

ENTERPRISE INVESTMENT SCHEME –A company carried on a trade of providing staff, stationery and literature to a firm of chartered accountants – Issue by the company of eligible shares (pursuant to the Enterprise Investment Scheme) – Of the sum raised by the issue of these shares the greater part was immediately applied in paying off company debts – Claim by the company that the conditions for relief for the purposes of the Enterprise Investment Scheme were satisfied in relation to the shares issued – Income and Corporation Taxes Act 1988 sections 289, 297, 306 and 312

THE SPECIAL COMMISSIONERS

CASTLETON MANAGEMENT SERVICES LTD Appellant

- and -

MISS J KIRKWOOD

(HM INSPECTOR OF TAXES) Respondent

Special Commissioner: MR T H K EVERETT

Sitting in London on 20 November 2000 and 15 March 2001

Mr Michael Sherry of Counsel, instructed by Alex Haythorne, chartered accountants, for the Appellant

Mr Michael Furness QC of Counsel, instructed by the Solicitor of Inland Revenue, for the Respondent

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DECISION

1. Castleton Management Services Ltd ("Castleton") claims that it has satisfied the conditions for Enterprise Investment Scheme ("EIS") relief laid down in Chapter III of Part VII of the Income and Corporation Taxes Act 1988 (as amended by the Finance Act 1984). Although the relief is given to individual shareholders, it is a pre-condition for claiming relief that the company issuing the shares has issued a certificate to the individual certifying that the conditions for relief, so far as they apply to the company and its trade, have been satisfied (section 306(2)). A company cannot issue such a certificate without the authority of the Inspector of Taxes (section 306(4)). Castleton is appealing against the Inspector's refusal to authorise such a certificate in relation to 299,900 shares issued by Castleton on 1 August 1997.

2. The relevant statutory provisions contained in the Income and Corporation Taxes Act 1988 are as follows:

"297(1) A trade is a qualifying trade if it complies with the requirements of this section.

297(2) ... the trade must not at any time in the relevant period consist of one or more of the following activities if that activity amounts, or those activities when taken together amount, to a substantial part of the trade –

(f) providing legal or accountancy services".

"289(1) For the purposes of this chapter, an individual is eligible for relief, subject to the following provisions of this chapter, if –

(b) the shares and all other shares comprised in the same issue are issued in order to raise money for the purpose of a qualifying business activity".

3. The Inspector of Taxes refused authority to issue the certificate on two grounds:

(1) That Castleton's trade was not a qualifying trade for the purpose of section 297, specifically because it comprised the provision of accountancy services.

(2) The shares were not issued to raise money for a qualifying business activity, as required by section 289(1)(b).

4. The issues in this appeal are whether either of these propositions was correct. Castleton must win on both issues in order to succeed in its appeal.

5. The evidence before me consisted of the oral evidence of the following persons:

(i) Mr Philip Felman. Mr Felman is a chartered accountant and managing director of Bartons Ltd chartered accountants. He has been a director of Castleton since 8 August 1997 and until April 1997 he was managing partner in the firm of Bartons Chartered Accountants. An agreed note of his evidence was provided to me during the second day of the hearing.

(ii) Mr Nigel David Wilan, an accountant who was employed by Castleton between March 1995 and March 2000

6. The documentary evidence consisted of a common bundle which included the Appellant's and the Respondent's statements of their cases and a very short statement of agreed facts. That document contained the statement that Castleton has since 17 October 1994 carried on a trade. Having heard oral evidence on the first day of the hearing, the Crown indicated that it might wish to resile from its agreement to the effect that Castleton carried on a trade and in those circumstances I granted an adjournment of the hearing on the application of Mr Sherry on behalf of Castleton. Very shortly thereafter the Crown indicated to Castleton that it no longer wished to resile from its agreement that Castleton carried on a trade and the hearing was resumed on 15 March 2001.

The facts

7. The statement of agreed facts reads as follows:

1. Castleton Management Services Ltd is a company limited by shares incorporated on 30th day of September 1994 (Company number 2972752) under the Companies Act 1985 and 1989.

2. The Appellant company has since 17 October 1994 carried on a trade, which has consisted of making its employees available to Bartons Chartered Accountants (a firm) under various contracts. The parties will refer at the hearing to the terms of the contracts for their full meaning and effect.

3. The Appellant company has carried on its trade wholly in the United Kingdom.

4. On 1 August 1997 299,900 eligible shares (as defined in section 289(7) ICTA 1988) were issued to five subscribers. The amount raised by the issue was £299,900. £262,375 of this sum was immediately applied in paying off company debts.

5. On 6 October 1997 a form EIS 1 - Enterprise Investment Scheme company statement was submitted to HM Inspector of Taxes Cardiff 2 requesting authority from the Inspector of Taxes to issue certificates to the subscribers that the conditions for relief for the purposes of the Enterprise Investment Scheme (sections 289-312 ICTA 1988) were satisfied in relation to the 299,900 shares.

