on the trade, by completing sales, for example, then it should not matter that the sale of Newco takes place within a week of the hive down. The nature of the trade transferred will obviously be important in determining how strong that argument is.[14]

If it was decided to effect a hive down during the administration, there is an interesting question as to the degree of risk of a *Ramsay*-type attack from HMRC. As happens in a pre-pack, a purchaser for Newco will be lined up before the predecessor company enters administration, and, most probably, before the hive down is complete. In the absence of any form of enforceable agreement, however, it is not considered that this will lead to the conclusion that beneficial ownership has passed before the hive down takes place. Whilst it can be said that, as a matter of fact, it is highly likely that the prospective purchaser will assume beneficial ownership of the subsidiary very soon after the predecessor company enters administration, that fact is not enough to alter the legal rights of the respective parties; the point at which the beneficial ownership passes remains a question of law. Indeed, in paragraph 06210 of their Company Taxation Manual, HMRC, referring to the pre-*MacNiven* interpretation of the *Ramsay* line of cases,

state that they would not expect *Ramsay* to be relevant where an entire trade, or part trade, together with its related assets and liabilities, are hived down with a view to its being carried on in other hands. Notwithstanding that, generally speaking, liabilities of the trade will be left behind in the transferor company, it is considered that in the absence of any unusual circumstances, for example the entry into an informal sale agreement before the hive down is complete, the risk of a *Ramsay*-type attack, whilst present, is small.

The conclusion is that pre-packaged administrations are not inherently consistent with the tax-efficient use of losses. This is partly as a result of the fact that the essential structure of a pre-pack does not lend itself easily to tax planning using losses or hive-downs, and partly as a result of the absence of specific tax rules designed with insolvency policy in mind. However, value can be extracted from tax losses in these circumstances, although the structure of the transactions involved will need to be adjusted slightly in order to accommodate the planning.

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[*] Gray's Inn Tax Chambers will be hosting a seminar on the subject of taxation in insolvency in the autumn. If you would be interested in attending then please email st@taxbar.com for further information.

[1] Sometimes also termed "pre-packaged sales" or "execution-only administrations".

[2] See, for example, the excellent research produced for R3 by Dr Sandra Frisby, available at http://www.r3.org.uk/uploads/documents/preliminary%20analysis%20of%20pre-packed%20administrations.pdf

[3] The limited warranties will often push the purchase price down; this will also happen if the purchaser is willing to take on some of the company's creditors.

[4] Effected either by the holder of a qualifying floating charge under para. 14 of Schedule B1 of the Insolvency Act 1986, or by the company or its directors under para.22 of the same.

[5] This is a problem frequently encountered in the field of taxation of insolvents and one which probably results from the fact that there are very few provisions of the tax code aimed exclusively at situations involving insolvency. Whereas our insolvency laws are specifically designed to deal with the problems that arise where a person's liabilities exceed his or her assets, our general tax laws are, understandably, not drafted with that purpose in mind. Accordingly, an application of those general provisions to the very specific situation of an insolvent taxpayer can give rise to tax consequences that are inconsistent with the aims of insolvency law; by and large the upshot will be that HMRC end up better off than the taxpayer's other unsecured creditors. This is the case when one is looking at loss use in administration. Given, however, that the Crown Preference was abolished as part of the Enterprise Act reforms it might be thought that a result that has the indirect effect of preferring HMRC is contrary to current insolvency policy.

[6] And can only be used against income profits, not chargeable gains.

[7] See Insolvency Rule 2.67(1)(j).

[8] It is understood that the pre-packs were first used in the context of administrative receivership before the Enterprise Act changes, after which administrative receivership was largely abolished and it became possible to appoint administrators out of court. However, in addition to certain limited exceptions, it remains open to charge-holders with debentures entered into before 15 September 2003 to appoint an administrative receiver.

[9] See HMRC's Company Taxation Manual para.06210

[10] See sections 768 and 769 ICTA 1988.

[11] There is an equivalent for intangible assets in FA 2002, Sch 29 para 58.

[12] Again there is an equivalent for intangible assets FA 2002, Sch 29 para 66.

