

EIS and the rural and equine business

By Julie Butler Posted October 19, 2016 In Tax

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Equine activities can qualify for Enterprise Investment Scheme (EIS) relief, for example the breeding of horses where land is not involved, together with show jumper investments and potentially other equine activities such as pinhooking (dealing in horses) provided these are not racehorses that have been competing on the track prior to sale. Following the Rio Olympics and so many high profile children of rock stars and billionaires entering the sport of show jumping, the opportunities are extremely commercial.



Care must be taken so as to ensure that commerciality can be demonstrated so the activity must be structured efficiently to qualify for EIS relief. The need for commercial justification and the identification of private use when setting up an EIS company has been highlighted by the recent case of *East Allenheads Estates Limited (TC45130)* a case heard at First-tier Tribunal (FTT) with regard to EIS eligibility. HMRC do pay close attention to EIS applications. As mentioned, an equine activity can qualify for EIS relief but any personal benefit needs to be identified.

By way of example, Prince Charles has recently said when attending Royal Ascot something along the lines that a person cannot appreciate gardening until you own a garden and, likewise, you cannot appreciate racing until you own a racehorse. The same can apply to show jumping – some ownership can really assist the interest in the sport and following Rio such an understanding is of great interest and commercial benefit. Recent sales of show jumpers would show there is significant commercial potential.

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The EIS tax advantages of any new equine business venture should be considered when reviewing the structure of any business so as to help the investors achieve maximum return and maximum tax efficiency. It is key to understanding the exact nature of the proposed business structure and plans for which EIS is being claimed to ensure that there is full compliance with the EIS rules. There must be a financial roadmap proving the ability to achieve future profitability.

Understanding a qualifying equine trade

The EIS is designed to encourage investments in small unquoted companies carrying on a qualifying trade. It is believed that many members of the equine business community do not appreciate the basic benefits and tax advantages of EIS and also “Seed EIS”, and above all they are unsure as to what equine activity does qualify as a “qualifying trade”. Such an investment can help the investors make the equine industry more commercial and to provide correct commercial tax support to the hard working, fledgling businesses within the commercial arm of the sport.

There is a lot of misunderstanding over EIS qualification. There is the 30% income tax relief on the subscription of the shares. In addition EIS deferral relief is available whereby a capital gain can be ‘rolled over’ into the purchase of EIS shares. The individual investor must retain the shares for a minimum of three years. If EIS shares are sold at a loss (after any income tax relief has been taken into account) these can be offset against income for the year and previous year instead of being offset against capital gains. There are concerns that the new 20% rate of capital gains tax (CGT) from 28% will make the EIS less attractive, but EIS schemes are still very attractive as efficient tax planning, particularly to the income tax relief on the original investment in the company.

EIS as a tax planning vehicle

The East Allenheads could perhaps be used as a case to demonstrate what not to do with an equine business wanting to apply for EIS.

The facts of the East Allenheads case were that for Mr Jeremy Hermann, a hedge fund manager, the choice of tax planning vehicle to operate his shooting business through was an EIS company. Mr Hermann started the grouse shooting business in 2002 when he bought East Allenheads grouse moor in Durham together with the adjacent Allenheads Hall, a large country property. Mr Hermann originally held both properties personally.

Some equine EIS companies might involve assets that were originally held privately, as was the case here, and boundaries between business and private ownership need to be established – ideally for an EIS equine company to succeed there will be no “backdrop of an original hobby”, no transfers of personal properties and no substantial losses.

Mr Hermann subsequently incorporated East Allenheads Estates Limited, and the company ran the grouse shooting on the estate once Mr Hermann decided that he wanted to make the shooting operation a proper business, from 2005 onwards. The moor was transferred into the company, but not the hall itself, although grouse shooting parties occasionally stayed there. In two years, the company made accumulated losses of more than £800,000, primarily funded by loans from the director.

Allenheads – Loss making business

The £800,000 losses provide a fair indication of the costs of running a grouse shooting operation whilst also raising questions regarding “duality of purpose” with costs as large as shown in this trade together with the nature of the trade. Mr Hermann’s first arguments were that he needed to speculate to accumulate and this was the reason for the losses.

“Speculate to accumulate” is a very sound business principle but an equine EIS company must show that any such speculation will result and can result in very positive returns on capital. Business plans must be produced.

Mr Hermann invested £6.5m in the company on 13 July 2007 by way of a share subscription and claimed EIS capital gains tax deferral reinvestment relief on this sum against other gains he had made. It was brought to the tribunal judge’s attention that at the time of the investment a restriction to £2m for reinvestment relief had been announced by HMRC and would come into force on 19 July 2007.

Lavish personal enjoyment

In the Allenheads case it was decided that the grouse moor business was pushing the limits on the difference between lavish personal enjoyment and commercial necessity. The money raised from the share subscription was mostly spent over the next year. The company spent £1.3m on improvements to Allenhead Hall (mostly on a spa complex), £3.5m on art and antiques (including a £2.9m Magritte painting) and £3.3m on acquiring a further moor and a farm. As the tribunal judge stated:

“The picture that emerges from the evidence is of expenditure on the various works at Allenheads Hall up to November 2007 dwarfing all other expenditure of the appellant in that period, then a major spending programme from November 2007 through to February 2008 on art and antiques and finally the land purchase in March/April 2008”.

