[2013] UKFTT 740 (TC)

TC03118

Appeal number: TC/2013/00103

INCOME TAX – claim for income tax relief for allowable capital gains tax losses – whether shares in qualifying trading company had become of negligible value at date of claim - appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

ROBERT BROWN **Appellant**

- and -

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

TRIBUNAL: JUDGE BARBARA MOSEDALE
JO NEILL

Sitting in public at Bedford Square, London on 4 November 2013

Mr A Povey of Povey Little Chartered Accountants for the Appellant

Ms P O'Reilly, HMRC officer, for the Respondents

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DECISION

1. Mr Brown submitted an amended tax return for the year to 5 April 2006 on 8 January 2008 claiming an income tax relief which converted a tax liability for that year of £68,020.60 into a tax repayment of £25,709.00. HMRC opened an enquiry into the return and closed the enquiry on 4 July 2012 amending the amended return to deny the claimed relief. Therefore, HMRC considers that Mr Brown has an outstanding tax liability for that year of £93,729.60.

2. The income tax relief claim was made under s 574 Income and Corporation Taxes Act 1988 ("ICTA") which allowed a taxpayer to claim an income tax relief on an allowable capital gains tax loss where he had subscribed for shares in a qualifying trading company. The taxpayer's claim to this relief therefore depended on whether he had an allowable capital gains tax loss: Mr Brown's claim to such a loss was made under s 272 Taxation of Chargeable Gains Act 1992 ("TCGA") which in effect created a loss when an asset had become of negligible value.

3. HMRC accept that all conditions for these reliefs were met by Mr Brown with the exception that they did not agree that the asset in question (shares in Microsharp Holdings Ltd) had become of negligible value. The hearing was therefore solely concerned with the question of whether the shares in question had become of negligible value at the relevant date (5 April 2006) and we did not consider any other conditions for the reliefs in s 574 ICTA or s 272 TCGA.

4. The appeal to HMRC was lodged in time. The appellant accepted an offer of a review. The review decision of 12 November 2012 upheld HMRC's decision and Mr Povey appealed to this Tribunal on 20 December 2012. Mr Povey does not accept that the appeal to the tribunal is out of time: he considers that the decision letter was not posted to him on the date it carries as it was not received by him until some time later. As HMRC do not take issue with the date of the appeal, and we accept that Mr Povey did appeal within 30 days of receiving the review letter, to the extent it is necessary to do so, we admit the appeal out of time.

The facts

Background

5. The evidence was largely a series of documents contained in the hearing bundle, including the accounts for Microsharp Holdings Ltd ("Microsharp") . Mr Povey also gave some oral evidence, which we accept, about the researches he had carried out in the value of shares in Microsharp. We also had hearsay evidence in that over the years Mr Povey had written to HMRC with an explanation of what had happened, and Mr Brown had also explained what had happened to HMRC officers in a meeting in in February 2011.

6. HMRC did not challenge the reliability of this evidence, although obviously they did challenge the conclusion Mr Povey and Mr Brown drew from it that the shares had become of negligible value by 5 April 2006.

7. Relying on all this evidence, but principally on the accounts and contemporaneous written documents, we find as follows.

8. Microsharp Holdings Ltd was incorporated on 6 May 1998 under the name Durand Technology Ltd. It did not change its name to Microsharp Holdings until 2007 but for the sake of consistency we will refer to it as "Microsharp" in periods both before and after its name change.

9. The appellant, Mr Brown, subscribed for 500 shares in Microsharp on 23 April 2002. These were 10p shares and Mr Brown paid £100 per share (£50,000 in total). Three weeks later, on 17 May 2002, Mr Brown subscribed for a further 500 Microsharp shares. These were also 10p shares but he now paid £400 per share (£200,000 in total). Therefore, Mr Brown paid in total £250,000 for 1000 Microsharp shares.

The IPR

10. We find that Mr Brown made this investment because it had been promoted to him and a number of other wealthy persons resident in the Channel Islands by a firm of brokers acting for the company. It was a research and development company working on various projects to develop saleable intellectual property. At the time of Mr Brown's investment he understood that there was a real possibility of the company selling intellectual property rights in an encryption system it had developed to either or both Microsoft and the Bank of England. Had the deal gone ahead Mr Brown expected to realise around ten times the value of his investment.

11. The expected contracts with Microsoft and the Bank of England did not complete and for a time the company continued to develop other technology.