[13] It is considered that group relief would not be available in the context of a pre-pack because, by definition, there will be arrangements in place, albeit informal, for a purchaser to acquire control of Newco but not of X Ltd.

[14] The recent case of *Barkers of Malton Ltd v Revenue and Customs Commissioners* [2008] STC (SCD) 884 is instructive in this respect. It was held by the Special Commissioners that a company which acquired a trade from its parent company did not "carry on" the trade (car dealing and repairing) during the 90 minutes before the transferee company sold the trade on to the appellant. Mere ownership of the trade was clearly not enough, and there was no evidence that the transferee undertook any trading activity during the 90 minutes that it owned the business. It incurred no expenditure and obtained no receipts, nor did it enter into any transactions during the period. These factors, coupled with the short duration of ownership of the trade and the fact that there was a “sense of inevitability” about the sale to the appellant, led to the conclusion that, for the purposes of section 343, the transferee did not carry on the business during the 90 minute period.

AVOIDING LAND TRADING TRANSACTIONS

by Patrick Soares

Under the Budget of 22 April 2009, the top income tax rate will go up from 40% to 50% in 2010/11. It is more important than ever that taxpayers who make a profit from the disposal of land make a capital disposal, paying tax – in the case of an individual – at 18%, as opposed to a disposal of trading stock. If a taxpayer acquires land with the intention and ability to hold on to it and receive rents for a period of time, and he disposes of the property because of an unexpected offer and keeps appropriate minutes showing the investment intentions, he should be able to establish the profit without difficulty as being one of a capital nature. On the other hand, if the taxpayer acquires land with a view to turning it over – even though he may receive rent in the interim – and he advertises for purchasers, that would clearly be a trading transaction. Between these two extremes is a whole host of possibilities. The writer's checklist on factors indicating whether the taxpayer is a trader or not, which has never let him down to date, is set out below.

TRADING CHECK LIST – POINTS TO CONSIDER IF THE TAXPAYER WANTS TO AVOID A TRADING ASSESSMENT

	Cases	Acts or omissions	Indicators for and against	Weighting
(1)	*Page v Pogson* 35	Repetition	If the taxpayer has carried out similar trading	5

	TC 545		transactions before, it is more likely to be a trader	
(2)	*Harvey v Caulcott* 33 TC 159	Involvement	If the taxpayer is involved in land transactions generally, e.g., as an estate agent, this points to trading	3
(3)	*Taylor v Good* [1974] STC 148	Motivation	An intention at acquisition to turn the land (as opposed to an intention to hold it long term) is a strong indication of trading	25
(4)	*Iswera v CC of IR* [1965] 1 WLR 6634	Enjoyment	No personal enjoyment, e.g., no personal occupation of a house or flat, may indicate trading	3
(5)	*Cooke v Haddock* 39 TC 64	Income	If the land is not income producing, this indicates trading	6
(6)	*McCelland v TC of C of A* (1971) 1 All ER	Gift/Inheritance	Land acquired by gift or by inheritance indicates non-trading	4

	969			
(7)	*Turner v Last* 42 TC 517	Time	Land held for a short time – this indicates trading	5
(8)	*Johnson v Health* [1970] 3 All ER 915	Retention	If the taxpayer would not find it difficult to hold the land long term, this strongly indicates non-trading	10
(9)	*Iswera v CC of IR* [1965] 1 WLR 663	Surplus	If taxpayer has acquired land surplus to its own occupational requirements this may indicate trading	4
(10)	*IRC v Livingston* 11 TC 538	Work	If the taxpayer has not worked on the land, e.g., built an extension or carried out a refurbishment, this indicates non-trading	5
(11)	*Turner v Last* 42 TC 517	Planning	If the taxpayer obtains planning permission, this may indicate trading	2
(12)	*IRC v*	Alterations	If the nature of	2

