Comment

Ames: a cautionary tale

Speed read

R Ames v HMRC highlights that current legislation, as drafted and interpreted by the courts, potentially deprives entrepreneurs and investors who have little or no income from deriving substantial benefits from claiming CGT relief under the enterprise investment scheme. To benefit from this relief, practitioners should ensure that clients claim income tax relief in the year in which they acquire their shares. Upon receiving tax determinations, practitioners should consult HMRC guidance to ensure that the decisions have been reached correctly. Should clients wish to appeal against these decisions, practitioners should warn clients of the frustration and anxiety that HMRC's delays and potentially uncooperative approach to litigation may cause.

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The case of *R Ames v HMRC* [2018] UKUT 190 reveals various issues concerning HMRC's approach to decision making and litigation, and the need for a change in EIS related legislation.

Case summary

In 2005, Mr Ames, an experienced skydiver, invested £50,000 for a 12% minority shareholding in a start-up indoor skydiving company. For two years, Mr Ames worked tirelessly as a director of the company to set up the business, working closely on the building's design and construction, gaining necessary consents and licences, managing working capital, finances and accounts, and planning for the development of the business. After many years, his investment paid off and by June 2011 Mr Ames had sold his shares for over £300,000, making a significant gain on his initial investment. Before he sold his shares, Mr Ames called HMRC for advice and an officer specifically confirmed that he would be exempt from paying CGT under the government-approved enterprise investment scheme (EIS), which is designed to encourage investment in start-up and early stage UK companies.

Because Mr Ames had not claimed income tax relief in the year when he acquired the shares, HMRC decided that Mr Ames was not eligible to claim CGT relief under EIS. This was in spite of the fact that the only reason Mr Ames had not claimed income tax relief in the year that he acquired the shares was that his income was just £42, which was fully absorbed by his personal allowance, and so he had no taxable income against which to claim EIS income tax relief.

On appeal, and despite the earlier assurance given to Mr Ames by the HMRC officer, the FTT upheld HMRC's decision, finding that HMRC had, in denying Mr Ames' claim for the CGT relief, correctly applied the legislation as worded.

In the course of their submissions, HMRC's representatives told the FTT that: 'HMRC's practice is to allow a late claim if they consider that the taxpayer has a reasonable excuse for his lateness.' Claiming income tax relief would have enabled Mr Ames to claim the CGT relief. As part of his late claim, Mr Ames had submitted a seven page letter to HMRC citing his 'reasonable excuse' for the delay, which detailed:

- his reliance on a piece of HMRC guidance, IR137, which did not warn that the lack of a claim to EIS income tax relief would block the CGT relief;
- his debilitating health and difficult personal circumstances; and
- his previous tax compliance record.

Despite all of the above, HMRC still refused his late claim for income tax relief.

Mr Ames, represented by Keith Gordon, of Temple Tax Chambers, and solicitors Mishcon de Reya, applied to the Upper Tribunal on two issues:

- a statutory appeal against the FTT's decision to refuse the CGT relief based on the wording of the EIS legislation; and
- a judicial review of HMRC's decision to deny his late claim for income tax relief.

Whilst the UT upheld the FTT's decision, it accepted Mr Ames' judicial review of HMRC's decision to deny his late claim for income tax relief, quashing the decision and requiring HMRC to remake it. After a five month delay, HMRC finally allowed Mr Ames' late claim relief for income tax relief, enabling him to claim the CGT relief.

Points to consider

Two main points arise from *R Ames v HMRC*. First, the FTT's and UT's interpretation of the EIS legislation and its consequent impact upon Mr Ames reveal a need to reform the legislation to enable low or zero income investors and entrepreneurs to benefit from the CGT relief.

Secondly, HMRC's approach to decision making and litigation in Mr Ames' case suggest that important public body safeguards are not working, and that HMRC, at least in this case, pursued its tax collecting duties unreasonably.

Flaws in HMRC's procedure: the initial decision

HMRC, as the government's collector of taxes, is tasked with a fine balancing act: to collect taxes rightfully due to the exchequer, whilst acting with the fairness and consideration of a public decision maker. The margins are often fine, and HMRC has a number of safeguards in place to ensure that its actions are carried out fairly.

