[2016] UKFTT 0254 (TC)

TC05029

Appeal number: TC/2015/04229

Income Tax – Claim under S 131 Income Tax Act 2007 for Share Loss Relief against income – whether taxpayer subscribed for shares – held yes - whether shares were valueless when acquired by taxpayer – held not – acquisition cost to be determined at market value - appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

JOHN LEWIS **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE PHILIP GILLETT
JACQUI DIXON

Sitting in public at Southampton on 5 April 2016

The Appellant appeared in person

Glynis Millward, Officer of HM Revenue and Customs, for the Respondents

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DECISION

1. This was an appeal against a closure notice for the year 2011-12 in respect of a disallowed loss claimed under s 131 Income Tax Act 2007. The loss being claimed was a loss of £99,900 in respect of shares in iFind Media Limited ("iFind") which had been claimed as to £29,520 against the Appellant's income for 2011-12 and £70,380 against the Appellant's income for 2010-11. The tax at stake was £28,319.59.

2. We heard evidence from the Appellant, John Lewis, Peter Harding, a potential investor in iFind, and Ray Khan, Mr Lewis's and iFind's accountant. We would mention that neither the Tribunal nor HMRC were expecting Mr Harding to be called as a witness, as the Appellant had not informed the Tribunal that he would be called, as required by the directions issued on 9 October 2015. However Mrs Millward, on behalf of HMRC, stated that she did not object to Mr Harding being called as a witness and we therefore decided that his evidence should be admitted.

Evidence

3. Mr Lewis explained that the company was formed in 2009 and was in the business of developing and selling software. The directors and shareholders of the company were Mr Lewis's son, Dominic Lewis, and Mrs Donaldson, who subsequently married Mr Lewis in 2012. Dominic Lewis and Mrs Donaldson each owned 50 shares of £1 each in the company.

4. Mr Lewis said that he had agreed with the directors at the outset that he would lend money to the company, over time, as and when required, up to a maximum of £100,000. He said that this loan was to be provided on an "equity equivalent basis", in that it would be interest free and would be converted into equity when the company was ready to move into the next phase of equity raising. The conversion rate was not set at the outset but was to be carried out based on a valuation of the company as at the time of conversion. In the event the loan of over £100,000 outstanding on 1 March 2011 was converted into 99,900 shares of £1 each on that date.

5. We were shown a letter from the two directors addressed to HMRC dated 20 November 2015 confirming the arrangement as described by Mr Lewis, but since this post-dated the events in question it was less helpful to us than it would have been had it been prepared at the time of the transactions.

6. It was agreed by both parties that in fact the moneys in question were paid in the first instance by Mr Lewis to his son, Dominic Lewis, who then paid them on to the company. Mr Lewis explained that the reason for using this circuitous route was that he did not want to make all of the money available at the outset since it was not needed by the company and Mr Lewis was concerned that if it was all made available immediately it might be spent too quickly. He therefore used Dominic as what he described as a "portal" for the investment.

7. Mr Lewis said that the reason for this was that Dominic was close to the company on a day to day basis and therefore knew what funds would be required.

However, under the terms of Mr Lewis's agreement with the directors Dominic was unable to onlend the money to the company without obtaining the consent of Mrs Donaldson. Mr Lewis said that Dominic's role in this was similar to that of being Mr Lewis's agent.

5 8. There was clearly some difficulty in establishing whether the loan to the company was a loan from Mr Lewis or from Dominic Lewis. It is extremely unfortunate that there was no written documentation of this complex arrangement, which might have made the position more clear. However, some evidence was available in that Mr Khan showed the Tribunal a set of accounts of the company dated 10 31 March 2010. Mr Khan explained that these were not fully finalised accounts in that the company was only required to file summary accounts at Companies House, but they were drawn up in the format of normal statutory accounts. Importantly, in the note in the accounts regarding related party transactions, it stated that the company owed £30,675 to Dominic Lewis, in contradiction of Mr Lewis's statement that the 15 loan was made by him. Mr Khan reiterated that these were not finalised accounts and were based on the work of a book-keeper employed by iFind. Since the moneys had been transferred in from Dominic Lewis's bank account Mr Khan suggested that it was possible that the book-keeper had automatically thought that it was a loan from Dominic.

