VAT UPDATE
OCTOBER 2008

Covering material from July – September 2008

Notes prepared by Mike Thexton MA FCA CTA

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1. INTRODUCTION

These notes contain a brief summary of some of the main VAT developments in the last three months – Tribunal and Court decisions, changes in legislation, Customs announcements. They are divided as follows:

- outputs generally;
- land and property;
- international matters;
- inputs generally;
- administration.

The same main headings will be used each quarter. If nothing has happened under a particular heading in a particular quarter, that heading will be omitted – but all headings will still carry the same number. That is why some headings are included with "nothing to report".

1.1 Appeals pending

It is not possible to compile a comprehensive list of cases under appeal, and some of those which are thought to be still "live" may be dropped without a hearing. The following is compiled from several sources, and is just an approximate guide to some of the arguments that do not appear yet to have been finally settled:

Note that the HMRC website now includes some information about pending appeals, described as follows:

"*This section is aimed primarily at Tax Practitioners and has been introduced to highlight HMRC VAT appeals in respect of Tribunal decisions, and appeals by either party in respect of decisions in the High Court or above. The VAT Appeal Updates document will be updated on a monthly basis and finalised cases will be retained for viewing for two months before their removal.*"

VAT Appeals Update on www.hmrc.gov.uk/library.htm

Awaiting the ECJ [HC = High Court; CA = Court of Appeal]:

- *Canterbury Hockey Club*: whether sports affiliation fees are exempt (questions referred by HC: Case C-253/07, hearing expected 3/7/08)
- *JD Wetherspoon plc*: whether the taxpayer is entitled to round the VAT on individual sales down (the Tribunal has not reported the UK appeal, but the ECJ has given it a number Case C-302/07, hearing expected 9 October 2008)
- *Loyalty Management UK Ltd*: whether the promoters of the Nectar scheme were entitled to deduct input tax on "redemption services" supplied by participating retailers (HMRC were granted leave to appeal to the House of Lords in April 2008; R&C Brief in this update concerning the treatment of similar transactions by affected traders: points out that the Lords have decided to refer questions to the ECJ)
- *Royal Bank of Scotland plc*: whether the taxpayer is entitled to round the percentage up in a special method (questions referred by the Court of Session, Case C-488/07, hearing expected 8 October 2008)

UK appeals awaiting hearing:

- *Baxi Group plc*: whether a promotion scheme created recoverable input tax for the company using the scheme on the cost of goods supplied to participating plumbers (HMRC were granted leave to appeal to the House of Lords in April 2008)
- *BMW AG*: HMRC's decision to align return periods where a cash flow advantage accrued to an exporting company (HMRC have applied for leave to appeal to the CA – HC decision covered in this update)
- *Boots Co plc*: treatment of "voupons" (HMRC's appeal to the HC – Tribunal decision covered in this update)
- *EMI Group plc*: whether UK rules on small gifts in course of business are in accordance with art.5(6) 6th Directive, and whether absence of transitional period in the law renders the capping rules ineffective (questions for referral are still being disputed; meanwhile, HMRC are appealing the latest of a string of Tribunal rulings to the HC)
- *Livewire Telecom Ltd*: whether a person involved in "contra-trading" was entitled to input tax recovery (HMRC have appealed to the HC)
- *Premier Food (Holdings) Ltd*: remitted to Tribunal following HC's explanation of errors of law in applying the definition of "confectionery"
- *Royal Bank of Scotland plc*: whether HMRC was entitled to refuse a special method that gave rise to 50% recovery of residual input tax (HMRC's appeal to the Court of Session, due to be heard July 2008)
- *RBS Deutschland Holdings GmbH*: effectiveness of scheme to avoid charging VAT on cars leased to UK customers (HMRC appeal to Court of Session, hearing 11 – 12 November 2008).
- *Scottish Equitable plc*: effectiveness of capping provisions (it has been reported that the Court of Session has decided to refer questions to the ECJ, although HMRC's list of appeals still shows this as awaiting the Court of Session)
- *Weald Leasing Ltd*: artificial leasing arrangements and abuse of rights (HMRC's appeal to the CA to be heard w/c 24/11/08)
- *WHA Ltd/Viscount Reinsurance Co Ltd*: whether the "offshore loop" plan was an abuse of rights (taxpayer has been granted leave to appeal to the House of Lords; Lords have stood the appeal over pending a potentially relevant infringement case in the ECJ)

In this update from previous lists:

- *Isle of Wight Council*: whether parking charges were subject to VAT (HMRC's arguments upheld by the ECJ)

2. OUTPUTS

2.1 Scope of VAT: linking supplies to consideration

2.1.1 Local authority parking

The ECJ has now given its ruling in the local authority parking case. The judgment is much clearer than the Advocate-General's opinion, and it appears that HMRC's arguments have been accepted on all points. It still has to be applied by the High Court, but it seems that the councils are likely to lose their case.

The judgment sets out the arguments very clearly. A public authority is generally treated as a non-VATable person if it is carrying on an activity as a public authority and operating within the special legal regime applicable to such authorities rather than within the normal commercial legal regime that applies to traders. It is for the national court to decide whether this applies, and this had been accepted by the UK courts as satisfied in the case of off-street parking supplied by local authorities on the basis of the *Fazenda Publica* case (C-446/98). The ECJ therefore proceeded on the hypothesis that the basic conditions for the councils to be treated as outside the scope were met.

A public authority acting as such will then only be subject to VAT if its activities were listed in Annex D (now Annex I), or if treating them as non-VATable "would lead to significant distortions of competition" (art.4(5) 6th Directive, original numbering). As parking is not listed in Annex D, the dispute was focused on the meaning of the expression about competition. Traditionally local authorities had regarded off-street parking as VATable, but 127 councils had put in claims following the *Fazenda Publica* decision, and the present dispute was a test case featuring claims of £1.6m from four representative councils (an island, a rural area, an urban area and a provincial region).

The first question

The first question referred by the High Court was:

Is the expression "distortions of competition" to be ascertained on a public body by public body basis such that, in the context of the present case, it should be determined by reference to the area or areas where the particular body in question provides off-street parking or by reference to the totality of the national territory of the Member States?

The argument put forward by the councils was that competition can only be measured on a local basis. There was no distortion of competition on the Isle of Wight if someone offered off-street parking in Manchester.