However, HMRC's approach to Mr Ames' claim for the CGT relief, which runs from its decision to deny Mr Ames' late claim for EIS income tax relief in October 2015 to its resolute and unwavering defence of its decision in the UT until the summer of 2018, has exposed significant flaws in decision making, and revealed that the safeguards are not consistently being adhered to.

HMRC's initial decision to deny Mr Ames' late claim for income tax relief exposes one such flaw. As well as citing a number of deeply debilitating health and personal issues in his seven page letter to HMRC on 6 August 2015, with seven further pages of supporting evidence enclosed, Mr Ames explained that he had always done his best to comply with his tax obligations. He had acted in good faith, and was not warned in the relevant HMRC guidance, IR137, that it was necessary to claim income tax relief to be eligible for the CGT relief.

When considering whether to accept Mr Ames' claim, HMRC explained in its letter to Mr Ames of 5 October 2015 that it followed its own guidance in its *Self Assessment Claims Manual* at SACM10040 ('the guidance'). The guidance was designed to ensure that its officers followed a fair and reasoned decision making procedure, which took into account all relevant considerations.

The guidance advises officers to consider five categories of case:

- where a claim is made late because of an error by HMRC (category 1);
- where the claimant told HMRC, within the time limit, that they intended to make the claim (category 2);
- where the claim is made outside the time limits for reasons beyond the claimant's control (category 3);
- where the claim forms part of a tax avoidance scheme (category 4); and
- exceptional cases outside categories 1 to 4, but in which the circumstances of the case make it unreasonable for HMRC to refuse a late claim for relief (category 5).

HMRC explained to Mr Ames that it denied his claim because his case did not fall within categories 1 to 3. Whilst category 4 was irrelevant to Mr Ames' submissions, Mr Ames' letter to HMRC on 6 August 2015 provided strong grounds for his claim to fall within the ambit of category 5. Category 5 was intended to prevent HMRC officers from fettering their discretion by only accepting late claims if the taxpayer's circumstances fell in to the specific cases identified as categories 1 to 3. However, HMRC's approach was to disregard category 5 on the grounds that Mr Ames' case did not fall squarely within categories 1 to 3, even though the very purpose of category 5 was to ensure that officers could also consider exceptional cases that fell outside categories 1 to 3. By incorrectly discounting category 5, HMRC ignored its own decision making safeguards, misapplied its own guidance, and as a consequence made a flawed decision. Indeed, the UT confirmed that this decision was flawed by quashing it and requiring HMRC to remake it while, this time, taking all relevant considerations into account.

Ratification of the initial decision

As a safeguard, by entrusting cases to solicitors at the pre-action stage, HMRC aim to sense-check the challenged decision. However, HMRC's solicitor's response to Mr Ames' pre-action letter, which set out his intention to seek a judicial review of HMRC's decision of 5 October 2015 to refuse the late claim, was also flawed. The solicitor acknowledged the existence of category 5, and used it to demonstrate that HMRC's policy is 'not rigid and unreasonable'. However, when it came to applying category 5 to the facts, the solicitor simply wrote that 'HMRC did not consider that the circumstances of [Mr Ames'] case were exceptional' without providing a full explanation. That the solicitor considered the circumstances to be unexceptional actually demonstrated a wholly rigid and unreasonable policy.

The solicitor had the opportunity to assess the merits of Mr Ames' claim, to realise that the amounts in question did not justify the costs of another court hearing, and to resolve the dispute. Instead, he stood behind a flawed decision, despite both the lack of a public interest in conducting the litigation, and the inevitable impact of the litigation on Mr Ames' health and wellbeing.