20 9. Over the period from April 2009 to 1 March 2011 Mr Lewis said that he had made 41 separate investments, ranging from £20,000 to £500, which totalled over £100,000. The Tribunal had been provided with bank statements for both Mr Lewis and his son showing these various investments but more helpfully we were provided with a summary of these transactions which attempted to match up the payments from 25 Mr Lewis to Dominic with the payments from Dominic to iFind. The payments from Mr Lewis to Dominic did not match up exactly with the payments from Dominic to the company, either individually or in total. On 21 July 2010 for instance Dominic had received £10,000 from his father but had, on 24 July 2010 paid on £9,800 to the company, and there were other similar mismatches. Mr Lewis explained that on 30 occasions Dominic had retained small amounts to pay for personal expenses, because he was at that time living on a very low income.

10. Mr Lewis said that during 2010 the company had started to build a small client base but the software was still being developed and the company was making losses. In late 2010 however the directors considered that it would be necessary to raise 35 further equity finance and with that in mind they started to talk to potential investors, primarily Mr Harding.

11. Mr Lewis said that he and the directors recognised that if the company were to attract additional equity investors then it would be necessary to convert the loan into equity, as new investors would be very unlikely to invest in equity of the company if 40 it were carrying any significant level of debt. The conversion of the debt into equity therefore took place at a board meeting on 1 March 2011 for which we were given a copy of the minutes. These minutes show clearly that the equity was issued to Mr Lewis. It was accepted by both parties that this was the relevant date for the establishment of the value of the shares.

12. Mr Khan explained that shortly after the issue of the shares to Mr Lewis, on 2 March 2011, the company received an email from Mr Harding, the proposed new investor, discussing the possible investment but he then withdrew from the deal a few weeks later. The company was by this time running out of working capital and Mr Khan advised the directors of the potential personal liability if they continued to trade when the company was insolvent. It seemed that the directors had put all their faith in Mr Harding making the necessary investment and that they therefore had no other potential investors in the pipeline. As a consequence the directors decided to stop trading.

13. It was agreed between the parties that the company ceased trading on 3 May 2011 and that at that time the shares in the company were worthless. However, HMRC contended that at the time the shares were issued, on 1 March 2011, the shares were also worthless, whereas Mr Lewis contended that at that time the company still had significant value embedded in the intellectual property which had already been developed and in the management team which was in place, even though it had severe cash flow problems.

14. We then heard evidence from Mr Harding. He described himself as a local business person and entrepreneur who had been introduced to iFind by Mr Khan. Mr Khan was a business contact of Mr Harding but did not act as his accountant.

15. Mr Harding said that he had first met Dominic Lewis in November 2010 and was immediately impressed by him, and thought he and his team were worth investing in. Mr Harding confessed that he was not an IT person and realised that such an investment would be high risk but he nevertheless decided to progress matters.

16. Mr Harding recalled that the initial request from Dominic had been for £75,000 in exchange for 30% of the company. However Mr Harding said that he was insistent that for an investment of this nature he wanted a controlling interest, which we will refer to as a 51% interest, although in view of his lack of knowledge of the IT business he would not want 100%, believing that there should be an opportunity for those closer to the business to participate in the equity of the company. He therefore wanted 51% of the company in exchange for the £75,000 investment.

17. Mr Harding said that he had a few meetings with Dominic over the period to March 2011 but that Dominic was reluctant to give up control of the company and eventually, in mid-March 2011 Mr Harding had decided not to participate because he had a number of other opportunities which he wished to pursue.

18. Mr Harding had written an email to Mr Khan on 17 November 2015, in support of this litigation, stating that he recalled that the company was looking for an investment of £100,000 for a 51% stake, and that he had been tempted to participate, in spite of the company's lack of profits, but in the end had decided that he wished to focus on other opportunities.

The Legislation

19. The legislation concerning the availability of Share Loss Relief, as far as is relevant to this case, is contained in s131 Income Tax Act 2007 as set out below:

> (1) An individual is eligible for relief under this Chapter ("share loss relief") if—
>
> (a) the individual incurs an allowable loss for capital gains tax purposes on the disposal of any shares in any tax year ("the year of the loss"), and
>
> (b) the shares are qualifying shares.
>
> This is subject to subsections (3) and (4) and section 136(2).
>
> (2) Shares are qualifying shares for the purposes of this Chapter if—
>
> (a) EIS relief is attributable to them, or
>
> (b) if EIS relief is not attributable to them, they are shares in a trading company which have been subscribed for by the individual.
>
> (3) Subsection (1) applies only if the disposal of the shares is—
>
> (a) by way of a bargain made at arm's length,
>
> (b) by way of a distribution in the course of dissolving or winding up the company,
>
> (c) a disposal within section 24(1) of TCGA 1992 (entire loss, destruction dissipation or extinction of asset), or
>
> (d) a deemed disposal under section 24(2) of that Act (claim that value of the asset has become negligible).
>
> (4) …