The Irish government believed that a member state should be free to determine how competition would be measured; the Italian government supported the councils.

The Commission agreed with the UK government that it was necessary to look at the activities concerned on a national basis. The judgment comes down very clearly in favour of the Commission and the UK's view. The following points are significant:

- it is necessary to interpret provisions such as art.4(5) in the context of the scheme and purpose of the 6th Directive as a whole, and to comply

with general principles such as the need for legal certainty and fiscal neutrality;

- the treatment of public authorities as non-taxable is a derogation from the normal rules of VAT and should therefore be interpreted narrowly;
- it is essential that the application of Community legislation must be certain and foreseeable, and the outcome on parking would be very difficult and constantly in dispute if it depended on an assessment of local competition – it would also potentially change over time, even in the same locality.

The judgment therefore determines that the question of whether there would be a significant distortion of competition must be determined by reference to the activity in question on a national basis without relating to any local market in particular.

The second question

The second question referred by the High Court was:

What is meant by the expression "would lead to"? In particular, what degree of probability or level of certainty is required for that condition to be satisfied?

The councils argued that HMRC would have to show that there was actual distortion of competition in order to deny them their reclaim – that there were traders who wanted to supply parking services and were put off by the difference in VAT treatment, or some other actual effect in the market. This view was supported by the Irish and Italian governments: the Irish argued that it should mean that there was a real probability of distortion, while the Italians argued for a strong probability.

The UK government and the Commission argued that the expression "would lead to" meant no more than "could lead to" in this context, and the meaning was that there only had to be a theoretical possibility of distortion. It was not necessary to show that distortion actually occurred.

The judgment again refers to the need to construe a derogation from the normal rules of VAT narrowly. As the expression in dispute restricts the derogation and returns the situation to the normal rules, it is not to be construed narrowly but given a wider meaning.

The answer is therefore that the expression "would lead to" encompasses not only actual competition but also potential competition, provided that the possibility of a private operator entering the relevant market is real and not purely hypothetical.

The third question

The third question referred by the High Court was:

What is meant by the word "significant"? In particular, does "significant" mean an effect on competition that is more than trivial or de minimis, a "material" effect or an "exceptional" effect?

The councils argued that "significant" should mean "a materially adverse effect", and meant that there had to be something more than simply the fact that the public authority had to charge VAT and its competitors did not.

The Irish government supported the view that the word implied something important and appreciable; the Italian government contended for "at least material and not merely negligible".

The judgment essentially agrees with the submissions of the UK government and the Commission that the word only means "more than negligible". Once again, as this restored the normal rules of VAT and restricted a derogation, it should not be construed narrowly. The court observed that the two parts of art.4(5) should be read together: activities in Annex D are treated as taxable "unless they are negligible", and other activities are treated as taxable "if they would lead to significant distortions of competition". It was sensible to view the two provisions as consistent with each other: activities could be outside the normal rules of VAT if they were negligible, but not if they were more than that.

ECJ (Case C-288/07): *HMRC v Isle of Wight Council and others*

2.2 Disbursements

Nothing to report.

2.3 Exemptions

2.3.1 Fund management

HMRC have issued two Briefs to explain the changes to the exemption for fund management following the *JP Morgan Claverhouse* decision and the March Budget, which have been given effect by Statutory Instrument. The amendments extend the exemption to the management of "closed-ended collective investment undertakings" such as investment trust companies, because they compete with open-ended investment companies which already enjoyed the exemption.

The Brief explains that an ITC will qualify if:

- its sole object is the investment of capital, raised from the public, wholly or mainly in securities;
- it manages its assets on the principle of spreading investment risk;
- all of its ordinary shares (of each class if there is more than one) or equivalent units are included in the official list maintained by the Financial Services Authority pursuant to s.74(1) of the Financial Services and Markets Act 2000; and
- all of its ordinary shares (of each class if there is more than one) or equivalent units are admitted to trading on a regulated market situated or operating in the United Kingdom.

A second Brief announced that, following representations from the industry, the definition was being refined again before the implementation date. The refinement is explained as reducing the scope of the exemption in respect of certain recognised overseas schemes:

Item 9, as amplified by Notes (6) and (6A), exempts the management of an authorised unit trust scheme within the meaning given in section 237(3) of the Financial Services and Markets Act 2000 (c. 8) ("FSMA"). It also exempts the management of certain collective investment schemes or sub-funds of umbrella schemes which are recognised pursuant to sections 264, 270 or 272 of FSMA or to an order made pursuant to section 409(1)(d) or (f) of that Act. The management of such schemes or sub-funds is excluded from the exemption if they have never been marketed in the United Kingdom or are not for the time being marketed in the United Kingdom and less than 5% of their shares or units are held by, or on behalf of, investors who are in the United Kingdom. Item 9 also exempts the management of an authorised open-ended investment company within the meaning given in section 237(3) of FSMA.

The Brief points out that the management of special investment funds is not within the "specified supplies" listed in SI 1999/3121; input tax incurred in providing such a service to an overseas fund would therefore not qualify for input tax recovery if the service was exempt in the UK. On the other hand, financial services in general are within Sch.5 VATA 1994, so no VAT would have to be charged to a scheme where the customer belonged outside the UK (presumably it would acquire the services for the purposes of a business). It therefore appears that this change will allow UK managers to continue to recover input tax on overseas sales without creating any output tax liability in this country.

The new law operates from 1 October 2008, but HMRC accept that it reflects the rules as they should have been since 1 January 1990. ITCs may therefore make claims:

- for the last three years leading up to the date of claim;
- for the period from 1 January 1990 to 4 December 1996, provided the claim is made by 31 March 2009.

The Brief also refers to the possibility of an unjust enrichment defence.

Revenue & Customs Brief 35/08, 48/08; SI 2008/2547

2.3.2 Jackpot

The last update included the first Tribunal decision in the *Rank* case. The Tribunal held that cash bingo machines should have been treated as exempt because treating them as taxable created a fiscal distortion: effectively identical supplies were distinguished by the law.

Now the other, more significant part of the dispute has also been decided, and the taxpayer has won again. The decision states that Rank's claim was for nearly £26m net, and that some 1,100 appeals by other traders had been stood over awaiting the outcome of this case. The subject of this claim was gaming machines, and the essence of the argument was the same: very similar machines were accepted as being exempt by HMRC either as a matter of law or a matter of practice, and that could not be accepted. The taxable machines also had to be exempt.