HMRC's approach to litigation

Once the judicial review procedure was in motion, HMRC's misapplication of its own safeguards continued. Mr Ames was a meticulous record keeper and had kept a handwritten note of his call with the HMRC officer, who had assured him before he sold the shares that he would be entitled to the CGT relief even though he had not initially claimed EIS income tax relief. To strengthen his case, Mr Ames submitted a properly completed subject access request to HMRC on 6 March 2017, to obtain compact discs of the recorded telephone conversations with the officer on 23 May 2011. On 21 March 2017, he received two compact discs from HMRC, in which conversations longer than 20 minutes played the first minute only. Only after a letter of complaint to HMRC, copying in the Information Commissioner's Office, did HMRC finally send Mr Ames an unedited recording of the calls, on 27 April 2017. It was clear from these recordings that the HMRC officer had indeed assured Mr Ames that he would be entitled to the CGT relief. It had taken nearly two months, and more letters, for HMRC to comply fully with Mr Ames' request. HMRC's delay and obfuscation would likely have deterred others less determined than Mr Ames.

In the recordings, the HMRC officer explained that Mr Ames would be able to obtain the CGT relief because he fell squarely within the exemption set out in HMRC's *Venture Capital Schemes Manual* at VCM30150, which exempted Mr Ames from the requirement to claim income tax relief on the grounds that claiming income tax relief would have reduced his tax liability to nil. However, in all communications with Mr Ames since he filed the relevant tax return for the year 2011/12, which would have enabled him to claim the CGT relief, HMRC attempted to ignore VCM30150, and instead pointed him towards another paragraph in the manual, VCM20020. Although similar in content to VCM30150, an extra sentence in VCM 20020 removed the exemption provided in VCM30150, upon which Mr Ames relied following his telephone call with the HMRC officer. The fact that HMRC published the version of VCM20020 which removed the exemption *just* two months after Mr Ames submitted his tax return, and sought to rely on it instead of VCM30150, demonstrates an awareness by HMRC that VCM30150 was harmful to its litigation position because it fully justified Mr Ames' decision not to claim income tax relief. VCM30150 had been removed at some point before October 2013, and the removal of this guidance was not recorded in HMRC's publicly available list of changes to its manual.

HMRC's tactics of inflexibility and delay were without regard either to the costs of the litigation or the health of Mr Ames. The UT appeal was delayed on a number of occasions due to the fact that one of Mr Ames' arguments was contingent on the decision of *Raftopoulou v HMRC* [2015] UKUT 579 (TCC), which had been appealed by HMRC. As the hearing of the *Raftopoulou* appeal was delayed a number of times, HMRC also repeatedly sought to postpone Mr Ames' case, as it was eager to show that he could not rely on the *Raftopoulou* UT decision as an authority. However, its requests for a stay were unreasonably delayed: in March 2017, each party was informed that *Raftopoulou* would be delayed until December of that year, but it wasn't until July 2017, some four months later, that HMRC eventually sought a stay of the *Ames* proceedings.

Even once the decision in *Ames* had been handed down by the UT, HMRC continued to take an unreasonable and uncompromising approach to Mr Ames. The time limit for Mr Ames to appeal the UT's decision to refuse the CGT relief was one month from the date of the decision. In practice, however, Mr Ames would not know whether he wanted – or needed – to appeal the decision until HMRC had re-made its decision on his late claim for income tax relief. If the latter were to be re-made in his favour, then he would be able to claim the CGT relief and therefore an appeal would not be necessary. Mr Ames' difficulty, however, was that he would almost certainly not know within one month whether HMRC had re-made its decision in his favour. He therefore sought HMRC's consent to suspend the time limit for appealing the UT's decision until one month after being notified of HMRC's reconsidered decision. HMRC refused this request. The UT's ready agreement to Mr Ames' request shows the unreasonable nature of HMRC's refusal.

HMRC's delays continued into the UT's costs determination. Set a deadline for making its costs application of one month following the UT's decision, HMRC submitted its costs application 13 days late. It had, it said, believed that an UT email, which gave HMRC 14 days to respond to Mr Ames' separate costs application, extended the deadline to submit its own costs application. As to HMRC's costs application itself, despite the fact that Mr Ames would not have needed to take the matter to the UT had HMRC's original decision to refuse his late claim for income tax been made correctly, and in spite of HMRC's continual delays to Mr Ames' subject access request for the recordings of his telephone conversations with the HMRC officer, it demanded its costs from Mr Ames in relation to the statutory appeal element of the Upper UT proceedings on the basis that it was successful on this point. The UT disagreed, and was critical of HMRC's delay in the costs process, ordering none of HMRC's costs to be paid.