20. In this case the Appellant is claiming that the shares became of negligible value within the meaning of s24 Taxation of Chargeable Gains Act 1992, as permitted by s131(3)(d) above. This provides, as far as is relevant to this case, as follows:

> (1) ...
>
> (1A) A negligible value claim may be made by the owner of an asset ("P") if condition A or B is met.
>
> (1B) Condition A is that the asset has become of negligible value while owned by P.
>
> (1C) Condition B is …

(2) Where a negligible value claim is made:

(a) This Act shall apply as if the claimant had sold, and immediately reacquired, the asset at the time of the claim or (subject to paragraphs (b) and (c) below) at any earlier time specified in the claim, for a consideration of an amount equal to the value specified in the claim.

(b) An earlier time may be specified in the claim if:

(i) the claimant owned the asset at the earlier time; and

(ii) the asset had become of negligible value at the earlier time; and either

(iii) for capital gains tax purposes the earlier time is not more than two years before the beginning of the year of assessment in which the claim is made; or

(iv) …

21. The key questions which emerge from this in the context of this case therefore are:

(1) are the shares "qualifying shares", and

(2) do they fall within subsection s131(3)(d) above in that the shares have "become of negligible value while they were owned by" the Appellant as required by s24(1B) TCGA 1992.

22. It was agreed between the parties that the shares were not shares to which EIS relief might apply but that the company was a trading company. The key question as to whether the shares were qualifying shares therefore was had they "been subscribed for by the individual" as required by s131(2)(b) ITA 2007.

Findings of Fact

23. We turn first to the question of whether or not Mr Lewis subscribed for the shares, which in our view turns on whether the loan to the company which was converted into shares was a loan from Mr Lewis or a loan from his son, Dominic Lewis. The evidence on this is confusing and contradictory.

24. Mr Lewis stated that he made the loans via the "portal" of his son in order to ensure that the money was only actually loaned to the company as and when it was needed. This seemed to the Tribunal to be an unusual way to arrange things, even more so in that the arrangement was not recorded in writing. Mr Lewis did explain that he had been told that a full loan and share sale agreement would have cost between £5,000 and £10,000 to prepare, which he did not think was appropriate, but nevertheless a simple exchange of a letter between Mr Lewis and his son, setting out this arrangement, would have been a more normal course of action.

25. We then examined the actual cash transfers between Mr Lewis and his son and between his son and the company. Had the arrangement been as clear and simple as that described by Mr Lewis we would not have expected Dominic Lewis to retain any part of the monies as they passed through his account, but the evidence was that he did retain monies from time to time, which indicated to us that he regarded the moneys as belonging to him, until he loaned them onto the company.

26. However, the one clear piece of formal written evidence presented to us on this subject was the minutes of the company's board meeting on 1 March 2011. These stated clearly that the shares had been directly issued to Mr Lewis. This was supported by the company's register of shareholders, which showed that the shares had been issued directly to Mr Lewis and that there had been no transfers of those shares between Dominic Lewis and his father, as contended by HMRC.

27. We cannot see any logical reason for the shares to be issued to Mr Lewis in this manner if the loan to the company had in fact been made by Dominic Lewis. Mr Khan, Mr Lewis's accountant, informed us that he had not mentioned the possibility of a claim under s131 to Mr Lewis until he was preparing Mr Lewis's income tax return for the year 2011-12. It therefore seems unlikely to us that the written evidence surrounding the issue of the shares was deliberately designed to facilitate a claim under s131. In our view there was no logical reason for the shares to be issued to Mr Lewis unless this was indeed in accordance with the longstanding intention of the parties to convert the loan to shares as explained by Mr Lewis. We therefore find as a fact that the shares were subscribed for by Mr Lewis.

28. We also find as a fact that the loan to the company was converted into shares on 1 March 2011 in order to prepare the company for an injection of equity funds from another investor, Mr Harding.

29. We then come to the question of whether or not the shares had any value when they were issued. It was agreed between the parties that the company ceased trading on 3 May 2011, just over two months after the shares were issued, and that the shares were worthless by that time. However we also heard from Mr Harding, whom we believe to be an experienced investor, that he was seriously considering making a significant investment in the company at or around the time that the shares were issued, and clearly he attributed value to the company at that time.

30. Mr Harding's potential investment foundered on the fact that Dominic Lewis was unwilling to cede overall control of the company to Mr Harding. Mr Harding made it clear that the lack of profits in the company did not concern him and that he attributed value to the company on the basis of its prospects and the quality of the management and development team.