6. On 12 May 1999 A L Davies, HM Inspector of Taxes Cardiff 2, issued a formal refusal to authorise the issue of a certificate under section 306(2) ICTA 1988 on the grounds stated above.

8. From the evidence before me I find the following further facts:

(a) Castleton's only trade consists of providing services under two agreements dated 28 June 1995, as varied (as to level of fees and the term of the agreement) by a further agreement dated 21 December 1995. Both of the agreements of 28 June were made with Martin Barton, Philip Felman and Nigel Morris, trading as Bartons Chartered Accountants. As the name suggests these three individuals were carrying on the profession of accountants and were themselves providing accountancy services.

(b) Under one of the agreements of 28 June Castleton agreed to provide the supply of printing, postage and stationery and "technical accountancy and taxation literature). Under the other it agreed to provide "the services of accounting and taxation staff" including persons to fulfil a number of specified job descriptions. Under both agreements the services were to be provided during normal working hours at Bartons' premises or at such other locations in the United Kingdom as the parties should agree.

(c) Until 1 July 1995 Bartons Chartered Accountants ("BCA") employed and paid its own staff in the usual way.

(d) In 1995 with the consent of its members of staff, BCA's employees became employees of Castleton. In the words of Mr Furness in cross-examination of Mr Felman, with which the witness concurred "the initial workforce of CMSL were former employees of BCA. They just transferred across".

(e) Whilst employed by BCA, its members of staff had been salaried in the normal manner. When they became employees of Castleton, BCA's staff were paid minimal nominal salaries and in addition received shares in Castleton and

dividends in respect of those shares. In the words of Mr Willan in his evidence-in-chief:

"I also held shares in CMSL and received dividends in respect of those shares. I understood that I had no right to the dividends and that these were payable in respect of shares and at the discretion of the directors. As with any owner/manager or worker shareholder I consider that the dividends could be paid because of the profit generated by CMSL supplying my person to BCA."

(f) Mr Willan's evidence continued as follows:

"Whilst employed by CMSL I worked as an audit senior and audit manager for Bartons Chartered Accountants (BCA) on their clients.

I did not provide accountancy services to BCA from CMSL. I provided accountancy services direct to BCA's clients whilst working under the sole direction and control of the partners of BCA from whom I took all my instructions.

As far as the clients were aware I was an employee of BCA and they had no knowledge of CMSL. If they phoned or wrote to me it was always Nigel Willan of BCA.

Each week I would complete a timesheet for BCA detailing the time I had spent working on each of their clients.

On a professional level I never had cause to seek advice or guidance from the directors and management of CMSL."

(g) In cross-examination of Mr Felman Mr Furness put the following question to the witness:

"BCA managed the staff on a day-to-day basis and BCA determined remuneration?"

Mr Felman's reply was "Yes".

(h) Mr Felman also confirmed in cross-examination that BCA determined hiring and firing and were responsible for interviewing and in addition BCA set the fees payable to Castleton. In addition BCA agreed the terms of service. Mr Felman stated "BCA would say you have been employed by Castleton and they would explain the dividends etc".

(i) In addition to supplying staff to BCA Castleton also supplied stationery and professional literature.

(j) It appears that Castleton rendered invoices to Bartons Chartered Accountants at quarterly intervals. 15 sample invoices were put in evidence covering the period from 22 December 1995 to 31 March 2000. Each of those invoices, save only the first, contains the following words "charges in accordance with the variation contract for the provision of services dated 21 December 1995." In the first such invoice the wording is "charges in accordance with the variation of the provision of services agreement dated 21 December 1995." In his evidence-in-chief Mr Felman agreed with me (with hindsight) when I put it to him that it would have been more appropriate for the invoices to say "provision of staff".

(k) The company secretary of Castleton was also the office administrator for BCA. She kept the records relating to Castleton's employees but all management decisions were taken by the partners of BCA.

(l) One of the terms of one of the agreements dated 28 June 1995 between Castleton and the partnership reads as follows:

"Castleton undertakes and agrees to take out adequate insurance cover including professional indemnity with an insurance office of repute to cover the liability accepted by it in Clause 3.5 and at the partnership's request agrees to produce a copy of the insurance policy or policies and relevant renewal receipts for inspection by the partnership." Despite the existence of this undertaking and agreement Castleton did not take out any such insurance cover. Mr Felman stated in his evidence that it was never envisaged that Castleton should do so.

(m) Although it appears that BCA received invoices from Castleton on a regular basis at quarterly intervals payment was not made promptly by the partnership to Castleton. Very large arrears accrued and in order to pay dividends Castleton had to resort to loans. The reasons for the partnership's failure to pay Castleton promptly were twofold. First, deferring payment to Castleton produced a substantial cashflow advantage for BCA. BCA accounted for VAT on the accruals basis. Castleton accounted for VAT on the remittance basis. Initially the contract between Castleton and BCA was to run for 40 years. Castleton would issue an invoice and BCA would include it as a cost in their VAT return and claim input tax: a subsequent repayment would be due. Secondly, BCA was in financial difficulties at the time, but in the words of Mr Felman in cross-examination; "the number one reason that the debts were run up was VAT: but we had substantial financial difficulties as well."