12. The principal director and shareholder of the company (Mr W Johnson) resigned as director in 2003 and Mr Coates, up to that time just a minority shareholder in the company, bought out Mr Johnson's shares in October 2003 and became the majority shareholder and principal director of the company. He also made loans to the company.

13. A letter from Mr Coates to Mr Brown and some other shareholders in October 2003 announcing this change recognised that the company was in serious financial difficulties and that it was Mr Coates' aim to prevent the collapse of the company and it was for that reason he had bought out Mr Johnson and injected new funds into the company.

14. Mr Coates also promised that those shareholders who had paid more than £20 per share on subscription would receive a gift of shares from Mr Coates to bring their average price per share down to £20. Mr Brown was the recipient of shares on this

basis but (as their acquisition cost was nil to Mr Brown) they form no part of his claim to loss relief.

15. A general letter to all shareholders from Mr Coates at this time also outlined the company's financial difficulties and Mr Coates' decision to support the company. It said that in future it would focus on developing two products for commercial exploitation: the "Microsharp screen film" and "Medisine" which was a product for medical screening. The company's other products in development were to be sold to Mr Johnson in return for the company reserving a small percentage of the sales value should the products be successful (but we note that later accounts only showed a very small income from IPR rights). The letter also reported that the Board would be offering new shares for sale at £10 per share and that Mr Coates would underwrite the first £2.5million of the offering. Overall the tone of the letter was very optimistic about the future of the company.

16. Nearly two years' later, another letter from Mr Coates to all shareholders dated 24 March 2005 pursues a similarly optimistic tone. Of the two remaining projects pursued by the company, Mr Coates was hopeful of being able to interest an unnamed partner in the "microsharp" project. The Medisine project was still ongoing. Mr Coates also reported he had invested a further £2.2million in loans and that the company needed to raise another £2million to continue to "its next stage of growth".

17. A letter from the Chief Executive officer (Mr Walker) dated 30 August 2005 reported that Mr Coates was prepared to convert most of his loan capital to equity capital. It reported that the company hoped to float the subsidiary which held the Microsharp IPR on AIM as soon as it was profitable. The letter predicted profitability in the next 6 to 12 months. Nevertheless, the letter also indicated that about £2 to £2.5 million would be needed to achieve profitability.

18. The company offered new shares for sale at £1 per share in October 2005 but no one other than Mr Coates subscribed. On 17 November 2005 Mr Derek Coates subscribed for a further 2,100,000 10 p shares at £1 each.

19. A letter to shareholders from Mr Walker on 12 December 2005 reported the sale of the IPR in Medicine to Mr Coates' company in order to raise funds. It also reported that Mr Coates had promised to put in another £1million of funding into the company in the next twelve months.

The accounts

20. The profit and loss accounts for the company showed that in all years of trading since and including 2001 it made very substantial losses. For 2001 its loss was approximately £2million; for 2002 just over £7million, and for 2003, 2004 and 2005 the loss was around £1million each year. We find it had always traded at a loss and that it was only able to do so because of substantial investment by shareholders.

21. The accounts for the year ended 31 December 2004, which were published in August 2005, were audited (as all the company's accounts were) by a Big Four firm of accountants. It included the following statement by the auditors:

> **"Going Concern**
>
> In forming our opinion we have considered the adequacy of the disclosures made in note 1 to the financial statements concerning the company's requirement for future funding. In view of the significance of this matter, we consider that it should be drawn to your attention but our opinion is not qualified in this respect."

The opinion referred to was that "the financial statements give a true and fair view of the company's and the group's affairs as at 31 December 2004 and of the loss of the group for the year then ended and have been properly prepared in accordance with the Companies Act 1985 applicable to small companies."

22. Note 1 to the accounts ran to some two pages of detail about the company's accounting policies. The first item stated that the accounts were prepared on the basis that the company was a going concern. It explained that the company's ability to earn profits depended on development of products, and that the development of products would require a further injection of capital of over £2million. It explained that the directors' plans for raising funds were at "an advanced stage" and included "initial interest from identified investors". It went on to say that the accounts were prepared on the basis that the necessary investment would be found and for that reason the directors considered it proper to produce accounts on the basis that the company was a going concern. We find that the auditors, from the above extract from their report, agreed.