31. We therefore find as a fact that the shares were not of negligible value when they were issued to Mr Lewis.

Valuation of Shares

32. If the shares were not of negligible value when they were issued then we must attempt to determine a value for them, which will then become Mr Lewis's base cost for the purposes of calculating any allowable loss under s131 TA 2007.

5 33. Mr Lewis has claimed a loss of £99,900 based on the nominal value of the shares issued to him on 1 March 2011. HMRC in contrast have stated their belief that the shares were valueless at that time. We do not agree with either proposition.

34. Mr Lewis stated in his evidence that it had been agreed at the outset that when the loan was to be converted into equity it would be converted at a value to be agreed
10 at the time of conversion. We heard that Mr Lewis had loaned more than £100,000 to the company but in the event 99,900 shares of £1 each were issued to him. We heard no evidence as to how this figure was arrived at and in particular heard no evidence that any attempt was made to calculate the value of the company at that time. We assume therefore that the figure of 99,900 shares was decided upon merely because it
15 brought the total number of shares in issue up to 100,000.

35. In our view therefore the shares were acquired by Mr Lewis otherwise than by way of a bargain made at arm's length and therefore, in accordance with s17(1) TCGA, their acquisition cost falls to be treated as an acquisition at their then market value.

20 36. The only evidence we have on this subject is as follows:

(1) Mr Harding stated that initially Dominic Lewis had asked for an investment of £75,000 in exchange for 30% of the company.

(2) Mr Harding had rejected this as he wanted to have a controlling stake and indicated that he would have been prepared to pay £75,000 for a 51% holding.

25 (3) Mr Harding's email of 17 November 2015 stated that Dominic had wanted £100,000 for a 50% holding but Mr Harding had decided against this.

37. It is well established that the market value of the shares can only be determined by the price which might be agreed between a willing seller and a willing buyer. Mr Harding was clear that the deal foundered because he wanted a 51% holding, which
30 Dominic Lewis was unwilling to concede, rather than any question of value, but nevertheless we believe that Mr Harding was a more professional and experienced valuer of shares in such a company than the other parties involved and that therefore his statement that he would have been prepared to pay £75,000 for a 51% holding seems to us to be the most reliable starting point for a valuation.

35 38. It was suggested on behalf of Mr Lewis that since the proposed investment of £75,000 for a 51% holding was less than the 75% holding which would be required to pass special resolutions then a valuation of a 100% holding, after the injection of the additional funds, would be of the order of £200,000. We accept that such an adjustment might be appropriate but not necessarily with the figure quoted.

39. In addition, if we are to determine a valuation for the shares held by Mr Lewis immediately after they were issued, at which time they effectively amounted to a 100% holding in the company, then we would also need to discount any such figure very heavily in order to take into account the fact that without a further injection of capital those shares might become totally worthless within a matter of a few months, which in fact is what happened. Any such adjustment would therefore be highly subjective.

40. The approach we prefer however is to start with what the position would have been immediately after an injection of new capital by Mr Harding, because the conversion was carried out by Mr Lewis and the directors of iFind, the two parties to the acquisition of the shares, with this transaction in mind. If this investment had proceeded Mr Harding would have held shares with a value of £75,000 and a 51% interest and Mr Lewis would have held a 49% interest. It is normal in such circumstances to attribute a control premium to the 51% interest and to value the 49% interest as a minority interest. If we take the control premium to be 10% of the £75,000, ie £7,500, then this produces a value for Mr Lewis's shares of £67,500. We then need to discount this figure to take account of the possibility that the new investment might not proceed.

41. We were told that at the time the shares were issued to Mr Lewis the directors believed strongly that the investment by Mr Harding would go ahead. They also believed that with this additional investment the company would be able to trade through its cash flow difficulties and realise the value of its intellectual property. This would argue in favour of a relatively small discount to that figure.

42. We therefore find that the value of Mr Lewis's shares at the time they were issued to him, and therefore his acquisition cost for the purposes of s131, was £60,000.

Decision

43. The Tribunal decided:

(1) that the shares were issued to Mr Lewis, and that he had therefore subscribed for the shares, as required by s131(2)(b) ITA 2007,

(2) the shares were not of negligible value when he acquired the shares but that they became of negligible value during his period of ownership, as required by s24(1B) TCGA 1992, and

(3) in accordance with s17(1) TCGA 1992, the shares fall to be treated as having been acquired for their market value at the time of their acquisition, which we have determined to be £60,000.

44. The Tribunal therefore decided that the Appellant's appeal should be ALLOWED but that his claim for share loss relief should be reduced from £99,900 to £60,000.

45. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

PHILIP GILLETT
TRIBUNAL JUDGE

RELEASE DATE: 18 April 2016