The law up to December 2005 excluded from exemption supplies from a "gaming machine", which was defined as follows:

(3) 'Gaming machine'' means a machine in respect of which the following conditions are satisfied, namely –

(a) it is constructed or adapted for playing a game of chance by means of it; and

(b) a player pays to play the machine … either by inserting a coin or token into the machine or in some other way; and

(c) the element of chance in the game is provided by means of the machine.

The element of chance in Rank's machines was provided by a Random Number Generator (RNG). At some point no later than 2003, new machines were being supplied to Rank which did not contain a RNG. Some had the RNG physically separated from the machine, for example contained within the plinth on which the machine stood or attached to the wall behind it; some were terminals connected to a single computer server which provided the RNG for a network of such terminals. Rank argued that these machines were not covered by the definition as a matter of law, and were treated as exempt as a matter of practice. By virtue of the ECJ's decision in *Linneweber* (Case C-450/02), Rank argued that its other gaming machines should also be treated as exempt because to draw a VAT distinction between effectively identical services offended against the fundamental principles of VAT.

HMRC argued that there was no fiscal distortion. On the matter of law, they contended that the location of the RNG was irrelevant: it was attached to the machine and was therefore part of its apparatus. On the question of practice, they argued that regarding such machines as exempt was a mistake by the authorities in their understanding of new products, and they had acted with due diligence in changing the law by December 2005 to make it clear that such new machines should be taxable. HMRC also argued that there was no fiscal distortion, because there was no evidence that VAT considerations affected the choice of machines operated by businesses such as Rank.

The Tribunal decision examines the nature of the machines in detail, and also considers other legislation relating to them such as the Gaming Act. A key point is that the Tribunal regards the expression "the machine" in the definition as requiring "one RNG per machine". Where there is a network, that would require the whole network (with perhaps 10 terminals) to be treated as a single machine. HMRC suggested that it was, but Rank's counsel pointed out that gaming legislation restricted the number of machines that could be sited on any premises. This interpretation would allow 10 times more terminals than everyone believed were permitted under those rules. Accordingly, the Tribunal held that such networks did not fall within the definition of gaming machines up to December 2005, and they were exempt as a matter of law. It was also clear from the evidence that HMRC had accepted this as a matter of practice until claims based on *Linneweber* had started arriving.

The Tribunal did not accept that machines which had a single RNG fell outside the definition just because the RNG was physically separated from them. However, by that point it no longer mattered: as the networks were exempt, and they competed with other machines that had been treated as taxable, the basis of Rank's argument had been established.

The Tribunal went on to consider the question of fiscal distortion. It rejected HMRC's argument that the trader's reasons underlying the installation of the machines was relevant, or that the trader had to show that there was a significant change in behaviour resulting from the difference in treatment. The facts spoke for themselves: effectively identical machines were treated differently, and that was fiscal distortion.

The question of whether HMRC could mount a defence based on "due diligence" was deferred. The chairman outlined the basis of such a defence but suggested that it would require a reference to the ECJ. HMRC were invited to go away and think about whether they wished to present such an argument in more detail.

VAT Tribunal (20,777): *The Rank Group plc (no.2)*

2.3.3 Welfare

A registered charity supplied services for the benefit of elderly people. HMRC ruled that the supplies were exempt within Group 7 Item 9 Sch.9 VATA 1994; as the charity's bills were paid by local authorities, it would prefer to charge VAT and argued that the supplies were standard rated. It contended that the nature of the supplies was not welfare, and this was backed up by the fact that the recipients of the supply were two county councils and various primary care trusts rather than the individuals.

From March 2005 onwards, the charity entered into an agreement with a subsidiary company to assign its service level agreements with the various "customers" to it. Although the charity still did all the work, the invoices were raised by the subsidiary which was not an eligible body so it would have to charge VAT. HMRC examined this arrangement to consider whether it was an abuse of rights; however, it was subsequently argued by the charity that its own supplies should be treated as taxable anyway, and this was the dispute that was heard by the Tribunal.

HMRC argued that the services promoted the physical and mental welfare of the elderly people concerned, and it was not material that payment came from the authorities under their statutory obligations. The services were welfare as defined in the law.

The Tribunal examined the service level agreements and concluded that each one represented a single service which should not be further subdivided. On the basis of the detailed descriptions in those SLAs, the Tribunal was satisfied that what the charity did fell squarely within the statutory definition of welfare. It did not matter who paid for the service, nor even that some of the benefit of the work was directed at supporting carers rather than at the elderly individuals themselves: the work was all "directly connected" with care for those elderly individuals.

The appeal was therefore dismissed.

VAT Tribunal (20,762): *Age Concern Leicestershire & Rutland*

2.3.4 More civic aims

The British Association for Shooting and Conservation (BASC) has grown out of the merger of a number of different associations, the oldest dating from 1908. It was incorporated under the Industrial and Provident Societies Act in 1997. It has a number of aims relating to the sport of shooting, including representing the interests of its members in promoting the right to hunt.

HMRC accepted that some of its subscription income is zero-rated as relating to the issue of a magazine, and some is exempt as relating to insurance. HMRC had ruled in 1994 that the balance was exempt, but in 1996 they issued a new decision that it should be taxable at the standard rate. BASC disagreed and continued to treat the income as exempt, and appealed against the resulting assessment of £397,551 for the year 2006.

The Tribunal had to consider whether the income could be exempt within:

- Group 9 item 1(e) as income of a body which has objects which are in the public domain and are of a political, religious, patriotic, philosophical, philanthropic or civic nature; or
- Group 10 item 3 as consideration for the supply by an eligible body to an individual, except, where the body operates a membership scheme, an individual who is not a member, of services closely linked with and essential to sport or physical education in which the individual is taking part.

BASC raised some relatively minor objections to the way in which the EU law was transposed into the VAT Act, but its main grounds for appeal were that the UK law should apply to exempt the income.

The chairman commented that there was a possible doubt about whether the subscription income really represented consideration for supplies to the members, but took support from the Court of Appeal's 1998 decision in *British Field Sports Society* for the view that it was, and that there was a direct link between what the members paid and all the activities that the association undertook on their behalf. The parties did not argue otherwise.