23. In fact, as mentioned above, on 17 November 2005 Mr Derek Coates subscribed for a further 2,100,000 10 p shares at £1 each, so the necessary capital to continue trading was raised. The accounts for the year to end 2005 show that these were the only shares subscribed for in that financial year.

24. Accounts for the earlier years had shown intellectual property rights as an asset of the company to the value of nearly £10million. This was written off by the 2003 accounts. Accounts for 2003 and later do not show a value against intangible assets. The 2004 accounts show that the company's liabilities exceeded its assets by over £2million.

25. In 2010 Mr Povey reported to HMRC that Mr Brown was not prepared to give his shares away and would not consider selling them for less than 10p per share.

26. There was a dispute over Mr Coates' motivation in continuing to invest in the company. Mr Brown's and Mr Povey's view was that Mr Coates was very anxious that the company should not be seen to fail as Mr Coates had a reputation which he wished to maintain. Mr Povey suggested that the Tribunal should not read into the fact that Mr Coates continued to invest as anything more than his desire to prevent the company going into insolvent liquidation.

27. We find that the accounts show that the company only continued to trade because of Mr Coates' continuing investment, and that Mr Coates' investment went beyond what was necessary to stave off liquidation. If his object was solely to avoid insolvent liquidation, he could simply have ensured that his funds were used to pay off the company's creditors and forced it into solvent winding up; instead he put in enough funds to let the company continue to trade and attempt to develop its IPR.

28. Mr Povey's submission was that Mr Coates did this not because he had any confidence in the company's IPR but because he wanted to be seen to do all that he could to save the investors' investment. We accept that his motivation was not entirely commercial as he was clearly was concerned about the perceptions of other investors as evidenced by his decision to give away part of his shareholdings to other shareholders who had paid rather more for their shares than he had, such as Mr Brown (see § 14).

29. We conclude that a prudent purchaser of Mr Brown's shares in April 2006 would have known this: such a purchaser would have known from the documents that Mr Coates was at the end of 2005 continuing to invest enough money in the company to allow it to continue with its one remaining technology project for the time being and would have known that Mr Coates had given away part of his shareholding.

The law

30. We find and the appellant accepts that the burden of proving that the shares had become of negligible value as at 5 April 2006 rests on him.

31. The provision which enables a taxpayer to make a negligible value claim are contained in TCGA s 24 s 1A which provides as follows:

> "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.
>
> …
>
> (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 …for a consideration of an amount equal to the value specified in the claim."

32. The same Act has provisions on valuation and in so far as relevant these are as follows:

> TCGA s 272 Valuation: general
>
> (1) In this Act, "market value" in relation to any assets means the price which those assets might reasonably be expected to fetch on a sale in the open market.
>
> TCGA s 273

> (1) The provisions of subsection (3) below shall have effect in any case where, in relation to an asset to which this section applies, there falls to be determined by virtue of s 272(1) the price which the asset might reasonably be expected to fetch on a sale in the open market.
>
> (2) The assets to which the section applies are shares and securities which are not quoted on a recognised stock exchange at the time at which their market value for the purposes of tax on chargeable gains falls to be determined.
>
> (3) For the purposes of a determination falling within subsection (1) above, it shall be assumed that, in the open market which is postulated for the purposes of that determination, there is available to any prospective purchaser of the asset in question all the information which a prudent purchaser of the asset might reasonably require if he were proposing to purchase it form a willing vendor by private treaty and at arm's length.

33. Both parties accepted that the principles enunciated in the FTT decision in the case of *Barker, Harper & Wickes* [2011] UKFTT 645 (TC) were right and we agree. In particular, the Tribunal in that case said:

> "[7] It was common ground between the parties that 'negligible value' means 'worth next to nothing' but not 'nil' and that the concept has no room for any notion of materiality in which the previous value of the asset would be taken into account by way of comparison with the value which is said to be negligible. The test in that regard is therefore an absolute one, the same for an asset previously worth a million pounds and an asset previously worth much less….

34. The Tribunal went on to say:

> "[47] …to speak of an asset which has become of negligible value as having a market value makes no sense. The very fact that it has no market value is why it is said to be of negligible value; if the asset has a market value, then its value cannot be negligible. That it may nonetheless have a subjective value to its owner is beside the point….it would be quite unworkable for the tax base to depend on the accident of personal attachment to an asset rather than upon a value evidenced by an actual or hypothesised arm's length transaction.
>
> [48] The test of eligibility for a claim under section 24(2) is therefore: does this asset have a market value? If the answer is no, a claim may in principle be made; if the answer is yes, no claim under this provision is appropriate…."