	Livingston 11 TC 538		the land interest is altered, e.g., a lease extended, this may indicate trading	
(13)	*Cooke v Haddock* 39 TC 64	Nature of Land	Some land interests , by their very nature, indicate trading, e.g., building a housing estate	2
(14)	*West v Phillips* 38 TC 303 *Simmons v IRC* (1980) STC 350	Reasons for Sale	Unanticipated reason for sale, e.g., unexpected offer, indicates non-trading	10
(15)	TMA 1970	Memory	Taxpayer has good memory – should help in defeating a trading attack by HMRC	2
(16)	TMA 1970	Taxpayer alive	More likely to defeat trading attack by HMRC	4
(17)	*Marson v Morton* [1986] STC 463	Comprehension	Taxpayer does not fully understand the land deal – indicates not trading	2

(18)	*Marson v Morton* [1986] STC 463	JV/Partnership	Existence of a joint venture or partnership structure may indicate trading	2
(19)	*Taylor v Good* [1974] STC 148	Minutes	Super contemporaneous 'minutes' kept of intentions not to trade – powerful indicator of not trading	5
(20)	*Taylor v Good* [1974] STC 148	Age	Age of taxpayer – land is the 'pension' of client – indicator of non-trader	1

Needless to say the weighting must be used with a degree of caution!

DECISIONS, DECISIONS: CHALLENGING A DECISION OF THE TAX TRIBUNAL

Laurent Sykes

Appealable decisions

Readers of this Review will already be familiar with the structure of the new tax appeals system which took effect from 1 April 2009. In the broadest of outlines, the key structural changes (there are other important changes too) are as follows:

- The First-tier Tribunal (or rather its Tax Chamber) takes over from the Special Commissioners, General Commissioners, VAT Tribunal and certain other tax tribunals.

- The Upper Tribunal (or rather its Finance and Tax Chamber) takes over from the High Court on hearing appeals on points of law from first instance tribunal decisions. Permission to appeal is needed. (In certain cases, a case which has been designated as "complex" may however start in the Upper Tribunal – such cases are likely to be few and far between however.)

The path that, say, an appeal against an HMRC assessment might now follow is set out in diagrammatic form at the Appendix to this note.

Un-appealable decisions by the First-tier Tribunal

There are however a number of decisions which the First-tier Tribunal might make which are not capable of challenge under the appeals route set out in the Appendix.

Decisions within this category include:

- decisions on a point of law which are "excluded decisions", that is to say, decisions which would otherwise benefit from the appeals process set out but which have been excluded from it under the Appeals (Excluded Decisions) Order 2009[1]. This would include a decision by the First-tier Tribunal under s138(4) TCGA 1992 (procedure for clearance in advance) and certain decisions relating to an inspector's ability to call for documents (previously under s20 TMA 1970 but now contained in Schedule 36 FA 2008[2]).

- decisions on a point of law against which there is stated to be no right of appeal. An example is a decision in relation to an application under s55 TMA 1970 to postpone payment of the tax shown as charged by an assessment until the appeal against the amount has been heard. S55 has been amended[3] and s55(6A) now states that "…the decision of the tribunal shall be final and conclusive".

- certain other decisions which are not on a point of law. Within this category would fall a decision

> not to give permission to appeal and most case management decisions. The concept of appealing a case management decision might be thought of as surprising. Why bother? Because such decisions can be important, both in terms of cost and case strategy[4]. By contrast, under the Civil Procedure Rules, it is possible to appeal a decision of the High Court, including a case management decision, if it is wrong (which it may be if the court erred in law or in fact or in the exercise of its discretion), or if it is unjust because of a serious procedural or other irregularity.[5]

What are the taxpayer's remedies in relation to the various types of un-appealable decisions of the First-tier Tribunal set out above? There are three avenues to consider.

1. Request a review

The First-tier Tribunal may, of its own volition or on an application by the aggrieved party, review its decision in certain cases.

Unfortunately, it is not, without more, possible to ask the First-tier Tribunal to review a decision which is not subject to a right of appeal. That appears to follow from the fact that the Tribunal may only undertake a review of a decision made by it where it has received an application for permission to appeal (which must be read as a valid application for permission to appeal).[6]

However, the First-tier Tribunal may set aside a decision it has made which "disposes of proceedings" if there has been a procedural hitch.[7] And the First-tier Tribunal can be made to re-consider a case management decision by an aggrieved party applying for a fresh case management decision which reverses the offending one. It is not clear in either case whether it will be the original decision-maker who will be doing the reconsidering.