> Although a number of safeguards are in place ... HMRC's approach in *Ames* suggests a tendency to push the boundaries

Even after the UT had quashed HMRC's decision and required it to re-make it, several months passed with no reconsidered decision. Only after Mishcon de Reya chased HMRC shortly before Christmas did HMRC provide Mr Ames with its reconsidered decision. Even the communication of this decision to Mr Ames was not straightforward. HMRC informed Mishcon de Reya by email that it had posted Mr Ames a letter communicating its reconsidered decision, but failed to attach that letter to the email. Mr Ames, having already waited for five months, therefore knew a decision was imminent, but had to wait on the postman to hear his fate. This pattern of infrequent and indirect communication displays a lack of appreciation from HMRC of the huge impact that litigation can have on ordinary taxpayers.

Amendments to primary legislation

The CGT relief available on a sale of EIS shares is a key incentive used by the government to encourage investment in start-up and early stage companies. However, the legislation as drafted, and as interpreted by the FTT and UT in *Ames*, requires taxpayers intending to claim the CGT relief to actually claim, rather than simply be eligible to claim, income tax relief. This adversely affects two main groups of EIS investors. First, those whose income is less than the personal allowance are required to disclaim their personal allowance (assuming that's even technically possible) so that they have at least some taxable income against which they can claim EIS income tax relief and ultimately therefore the CGT relief. Secondly, taxpayers with no taxable income at all simply cannot claim EIS income tax relief, and so are never entitled to claim the CGT relief. This might include EIS investors with capital but no income, or UK resident but non-domiciled EIS investors who claim the remittance basis and have no UK income tax liability. There is no rational reason why such individuals who invest in a qualifying EIS company should be denied the CGT relief on a future sale of their shares.

Most start-up and early-stage businesses operate at a loss for the first few years and cash is usually short. For that reason, founder or director shareholders in EIS companies will often not take a salary initially, and will sometimes have ploughed their life savings into the business on acquiring their shares. These risk-takers are the very people who are intended to benefit from the EIS and yet the perverse effect of the legislation is that they may be disqualified from claiming the CGT relief if they had no income when they acquired their shares.

The EIS rules seem to encourage only those individuals with UK taxable income to invest in start-up and young companies. Such a requirement is unduly limiting, and cannot possibly have been Parliament's intention. It would therefore be sensible to make a minor change to the EIS legislation, to ensure that claiming the CGT relief is not contingent on having claimed income tax relief at the outset.

Conclusion

Ames provides tax practitioners with plenty of food for thought. The UT reaffirmed the need to have claimed income tax relief in order to claim the CGT relief. HMRC is likely to pursue taxpayers who fail to do so, even where exceptional circumstances arise.

Although a number of safeguards are in place to ensure HMRC makes the correct decision, corrects any flawed decision made by an officer, and pursues any litigation fairly, its approach in *Ames* suggests a tendency to push the boundaries and ignore these safeguards. In *Ames*, HMRC overlooked pertinent guidance criteria, cropped audio recordings of conversations held between its officer and the taxpayer, consistently delayed proceedings, and delayed re-making its initial decision. Such behaviour continued even once it had become aware of the taxpayer's health and personal difficulties.

Action points

- Until legislation changes, ensure that clients who intend to claim the EIS CGT relief claim EIS income tax relief in the year in which they bought shares in their business. If they have no income, they should find a way to generate some, however small.
- Be alive to flaws in HMRC's decision making procedures, and check whether it has considered all of the relevant guidance.
- When advising clients on claims to the FTT or the UT, warn them of the frustration and anxiety that HMRC's delays, and potentially defiant approach to litigation, can cause. ■

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- Cases: *R Ames v HMRC* (10.7.18)