35. Again, we agree with what the Tribunal said here and we did not understand either party to dissent from these propositions. The dispute in front of us was simply whether or not as at 5 April 2006 the shares had a value.

36. The Tribunal in that case went on at §49 to say that because 'negligible value' was the opposite of 'market value', it followed that the rules in s 272 and 273 would apply to negligible value claims. In other words, if applying s 272 and 273 gave the

asset a market value, then it was not of negligible value; but if applying s 272 and 273 did not give it a market value, then it was of negligible value. Again, we agree with what the Tribunal said here and we did not understand either party to dissent from this proposition.

37. We also consider that it follows that the Tribunal was right to say, as it did at §50, that the only information relevant to determining whether an asset was of negligible value would be information available to a prospective purchaser at the time the claim under s 24 was to have effect: in this case that was 5 April 2006.

38. For instance, Mr Derek Coates subscribed for a further nearly 1 million shares at £1 per share in December 2007. This was after the date on which Mr Brown claimed that his shares had become of negligible value and we agree with Mr Povey that it is not relevant. The hypothetical prudent purchaser on 5 April 2006 could not have known about it.

39. And for this reason we accept Mr Povey is right to say that the 2005 accounts are not relevant because they were not available as at 5 April 2006. However, we do not think much turns on this as the 2005 accounts continue the trend from the 2004 and earlier accounts. We consider that, as at 5 April 2006, a prospective purchaser would have known that the IPR in Medisine had been sold as, although only reported in the 2005 accounts which were not available at that time, it was also set out in a letter to shareholders in late 2005 (see § 19) and we consider a prudent purchaser would have asked the hypothetical vendor to show all letters to shareholders prior to the hypothetical transaction date of 5 April 2006.

40. Having considered the law and the facts we consider each parties' submissions and reach our conclusion.

Submissions

41. HMRC's position was that in 2006 that Company valued its shares at £1, Mr Coates had injected yet more funds into the company and remained optimistic about its prospects, and that therefore, while HMRC accepted that the shares were worth considerably less than what Mr Brown had paid for them, HMRC did not accept that Mr Brown's shares had become of negligible value as at 5 April 2006. Mr Povey's view was that at that date, viewed realistically, they had a nil value and there was no market for them.

The company had always made a loss

42. One of HMRC's contentions is that the company had always been loss making; it was loss making in 2002 and loss making in 2006. Nothing had changed and therefore the fact it was loss making did not mean its shares were of negligible value.

43. We agree with Mr Povey that this reasoning is not sound. A company cannot continue to be loss making without the value of its shares being affected. The more losses accumulate, the lower the value of the shares.

44. However, the question is not whether Mr Brown’s shares reduced in value: everyone is agreed that they did. The question is whether they were of negligible value as at 5 April 2006 and the fact that the company was always loss making does not prove that either way.

The investment was high risk

45. HMRC point to many factors known to Mr Brown at the time he made his investment which show that the company was portrayed as a high risk investment. Mr Brown and Mr Povey accept that the investment was high risk with the hope of very high returns.

46. However, whether the investment was high risk does not seem relevant to us to the question of whether the shares had become of negligible value. HMRC and the appellant accept that the shares had value in 2002 and that all the conditions for the relief were fulfilled with the exception that HMRC do not accept that the shares had become of negligible value by April 2006. That Mr Brown’s investment was high risk does not answer that question.

The company continued to trade after 2006

47. HMRC say that the company was still trading after the date on which the claim was to have effect. We agree with Mr Povey that the fact that the company continued to trade after April 2006 does not answer the question of whether its shares had value as at that date. While a prospective purchase might well consider whether the company was trading to be relevant to its value, it is by no means the only thing that is relevant and we do not think that it follows the merely because it is trading a prospective purchaser would consider that the shares had value.

Mr Brown’s view of the value of the shares

48. HMRC consider Mr Povey’s statement in the letter in 2010 (see § 25 above) that Mr Brown would not sell his shares for less than 10p per share indicated that the shares had value. However, we do not agree.

49. We agree with Mr Povey that the question of negligible value is (as per s 273(3)) whether a prudent purchaser would give value for the shares: not whether Mr Brown, who was clearly not a detached bystander but someone who was angry at being sold a 'pup', was prepared (or not) to give away his shares. We find Mr Brown’s views are irrelevant to the question of whether there was a true market for the shares.