As in other recent cases on the "civic nature" exemption, the Tribunal held that the objects of the company were too broad and not sufficiently focussed to fall within that expression. It was a public-spirited and responsible body, but that did not make it exempt, particularly as exemptions must be construed strictly and narrowly. Although the company carried out some political lobbying, it was not generally a political body either.

In relation to Group 10, the chairman held that the supplies were not sufficiently closely related to sporting activities to qualify for exemption, even if it was accepted that the UK's addition of the expression "essential to sport" was a departure from the 6th Directive. The Directive's expression "to persons taking part in sport" suggested to the chairman a supply that had a direct link with actual participation. "*None of BASC's supplies is in that category: it does not provide to its members the land on which they may shoot, the game they may shoot at or the guns with which they may shoot it.*"

Accordingly, the appeal was dismissed. The chairman left it to the parties to determine what adjustment should be made for allowable input tax.

VAT Tribunal (20,739): *The British Association For Shooting And Conservation Ltd*

2.4 Zero-rating

2.4.1 Pringles

Most "potato products" are standard rated as exceptions to Group 1 of Schedule 8. Pringles crisps have traditionally been so treated. In Tribunal 18,381, the manufacturers argued that a new, thicker "dipping Pringle" which was only 36% made of potato should be zero-rated like tortilla chips, rather than standard rated like crisps.

Customs argued that they were too similar to the existing crisps to be treated differently. However, the Tribunal agreed with the taxpayer. The implication of the legislation was that potatoes had to be the majority ingredient, perhaps the overwhelming majority. The new product was at least as similar to a tortilla chip as it was to a potato crisp.

However, another Tribunal came to a different decision on "regular Pringles". These are made of a number of different types of flour (including rice flour, corn flour and wheat starch) together with fat and emulsifier. The potato content varies, but is likely to be around 42%. The company argued that the earlier decision, together with the fact that Pringles are not similar to crisps and are not called or marketed as crisps, meant that they should be zero-rated as well.

The definition of the excepted item is "*potato crisps, potato sticks, potato puffs and similar products made from the potato or from potato flour, or from potato starch*". The Tribunal chairman said that this created two separate tests: the item had to be a "similar product" to those listed, and it had to be made from potatoes. Tortilla chips might be quite similar to crisps, but they were not made of potatoes; there were also potato-based products that were not similar to crisps, and they also would not be excepted.

The Tribunal examined the background to the legislation in detail. It acknowledged that there is no logical basis for it now: it pre-dates VAT, having been introduced in 1969 to levy purchase tax on foodstuffs which were more likely to be bought at a confectioner's than at a grocer's. The market for such products has developed beyond recognition since then, but the law has stayed the same – taxing potato snacks, popcorn and peanuts, but leaving untaxed many other competing products. Given that the law was no longer logical, it was not particularly helpful to try to discern or apply the purpose of Parliament in passing it.

After considerable thought, the chairman decided that "made from potato flour" applied to a product whose largest single ingredient was potato flour; Pringles might be different from other crisps, but they were nevertheless similar to potato crisps. They therefore satisfied both parts of the exception. The appeal was dismissed.

The High Court judge has now allowed the company's appeal. The two limbs of the excepted item were not wholly separate but rather should be read together. The items which were "similar" in the second part of the test should be as much made from potato as those in the first part. A potato stick made from pure potato would have some other products in it, such as residual oils, but it would be predominantly potato. A stick made of potato flour would correspond to that; a stick made of flour that was half potato and half something else would not. On the basis of the Tribunal's findings of fact about the constituents of Pringles, they were not "made of potato flour" within the meaning of the statute.

High Court: *Procter & Gamble (UK) v HMRC*

2.4.2 Ciabatta melts again

A company operates 39 bakery outlets in the north-west of England. One of its products is a "ciabatta melt", which is supplied from a factory in half-cooked condition and finished on the premises. According to food safety regulations, hot food must either be maintained at a temperature above 63 degrees Celsius, or else cooled rapidly to below 8 degrees. It is therefore practically impossible for such food to be sold at the ambient air temperature; if the trader chooses the hot option, it will be above the ambient air temperature at the time of supply, and HMRC are likely to argue that it is standard rated.

In *Ainsleys of Leeds Limited* (19,694), the Tribunal accepted that a similar product could be zero-rated because it was not the intention of the trader that the food should be consumed at above the ambient air temperature. There were various other reasons for the heating of the product, and the temperature of consumption was a matter of indifference. The managing director of the current appellant knew Mr Ainsley well and submitted a claim for repayment on the basis that the facts were identical.

The managing director was subjected to cross-examination by HMRC's counsel and he stuck to his line that the purpose of heating the melts was to sell them freshly cooked, not for hot consumption. There were other products called "toastie melts" which were similar but were standard rated, because it was expected that customers would eat them hot. The Tribunal chairman appears to have been convinced by this.

The chairman also comments that it was surprising that HMRC should take such a similar case to the Tribunal when they did not choose to appeal the *Ainsleys* case further. Although the Tribunal does not set a binding precedent, the cases were so similar that the decision would surely be the same – unless HMRC believed that the earlier decision was flawed, in which case they should probably have appealed it.

VAT Tribunal (20,761): *Waterfields (Leigh) Ltd*

2.4.3 For young children?

Item 1 Group 16 Sch.8 VATA 1994 provides zero-rating for "*Articles designed as clothing or footwear for young children and not suitable for older persons*". This resolves into two tests: one of design and one of suitability. An item must satisfy both tests before it can be zero-rated.

A company retailed school uniforms. It disputed a decision by HMRC that some of the larger clothes it sold were standard rated. These fell into the following categories:

Primary and middle school garments that fell outside the size criteria in Notice 714: HMRC had accepted before the hearing that these fell within the exception provisions of the Notice and would therefore be zero-rated.

Secondary school garments that fell outside the measurements in the Notice, but which had been modified from the normal dimensions used by the manufacturer so that they have smaller collars and cuffs than the standard: they are designed to fit younger but overweight children. HMRC accepted during the hearing that these might possibly meet the design criteria, and agreed to discuss them further with the appellant.

Secondary school garments that fell outside the measurements in the Notice and which had not been adapted by the manufacturer: the trader's argument here was that they were generally sold at induction evenings and were therefore bought for children who were under 14 at the time (generally only 11).