The racehorse activities and the show jumping EIS companies should not involve “lavish personal enjoyment”. Some interest and knowledge of the sport is useful to make an informed decision of the business plans and investment understanding. The main business purpose of an EIS company must be profit and commercial return.

In the Allenheads’ Tribunal case the facts show that HMRC initially refused to approve the EIS claim regarding the grouse moor on the grounds that the money had not been spent for the purposes of any qualifying business of the company. The status of a qualifying business can be a complex decision; in this case it was argued that part of achieving sales in the shooting industry can involve lavish entertainment. The art and antiques were not business assets at all, and the expenditure on the spa complex had provided improvements to the hall which Mr Hermann owned personally. Mr Hermann disagreed with this decision and appealed. The case then went to the First-tier Tribunal (FTT).

Many might wonder how these EIS type rural and equine enterprises might work. Firstly there has to be genuine proof of commercial return which might seem “alien” where horses are involved. Such operations can involve the purchase of young horses then the international sale of show jumpers taking advantage of the original 2012 “golden glow” with a move to the strong overseas market. Identifying show jumping talent at an early stage then selling to the professional market “ready-made” to compete on the buoyant international stage.

For polo EIS companies the business structure can be to sell “accomplished” polo ponies to “patrons”, having identified quality young stock then providing the added value to convert “high goal” ponies ready for the commercial market.

For the racing activity the EIS business model can involve “pin hooking” likely young stock at the sales ready to sell on to the international market. “Pin hooking” might be described as the exotic term for horse dealing – buying well from an inexperienced breeder, racing and selling at the “ripe” point for a racing future. Equine talent needs to be identified and matched with the appropriate EIS company and it needs harnessing with a tax efficient EIS structure.

Mallalieu v Drummond

The *Mallalieu v Drummond* case is still frequently used in tribunal considerations such as this where there is private use as in the East Allenheads case. Mr Hermann argued that his business model was to aim at the very richest customers who wanted the best. Although the hall was Mr Hermann’s personal property, and the art was on its walls, it was argued the purpose was to make the venue fit to entertain this type of clientele. As long as such an approach was his intention, any private benefit he received would be held as incidental.

The tribunal judge did not agree with Mr Hermann's arguments for "incidental private use" with regard to the grouse moor following the ruling in *Mallalieu v Drummond* which is the only case of its type able to be taken into account, and the test referred to was deemed to be purely subjective.

There was no firm finding by the Tribunal on whether the art and antiques were purchased for the purpose of the trade. The problem was that the purpose of the company at the time of the investment was deemed to have included a purpose of benefiting Mr Hermann, and this benefit was considered more than just incidental to its main business purpose. The tribunal judge said a comparison of the investment made with the £760,000 company turnover suggested that the personal benefit and personal enjoyment must have been paramount.

Must raise money to carry on a qualifying trade

The judge's view in the *Allenheads* case was that the shares were not issued with a view to raising money so that the company could carry on a qualifying trade on a commercial basis. Although some of the money had been spent on qualifying purposes, far too much of the monies raised had not. For that reason, the refusal to grant an EIS certificate was upheld by the judge of the FTT.

The *East Allenheads* case gives guidance to tax advisers and investors that any trade connected with the EIS claim must not include personal benefit and that HMRC are scrutinising such claims in depth and detail. Any equine business must take this into consideration.

A key point is that it is not necessarily the trade of shooting on the grouse moor that is the concern for an EIS claim here. Providing, for example, the trade can be proved to be a qualifying trade run on a commercial basis, then an EIS claim can be valid. The same approach applies to equine EIS as equine investments could be considered uncommercial but business plans must be prepared and profits achieved in order to qualify. There are many equine activities that are profitable. The problem can be where the proposed EIS application involves personal benefit.

Objective use of the investment will have to be undertaken and the inappropriate use of personal property must be carefully considered from the outset of the application, in order for an EIS claim to survive HMRC scrutiny. A shooting operation together with other rural activities such as pinhooking and investments in show jumpers or polo ponies CAN qualify for EIS but the trade must be commercial and not contain expenditure relating to “personal enjoyment”. An interest in the subject of the investment, e.g. show jumpers or racing does not mean personal enjoyment is disallowed. A parallel can be investors in “green” and eco-friendly companies – again, personal enjoyment is acceptable if the investors enjoy generic “eco-activity”. It can be difficult to prove the difference between objective commerciality and personal enjoyment – evidence of commercial business plans helps. The Allenheads case gives helpful guidance on personal enjoyment, profitability and how to demonstrate qualification for EIS relief.

Company director

Another recent case *N Bell (TC4969)* provides guidance as to whether conditions for a company director to qualify for EIS relief had been achieved. The HMRC concern was because Mr Bell was a director he must prove ITA 2007 section 169 applied. Mr Bell was appointed a director of the EIS company on 1 February 2008. For shares bought in 2011 and 2013 the Tribunal dismissed the claim for EIS for investments after January 2011 as the three year limit has expired under condition C of section 169.

For equine EIS companies where the director invests in the company it is essential to achieve the correct timing. EIS relief is extremely valuable to the investor and beneficial to encourage the equine, rural, sporting and racing industries.

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