The company’s own valuation of its shares

50. The evidence showed that the company had offered new shares for sale at £1 per share in late 2005(§ 18). HMRC says that this is evidence that as at 5 April 2006 the shares did not have negligible value.

51. We consider that it would only be evidence that the shares had value if someone had actually bought shares at that price. We have found (see §18) that the only new shares subscribed after 2003 were issued to Mr Coates. The fact that Mr Coates was prepared to inject new capital into the company, whether through optimism or a desire to preserve his reputation, is very different to saying that he (or any other prospective purchaser) was prepared to buy the shares of existing shareholders.

52. Mr Coates was a pre-existing shareholder and also cannot be seen as a disinterested subscriber. We do not consider the offering of new shares at £1 by the company means that Mr Brown's shares had a £1 value at that time.

Earnings valuation

53. Mr Povey's case was that there were only two ways of valuing a company: one was to look at the net present value of its assets and the other was to look at its earnings potential.

54. An investor looking at the shares' earning potential would look at what dividends had been paid in last three years. None had been paid. What is more no dividends could be paid until a sum greater than its accumulated losses of over £15 million had been realised in profits. In his view the company's shares had a nil valuation on the basis of their earnings potential.

Value of assets

55. An investor looking at the net present value of the company's assets would see from the accounts, whether the 2004 or 2005 accounts, that its liabilities exceeded its assets by about £2million. Again, on this basis the shares had a nil value.

Hope value?

56. We did not really understand Ms O'Reilly to dissent from Mr Povey's view of the assets or earnings potential of the company: HMRC's case was that notwithstanding the company's enormous losses and lack of assets, the shares still had "hope" value as at 5 April 2006: there was hope that some of the IPR that it still had would one day realise significant value. HMRC took this view even though in its accounts (audited by a very reputable firm) any value in its IPR had been written off two years before.

57. What hope was there of future success? Of the two remaining items of IPR, Medisine had been transferred to Mr Coates in part payment for at least some of the capital he had injected into the company. We consider that a prospective purchaser would have known this (see §39). The remaining IPR in 'Microsharp' might go the same way, as Mr Coates was a substantial creditor, leaving the company with no hope value or it might simply fail to achieve any value.

Decision

58. HMRC's case seems to be that as at 5 April 2006, Mr Brown's 1000 shares were worth around £1000 (ie about £1 each), and Mr Povey's case was that a prudent purchaser would not be prepared to pay anything for the shares. HMRC indicated that they were likely to accept that as of 2013, with an application to strike the company off the register, the shares are now of no value but they do not think this was true in 2006.

59. If there was a market for the sale and purchase of shares already in issue, then by definition the shares would not be of negligible value, but we accept Mr Povey's contention that it is possible to show that shares have become of negligible value without the company being struck off or going into liquidation.

60. We accept that the shares were of no value on normal methods of valuation. The company's liabilities exceeded its assets and no one would place current value on the possibility of future dividends because it was so very remote the company would ever earn sufficient profits to pay dividends.

61. We accept that, despite this, one person, Mr Coates, continued to invest in the company (although he was not in the market to buy out existing sharesholders). It would be apparent to a purchaser that because of this, the company was not imminently going to cease trading so there was a possibility of the IPR in Microsharp being developed to profitability.

62. We agree that investing in the shares in this situation would very much be a gamble but we do not think that a prudent purchaser is necessarily a risk averse one. A prudent purchaser would simply put a value on the shares which reflected the risk he was taking of getting no return. The question is not whether buying the shares was a gamble, but whether the risk of not getting a return was so high the value of the shares to a prudent purchaser would be next to nothing.

63. The evidence shows that no one, other than Mr Coates, was prepared to take this risk at a price in 2005. Mr Coates was not in the market for buying other shareholders' shares and his motivation was shown not to be entirely commercial. Therefore, that he purchased new shares does not indicate that there was a market for existing shares as at April 2006. On the contrary, the fact that no new investors invested shows, in our view, that there would have been no market for pre-existing shares because the market did not consider the shares had hope value.

64. In conclusion, on the particular facts of this case, the appellant has discharged the burden of showing that the shares had a negligible value as at 5 April 2006. The appeal is allowed.

65. 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.

BARBARA MOSEDALE
TRIBUNAL JUDGE

RELEASE DATE: 11 December 2013