HMRC had accepted zero-rating for the first category; the second category was to be discussed, and the Tribunal made no finding; the third category failed the design test, and the appeal was therefore dismissed.

VAT Tribunal (20,758): *Forsters School & Leisurewear Ltd*

2.4.4 New manual

HMRC have published a new "clothing manual" which explains the liability of supplies of clothing and footwear as set out in Group 16 Sch.8 VATA 1994.

www.hmrc.gov.uk/manuals/vclothingmanual

There is also a new manual explaining the rules on protective equipment.

www.hmrc.gov.uk/manuals/vprotequipmanual

2.4.5 Books etc.

Two companies provided "wedding books" to members of the public and to professional photographers. These were similar to traditional wedding photograph albums, but were produced using modern technology as books rather than albums into which loose pictures were inserted. A certain amount of text could be added at the direction of the customer.

HMRC ruled that the supplies were standard rated supplies of a photo album rather than a zero-rated supply of a book. Alternatively, there was a single supply of photographic services of which the resulting "book" was an integral part, and was not a separate zero-rated supply.

The Tribunal examined the meaning of the word "book" in the legislation and in precedent cases such as *Colour Offset Ltd*. The conclusion was that the product did not fall within the ordinary meaning of "book" and did not qualify for zero-rating. On the question of separate supplies, the Tribunal concluded that there was a single supply of photographic services. Although the circumstances were slightly different for the two companies – one supplied the photography as well as the book, and the other turned the pictures of other professional photographers into a book – the essential nature of the supply was the same in both cases.

This is a little strange in that the first part of the decision makes the second part unnecessary, but presumably the Tribunal wanted to deal with both issues in case there is an appeal. The trader lost here on both arguments, either of which would be enough to make the supplies standard rated.

VAT Tribunal (20,783): *Risbey's Photography Ltd; Digital Albums Ltd*

2.5 Lower rate

Nothing to report.

2.6 Computational matters

2.6.1 Rounding again

In the case of *Topps Tiles*, the UK Tribunal had to consider whether it was appropriate to round down the VAT on all individual sales, or whether it should be rounded "mathematically" (up or down) to give the right overall result when looking at the total transactions for a period. The case also raised the question of whether the rounding should be applied to individual items, individual lines on an invoice or the total of an invoice. The Tribunal held that the most accurate calculation was the best: mathematical rounding applied to the largest possible figure.

The same issues have now been raised in questions to the ECJ in a Dutch case. After the supermarket chain Ahold decided that it should be entitled to round down, and do so item-by-item rather than on totals, Netherlands law was changed to require mathematical rounding. To test the rules, Ahold prepared alternative calculations in two of its supermarkets: its traditional approach, which was to round "per shopping basket" (or invoice) by totalling the standard rated items (applying 19/119) and lower rated items (applying 6/106) and items that were not subject to VAT; and a different approach that rounded down on each individual item in the basket. The difference was an alleged overpayment of €1,414 that became the subject of a test case. This reached the Hoge Raad, which decided to refer the issue to the ECJ.

The questions for consideration are as follows:

"*Is the rounding-off of VAT amounts governed solely by national law, or – particularly in view of the first and second paragraphs of Article 2 of the First Directive 1 and Article 11 A(1)(a) of the Sixth Directive and Article 22(3)(b), first sentence, (version as at 1 January 2004) and (5) of the Sixth Directive 2 – is it a matter for Community law?*

If the latter is the case, does it follow from the aforementioned provisions of the Directives that the Member States are required to permit rounding-down per article, even if different transactions are included in one invoice and/or one tax return?"

The parties to the dispute agreed that the rounding should be carried out "per item", but the Dutch court took the same view as the UK Tribunal in its opinion – that the rounding should be applied to the total of the transactions for a period. This is because "*the euro is considered a unit of account rather than a currency – only when determining the total VAT amount payable can the euro be considered a VAT relevant currency and at that point rounding-off is relevant*".

The Advocate-General gave an opinion that broadly agrees with the Dutch court, although not for such an obscure reason. His starting point was that there is nothing in the Directive which explicitly deals with rounding calculations, so it must be up to member states to regulate how this is done. In drawing up their own rules, member states must not do anything that is contrary to the Directive.

The Advocate-General considered that a rule permitting rounding down on each item would be contrary to the Directive. He commented that the distortion would be substantial, even if the individual calculations were only in fractions of a cent – the UK submitted an estimate of the likely

cost to the UK revenue if rounding were permitted as approximately £70m pa in respect of the four largest supermarket chains, and the Advocate-General found that a credible estimate. As a result, systematic rounding – always in the same direction – would be significantly distortive and should not be allowed.

The Advocate-General went on to argue in favour of maintaining the records of a retailer in VAT-inclusive figures up to the preparation of the return, and rounding only at that stage, to minimise the distortion and so provide the authorities with the most accurate amount of VAT possible.

Fortunately, the ECJ's final judgment does not require member states to do anything that would involve changing existing practice. It rules that there is nothing in the 6th Directive or elsewhere in community law that prescribes a particular method of rounding, so it must be up to the member states to determine how rounding shall be carried out. Member states must decide on their own rules having regard to the principles of fiscal neutrality. The observations of the Advocate-General on proportionality and the best way of achieving it are then relevant, but they will not be prescriptive for member states who want to do something slightly different (e.g. to round per invoice or per invoice line, rather than maintaining all the records in VAT-inclusive amounts).

There is also nothing in the 6th Directive that requires member states to allow all rounding to be made downwards. In effect, that judgment means that member states are free to require mathematical rounding.

ECJ (Case C-484/06): *Fiscale eenheid Koninklijke Ahold NV v Staatssecretaris van Financiën*

Note that the same issues appear to be covered by the case of *JD Wetherspoon plc*, referred by the UK Tribunal and expected to be heard in October 2008. The Tribunal has requested rulings on:

- whether the rounding of VAT was governed solely by national law, or by Community law; on whether Community law prevents the application of a national rule or practice of the national taxing authority which requires rounding up of any given VAT amount whenever the fraction of the smallest unit of currency is concerned is at or above 0.5;
- whether Community law requires that taxpayers be allowed to round down any VAT amount which includes a fraction of the smallest unit of currency available;
- whether Community law requires rounding at the level of each individual item, each line of goods, each supply (if more than one supply is included in the same basket), each transaction/basket total, or each VAT accounting period or some other level.