(n) The primary reason Castleton was set up and its staff paid mainly by dividends rather than through salaries was, in the words of Mr Felman in his evidence-in-chief "we tried to mitigate the national insurance contributions." "We make no secret of the fact that staff were paid the dividend because that was tax effective. The position of the head of the Contributions Agency is that no national insurance contributions are due if dividends are paid in accordance with company law."

(o) As at 31 July 1997 Castleton was owed £288,548 in unpaid fees from BCA. As stated above it was deliberate policy on the part of BCA that they should not pay Castleton's invoices promptly. By deferring payment BCA received a considerable cashflow advantage.

(p) Although owed a very substantial sum of money by the partnership Castleton continued to declare dividends. In the year to 31 July 1997 Castleton declared dividends of £104,894 having declared dividends of £74,100 in the previous year. As stated above it was financed by loans which were essential to enable the dividends to be paid whilst it was not receiving the payments to which it was entitled under the terms of its invoices issued to the partnership.

The contentions of the parties

9. Mr Sherry, who appeared for Castleton, submitted that all that Castleton did was to provide staff to BCA. In his submission it did not provide accounting services to the partnership.

10. He also submitted that the money raised by the issue of shares was used to discharge borrowings of the company, which borrowings had been incurred for the purposes of the trade. Effectively they financed working capital, principally debtors.

11. Mr Furness QC, who appeared for the Inland Revenue, submitted that by supplying accounting staff to the partnership the company was in fact providing accountancy services.

12. He also submitted that the shares were not issued to raise money for a qualifying business activity. In his submission the shares were issued to raise money to satisfy the debts incurred in order to provide dividend payments when the company had decided (or the partnership had decided for the company) not to collect the fees owed to Castleton by the partnership.

Conclusions

13. In his evidence Mr Felman was very frank and open about the purpose for the establishment of Castleton. The partnership was in serious financial difficulties following the acquisition of an accountancy practice in Pontypridd which turned out to be a liability rather than an asset. There was a real risk that the whole business of the partnership might collapse and it was necessary to make savings. In Mr Felman's words in his evidence-in-chief "we had to economise. So we tried to mitigate the national insurance contributions. That was the primary reason CMSL was set up."

14. In addition, the partnership also secured a substantial cashflow advantage owing to the manner in which VAT was dealt with as between Castleton and the partnership. Initially there were problems with Customs and Excise but eventually a settlement was agreed between the partnership and Customs and Excise to the partnership's advantage.

15. However, the national insurance contributions and VAT aspects of the facts of this appeal are background to the main issue, namely did the activities of Castleton "amount to a substantial part of the trade of providing accountancy services?"

16. Inevitably the answer to this question in the absence of authority, must be provided by impression. Mr Sherry for Castleton has submitted that all Castleton was doing was supplying employees, stationery and professional literature to the partnership which in turn provided the accountancy services to its clients. However, Castleton's invoices speak of the "provision of services" and Mr Felman in his evidence-in-chief admitted that with the benefit of hindsight the invoices might have been differently worded

17. It is I believe common ground in this appeal that whatever else Castleton was doing it was providing the services of accountants to the partnership. Mr Furness has submitted that the distinction between the provision of the services of accountants and the provision of accountancy services is in fact a distinction without a difference and having heard all the evidence I am driven to the conclusion that I must agree with him.

18. The clients of the partnership would have detected no change in the relationship between themselves and the partnership following the interposition of Castleton in July 1995. The same lady or gentleman accountant would be dealing with their affairs in the same way. The only difference was in the terms of

employment of that lady or gentleman accountant. In my judgment by supplying the person, i.e. the services of an accountant, to the partnership Castleton must be viewed as supplying accountancy services. Such an activity in my view cannot be viewed merely as the supply of a human being. One has to look at the qualification of the person supplied and the purpose for which he or she was supplied and in the circumstances of this appeal I can come to no other conclusion than to say that the Inspector was correct when he refused to authorise the issue of a certificate pursuant to section 306(2) Income and Corporation Taxes Act 1988 on the grounds that the trade of Castleton is not a qualifying trade consisting of activities excluded by section 297(2)(f) of the same Act.

19. Having come to that conclusion it is not necessary for me to consider whether the shares issued on 1 August 1997 were issued in order to raise money for the purpose of a qualifying business activity. I have found the relevant facts in relation to that question should this appeal proceed further.

20. The appeal fails and I uphold the decision of the Inspector to refuse to authorise the issue of a certificate pursuant to section 306(2) Income and Corporation Taxes Act 1988.

T H K EVERETT

SPECIAL COMMISSIONER 11 April 2001

SC 3111/99-CAS.EVE