2. Judicial review of the First-tier Tribunal by the Upper Tribunal

Suppose reconsideration by the First-tier Tribunal of its decision fails to achieve the intended effect or is not available?

The power of the High Court (as successor to the old Court of King's Bench) to conduct a judicial review of public bodies, including tribunals which are not superior courts of record, derives from the common law (although it is now reflected in statute[8]). A "synthetic" judicial review function has been granted to the Upper Tribunal under the Tribunals, Courts and Enforcement Act 2007 (the "2007 Act")[9]. Most of the powers exercisable by the High Court have been granted to the Upper Tribunal and the statute provides that, in deciding to grant the various remedies sought, the Upper Tribunal "must apply the principles that the High Court would apply".

The heads of judicial review are often cited as illegality, irrationality (unreasonableness) and procedural impropriety (or unfairness).[10] It is often said, particularly

in the context of the first of these heads, that a judicial review is not concerned with the correctness of the decision under review, but rather whether the public body decision-maker has acted within the bounds of the powers conferred on it. However the distinction has become blurred as the field of judicial review has developed. A decision of the First-tier Tribunal may be capable of challenge where, on a proper construction of the relevant statute, the decision maker has failed to take account of relevant considerations or has taken into account irrelevant considerations[11]. It may also be the case that a decision of the First-tier Tribunal can be challenged where it contains an error of law – although there is perhaps still a question as to whether this must be on the face of the record in order to be subject to judicial review, particularly where the decision is stated to be final.[12]

Judicial review is unlikely to be capable of fully being ousted unless the wording is very clear. Even the wording contained in s55(4) TMA 1970 mentioned above, to the effect that the decision of the tribunal is to be "final and conclusive", is unlikely to be fully effective. The supervisory jurisdiction of the High Court is not readily excluded and it seems likely that this would also be true of the jurisdiction of the Upper Tribunal[13].

The supervisory jurisdiction of the Upper Tribunal does not however extend to "excluded decisions" (the first of the three categories of un-appealable decision set out above) unless, that is, the High Court transfers the

matter to the Upper Tribunal[14]. That is a deliberate limitation in the Upper Tribunal's judicial review powers under the 2007 Act.

3. Judicial review of the First-tier Tribunal by the High Court

There appears to be no reason why, if judicial review of a decision of the First-tier Tribunal by the Upper Tribunal is not available because the decision of the First-tier Tribunal is an "excluded decision", an application for judicial review cannot be made, and succeed, in the High Court in the usual way. The High Court may decide to refer the matter to the Upper Tribunal which would then have the ability to conduct a judicial review)[15], but it may decide to conduct a judicial review of the tribunal's decision itself. (Where by contrast judicial review by the Upper Tribunal is available, the High Court is likely to refuse permission or transfer the matter to the Upper Tribunal, unless there are very good reasons why it should not.)

Un-appealable decisions by the Upper Tribunal

Suppose it is a decision of the Upper Tribunal which it is sought to challenge? Judicial review of the Upper Tribunal is not possible, be it "synthetic" judicial review under the 2007 Act or traditional judicial review by the High Court (since the Upper Tribunal is a superior court of record[16] and therefore not subject to judicial review). The only option then, in relation to a decision of the Upper Tribunal which does not benefit from the