These questions appear to be resolved by the Ahold decision, and it is not clear whether anything different is involved in this case. The Tribunal has not reported its decision or its findings of fact, even though the ECJ has allocated the case a number and a date on its timetable.

2.6.2 Leisure passes

A company supplied a pass which entitled the holder to visit a number of attractions in London over a set period. The passes were like credit cards with an electronic chip which could be read by a machine at the attraction. Entry to some of the participating venues would be exempt, others would be taxable.

The company tried to argue that the cards qualified as "face value vouchers" within VATA 1994 Sch.10A. Holders could visit each attraction once only during the validity of the pass, so the theoretical "face value" was the total entry price of one visit to each of the attractions.

The Tribunal did not accept this. There was no face value on the voucher in the normal sense. It was not intended that holders would visit everything – this had apparently only been achieved once. The card was a single supply of the right to visit attractions over a period, and it neither qualified as a voucher nor for any reliefs or exemptions.

The Tribunal commented that this was perhaps an anomalous result because it meant that there would be a VAT cost to foreign visitors to exempt attractions, but it was not possible to interpret the VAT law in any other way.

The High Court has upheld this decision. There was no monetary limit shown on the pass, only a time limit. The pass never expired because the holder had exhausted a monetary value which could be consumed; it would only expire because the period of validity had ended or the holder had used it once at each of the listed attractions. It did not fall within Sch.10A.

High Court: *Leisure Pass Group Ltd v HMRC*

2.7 Discounts, rebates and gifts

Nothing to report.

2.8 *Compound and multiple*

2.8.1 More weight loss

The organisation Weight Watchers recently went to the Court of Appeal in an argument about whether they were providing a single taxable service or a mixed supply including zero-rated printed matter. Now a company has been to the Tribunal arguing a similar question, except that the possible zero-rated element was a "dietary food pack".

The appellant company was one of some 300 franchisees whose business would be affected by the decision. The franchisor operates under the name "LighterLife". The programme offers rapid weight loss to the seriously overweight, and is supposed to work by a combination of replacement of other food by dietary LighterLife food packs and counselling and advice in weekly group sessions run by the franchisee. The customers pay for the food packs but make no specific payment for the support services. It was accepted that the food packs would, on their own, be zero-rated.

The Tribunal identified the issues as follows:

(i) does a participant give consideration for the provision of the support services: when he pays for the food packs is that payment also consideration for the support services, or are they provided free?

(ii) if consideration is given for the support services, is the Appellant making two separate supplies, one of support services and the other of food, between which the consideration should be apportioned, or one single composite supply?

(iii) if the Appellant is making a single composite supply is that supply zero-rated (as a supply of food) or standard rated?

(iv) if the Appellant is making multiple supplies for consideration, how should the consideration be split between the supplies?

In relation to the first issue, the Tribunal considered a number of precedent cases and suggested that the approach should be as follows:

1. the object is to determine whether there was an agreement between the Appellant and its customer pursuant to which there was reciprocal performance – the money paid constituting the value given for the goods, the services or the goods and services;

2. whether or not there was such an agreement requires consideration of objective factors by reference to all the circumstances;

3. that may involve finding the precise way in which performance satisfies the interests of the parties;

4. the subjective reasons which led the parties to enter into the agreement, and what a party might have believed or knew are irrelevant save in so far as such reasons or belief are objectively reflected in the circumstances;

5. the fact that a party may choose not to avail himself of a benefit does not mean that he has not given consideration for its being made available. But, the fact that the provision of an extra service does not affect the price may suggest that the service is not provided for consideration.

The Tribunal examined what the LighterLife programme involved in detail in order to decide what the customers obtained for their payments. In the

advertising material and in the way the programme operated, it appeared that the counselling sessions were important. The Tribunal therefore held that consideration was being given for those services in the form of part of the payment for the food packs.

Next, the Tribunal considered the relationship between the counselling and the food packs, and decided that "forward-looking" counselling was not ancillary. Some of the initial counselling might be regarded as such, because it was basically encouragement to stick to the diet and use the food packs in the best way – but later in the programme, the advice was how to keep the weight off while returning to other foods.

Next, the Tribunal examines whether it would be artificial to split the supplies, and decides that it would not. Although apportioning the single consideration would cause some difficulties, it would be very different from apportioning the price of a restaurant meal. The two parts of the supply were quite distinct: they each had their own purpose and neither would be useless without the other.

The Tribunal notes in passing that it would have decided that a single supply would be standard rated because it could not be described as simply a supply of food. The decision then considers how the multiple supply should be split. HMRC suggested that 60% should be food; the appellant argued for 91%. The Tribunal observed that it was difficult to arrive at either market values or profit margins for establishing an apportionment, and even a cost-based approach would have to be an approximation. Its suggestion was that:

- all the costs of the food packs themselves were clearly related to the zero-rated sale;
- the remaining costs should be allocated 25% to zero, 75% to standard;
- the result was 2/3 zero, 1/3 standard.

The appeal was allowed in part on that basis.

VAT Tribunal (20,757): *David Baxendale Ltd*

2.9 Agency

Nothing to report.

2.10 Second hand goods

Nothing to report.

2.11 *Charities and clubs*

2.11.1 Charity challenges

HMRC have issued a Brief to set out revised guidance on "charity challenge" events which raise funds through sponsorship of the individuals taking part. The new guidance is incorporated as an update to Notice 701/1 (issued April 2000, updated July 2008).

Following representations from the charity sector HMRC have been working with the sector to produce revised guidance to assist charities to determine the correct VAT liability of such events.

HMRC have now produced revised guidance with examples and a flowchart to be used with the guidance. The revised guidance is included as updates to Notice 701/1 *Charities* and Notice CWL4 *Fund-raising events: Exemption for charities and other qualifying bodies*.

The guidance will have effect from 31 July 2008. However, HMRC are aware that some charities are likely to have signed contracts sometime before the events are due to take place. HMRC therefore accept that where a contract for an event has been signed or negotiation with suppliers has started or the event has been publicised prior to the publication of the new guidance, charities can account for VAT using their previous procedures.

Charities may wish to revisit their previous records and make claims for VAT incorrectly treated in respect of previous contracts.

The new guidance states that participation in such events will only constitute a supply by the charity if there is a requirement for the participant to pay the charity a set amount as a condition of taking part. If that is not the case, there is no consideration for a supply and any money passing is a donation.

If there is such a minimum contribution, the supply can be within the fundraising exemption unless:

- the charity is supplying a package which includes accommodation and travel;
- the charity is supplying bought-in accommodation;
- the charity is supplying accommodation from its own resources amounting to two nights or more.

In the first two cases, the supply is likely to be within TOMS. The precise treatment will depend on whether the charity is acting as a principal or as an agent for a specialist company which organises the package. Those charities affected by this should study the guidance in the original.

Revenue & Customs Brief 36/08

2.11.2 Value of supplies of fundraiser

An individual entered into an agreement with a charitable trust which provided holidays for disabled people. He would act as a national fundraising manager. The structure of fundraising through collectors in supermarkets was set out as follows:

"C*ollectors would be paid 35% of the money taken by them and field managers who were to supervise the collectors would be paid 10% of the money taken by the collectors they were supervising and 5% would be paid to a booking clerk who arranged with supermarkets that the collectors could attend. Mr Hands said that initially he proposed that he should receive 25% to cover the expenses of running an office, managing the collectors and other staff and to provide his income. The Trust would then have received 25% but by negotiation the parties arrived at the agreed figure of 20% for the Trust upon it being agreed that Mr Hands would also provide the tickets.*"

However, two representatives of the trust did not agree that this breakdown had been agreed. The appellant admitted that it had not been operated exactly as described. He argued that he had ended up with about 35% of the money collected, and that is what he should have to pay output tax on. The possible technical merit of this depended on the agreement creating a direct relationship between the charity and the other people who kept some of the money.

HMRC argued that he was independent of the charity and the agreement provided for him to receive 80% of the takings. He then met his own costs out of that 80%. That was no different from many other traders. He would account for output tax on the 80% and deduct input tax to the extent that his expenses were VATable (which, in the main, they would not be).

The Tribunal preferred HMRC's version of the situation. It appeared that the appellant operated independently of the charity, to the extent that he eventually fell into dispute with the charity and ceased the relationship. As a matter of fact, he received the 80% and only passed on 20%. A misdeclaration penalty was also confirmed.

VAT Tribunal (20,788): *Terry Hands*

2.12 Other supply problems

2.12.1 Goods or services, or both?

A company supplied scaffolding for construction projects. It argued that its supplies fell within Sch.8 Group 5 item 2(a): the supply of services in the course of construction of dwellings. However, HMRC argued that the supplies were excluded from zero-rating by Note 20, which refers to "services described in para.1(1) Sch.4". This in turn refers to transfers of undivided shares of property or of possession of goods. HMRC's policy is that the supply of scaffolding includes the hiring of goods (transfer of possession), and this is always standard rated.

The Tribunal was referred to three cases which have considered this issue:

- *Peter J Guntert, The Abingdon Scaffolding Co.* (10,604) in which the supply was held to be wholly standard rated;
- *GT Scaffolding Ltd* (18,226) in which it was held to be wholly zero-rated;
- *R&M Scaffolding Ltd* (18,955) in which it was held to be a multiple supply, partly zero-rated.

The facts of the last two cases were distinguished at that time – the later decision was based on the evidence that the scaffolder certified the structure as safe and then handed over possession to the customer. In the earlier case, the scaffolder was so bound by safety regulations that the Tribunal considered the company to remain in possession of the structure throughout the period it was erected.

The appellant argued that its supplies were identical to those in the *GT* case. The chairman disagreed: there was an important distinction in one of the terms and conditions, which restricted liability for losses arising after erection to those attributable to the appellant's negligence. In effect, other risks had been passed to the customer, and this constituted a transfer of possession for the purpose of the zero-rating provision. HMRC's counsel suggested that the *GT* decision was incorrect in any case, but the Tribunal distinguished the facts rather than disagreeing with the principle. The appeal was dismissed.

As the appeal was only against the principle of any of the supply being standard rated, it appeared that HMRC's apportionment of the consideration between zero-rated services (erection and removal of the scaffold) and standard rated hire was not disputed by the appellant. The assessment was therefore confirmed.

VAT Tribunal (20,741): *Pharaoh Scaffolding*

3. LAND AND PROPERTY

3.1 Exemption

Nothing to report.

3.2 Option to tax

3.2.1 Transfer of going concern and OTT

A property investment company acquired the landlord's interest in a lease which had been entered into for 25 years from 1986. A pair of individuals acquired the tenant's interest and sub-let the property to another individual from July 2001 until 2010. The sub-tenant operated a restaurant business as a partnership which applied for VAT registration with effect from 6 April 2003.

In June 2003 the appellant (the property company) elected to waive exemption over the property. Later that year they decided to sell their interest to the tenants. The missives provided that the intention was for the transaction to be treated as a transfer of a going concern, but that the purchaser would pay the VAT to the vendor if and when Customs issued a ruling that the transaction was VATable.

The evidence about what happened next appeared to be unclear and incomplete. It seems that the purchasing tenants and their solicitor gave assurances to the vendors about the conditions for TOGC status that were not then followed through: no effective option to tax was made, and the lease was very soon surrendered so that the individuals could carry on a restaurant business in partnership. When HMRC discovered these facts, they assessed the vendor for VAT on the sale of the property.

The Tribunal recognised the reliability and good faith of the director of the appellant, and had some sympathy for the difficulties that the other party to the transaction had caused him. However, the appeal had to fail for the reasons that HMRC advanced: the conditions for TOGC status were not met for several different reasons. It was certainly not enough that the director had believed in good faith that the sale would be a TOGC.

The Tribunal commented that an action by the vendors to recover the VAT from the purchasers in the local Sheriff Court seemed indefensible, although it was not possible to be absolutely sure about this without sight of all the evidence produced there. Of course, winning the action is one thing: recovering the cash is another. However, the purchasers ought to be able to recover the VAT in their turn from HMRC – provided there is no other problem with that claim, such as HMRC operating the cap.