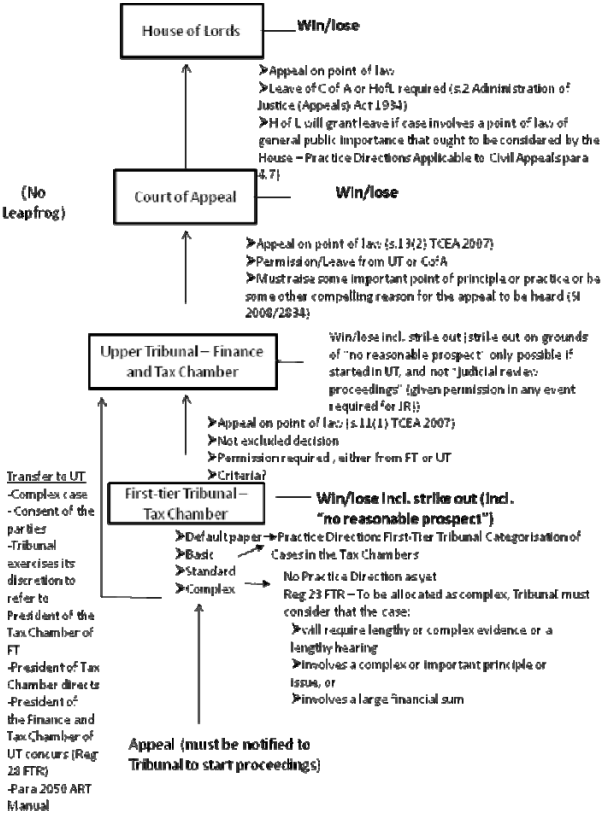
appeals process set out in the Appendix, is to rely on a review.

This makes certain decisions of the Upper Tribunal less capable of challenge than a decision of the High Court. The 2007 Act only permits an appeal from a decision of the Upper Tribunal to the Court of Appeal on a point of law. By contrast, the Civil Procedure Rules do permit an appeal against a decision of the High Court if the decision is wrong or if it is unjust because of a serious procedural or other irregularity.

Conclusion

From experience, it seems that the fact that apparently un-appealable decisions can be challenged through a judicial review is often missed. Failure to mention judicial review in the TMA 1970 does not help to highlight the availability of the remedy. Nor does wording in the TMA 1970 which states a decision to be final, when in fact it may be capable of challenge. Needless to say, being aware of the supervisory jurisdiction of the Upper Tribunal and the High Court can be a valuable weapon in the tax advisor's armoury.

APPENDIX



[1] SI 2009/275

[2] S17(2) Interpretation Act 1978 provides that: "Where an Act repeals and re-enacts, with or without modification, a previous enactment then, unless the contrary intention appears, (a) any

reference in any other enactment to the enactment so repealed shall be construed as a reference to the provision re-enacted…." Under s23 "enactment" is extended to include subordinate legislation.

[3] By the Transfer of Tribunal Functions and Revenue and Customs and Appeals Order (SI 2009/56)

[4] For an example see *Davies & Anor v Revenue and Customs* [2008] EWCA Civ 933.

[5] Rule 52.11(3) CPR. Additional considerations arise where the decision is a case management decision. See Practice Direction—Appeals PD 52 para 4.5.

[6] Regulation 41 of The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 (SI 2009/273)

[7] Regulation 38

[8] See for instance s30 Supreme Court Act 1981

[9] Under s15 of the 2007 Act

[10] *Council of Civil Service Unions v Minister for the Civil Service* [1985] AC 374 at 410/411 per Lord Diplock

[11] See by analogy *Associated Provincial Picture Houses Ltd v Wednesbury Corpn* [1948] 1 KB 223 at 229

[12] See for recent discussion *R (Sivasubramaniam) v Wandsworth County Court* [2003] 1 WLR 475 at 486-489

[13] S15(4) and s15(5) of the 2007 Act (Upper Tribunal to apply the same principles as the High Court) might be argued as the basis for this

[14] S18 and s19 of the 2007 Act

[15] S19 of the 2007 Act.

[16] S3(5) Tribunals, Courts and Enforcement Act 2007

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.[43]

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[44]

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[45]

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[46]

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

Members of Chambers

Milton Grundy (Head of Chambers)
Michael Flesch QC
David Goldberg QC
David Goy QC
John Walters QC
Philip Baker QC
Felicity Cullen QC
Patrick Soares
Barrie Akin
Patrick Way
Aparna Nathan
Conrad McDonnell
Nicola Shaw
Michael Thomas
Marika Lemos
Hui Ling McCarthy
Michael Jones
Laurent Sykes

Senior Clerk: Chris Broom
GRAY'S INN TAX CHAMBERS
Gray's Inn Chambers, 3rd Floor, Gray's Inn,
London WC1R 5JA
Tel: 020 7242 2642 Fax: 020 7831 9017
e-mail: clerks@taxbar.com