VAT Tribunal (20,742): *Sydenham Commercial Property Ltd*

3.2.2 OTT "washing out" scheme

A partnership operated a self-storage business from a building which had been opted in January 1995. In 2004 (after 31 March, the expiry of the capital goods scheme adjustment period for the partnership) they sold the building to a company which did not wish to charge VAT to its customers, nor to incur £875,000 of irrecoverable input tax on the purchase of an opted building. The parties to the transaction therefore tried to argue that the option was disapplied on the transfer of the building between them.

HMRC alleged that the transactions entered into by the parties formed a tax avoidance scheme called an "option washing out" arrangement. This was intended to use (or abuse) anti-avoidance provisions to create the result that the parties wanted – a sale without output tax.

The idea of the scheme was that the purchaser would pay for certain works to be carried out to upgrade the fire safety in the building. This would amount to more than £250,000 and would make the building a capital item once more. The intention of the purchaser to occupy the building without opting to tax it would then lead to the disapplication of the option to tax, because at the time of the vendor's grant, a financier of the development would be expected to occupy the building for exempt purposes. A letter was sent to Customs to confirm that this was how the rules worked; after an initial rebuff another letter was sent explaining how the scheme worked in more detail. At this point the officer appeared to realise that this was a tax avoidance scheme and refused to give a ruling.

The purchaser took counsel's opinion on the likely success of the scheme and was assured that there was a 90% chance of it working as it was supposed to. On that basis the parties proceeded with the transaction. The vendor sent a letter to Customs on 30 November 2004 explaining what had happened and asking for confirmation that "all was in order" (i.e. that the option would not apply to the sale). Customs replied at length in December 2005 stating that VAT was due on the disposal of the site.

Assessments were subsequently issued for £393,750 (in respect of the sale of the business in one quarter) and £875,000 (in respect of the sale of the building in the next quarter), together with misdeclaration penalties on both amounts. It was suggested that the penalties could be mitigated by 5% for cooperation with Customs' enquiries. Subsequently Customs dropped the assessment on the business itself (apparently accepting that it could be a TOGC separate from the business) and also the penalty (presumably on the basis that a reasonable trader would rely on confident professional advice). An argument based on "abuse of rights" was also dropped, and a revised statement of case introduced as late as March 2008 in preparation for the Tribunal hearing.

The appellants' counsel analysed the arguments for disapplying the option to tax as follows:

(a) the Property was an asset falling in relation to the West London as grantor to be treated as a capital item for the purposes of the Capital Goods Scheme Regulations (Regulations 112 – 116 of the VAT regulations 1995) (paragraph 3A(2)(a)).

[He called this the objective test.]

or

(b) West London, the grantor, or Shurgard, a person responsible for financing West London's development of the Property for exempt use, intended or expected that the Property would become an asset falling in relation to West London to be treated as a capital item for the purposes of the Capital Goods Scheme Regulations (paragraph 3A(2)(b)).

[He called this the subjective test]

The Tribunal agreed that these two tests were the correct interpretation of the law. However, the Tribunal was not persuaded that the property was a capital item from the vendor's point of view. The works were carried out with a view to selling the property, not to using it in the self-storage business; that was clear from a great deal of evidence. The date of cessation given in the partners' self-assessment tax returns suggested that they regarded their activity as ceasing before the works were carried out. The Tribunal therefore believed that the objective test failed.

The appellant's subjective test was based on the argument that the parties expected the property to become a capital item because their professional advisers said that it would. The Tribunal rejected that as "*tantamount to asserting that because a person desires their intended actions to have a particular legal consequence, they are to be construed as having that consequence, no matter what their actual effect in law*". In any event, because of the interpretation of "capital item" adopted by the Tribunal in relation to the objective test, the parties had not really expected the property to become one. They might have mistakenly believed that what they intended to do would create a capital item, but that was not the case.

As the Tribunal formally allowed the appeals against the earlier assessments and the misdeclaration penalty, it did not award costs against the partially successful appellant. However, it dismissed the appeal against the 2008 assessment for £875,000 plus interest on the sale of the building.

VAT Tribunal (20,797): *Shurgard Storage Centres UK Limited & Graham Anthony Farley and Philip Robert Cox*

3.3 Developers and builders

3.3.1 Building materials

A company supplied indoor swimming pools in new houses. HMRC ruled that the supply of two different items failed the test for "building materials" and could therefore not be supplied zero-rated (and the input tax would be blocked for the developer making an onward zero-rated supply of the completed house):

- electrically-powered, fully-retractable and insulated swimming pool covers;
- a moveable tiled floor to an indoor swimming pool that could be locked in its "high" position, so that the swimming pool completely disappeared and the floor became part of the tiled floor in the house in question.

HMRC accept that swimming pools can be zero-rated within new houses, but they argued in this case that this is not because they are themselves "building materials" – it is because they are created out of the same kind of materials as the rest of the house. It is not accepted that swimming pools, and the various pieces of equipment that go with them, are "ordinarily installed in dwellings".

In addition, both the retractable covers and the moveable floors were electrically powered and were therefore excluded from "building materials" by virtue of being "electrical appliances". This was the decision of the Tribunal in the case of *Leisure Contracts* (19,392), in which the Tribunal had held over its decision to await the ECJ's judgment in *Talacre Beach Caravan Sales* (Case C-251/05). When that case confirmed that a single sale can be partially zero-rated, the taxpayer in that case accepted that the covers were excluded from zero-rating.

The Tribunal observed that HMRC's Notice 708 section 13 lists "articles ordinarily incorporated in buildings" and includes indoor swimming pools. It was sensible to interpret the law as meaning "ordinarily incorporated in the type of dwelling under consideration", rather than "ordinarily incorporated in all dwellings", because HMRC's list made no sense otherwise. Swimming pools were commonly incorporated in luxury homes.

The Tribunal then considered that retractable covers are ordinarily installed with a swimming pool, as over 90% of new pools would have one. The fact that such a cover might be electrically powered did not make it "electrical equipment": it could easily be operated with a manual crank instead, and the cost of the electrical motor was trivial in comparison. The appeal was allowed in respect of the retractable covers.

However, the moveable floors were highly unusual: it was suggested that only a handful had so far been installed in the UK. The floor was not a fundamental part of the pool itself (which could then be treated as a single item). The floors were therefore not "ordinarily installed" even in the context of luxury homes, and were therefore excluded from zero-rating.

VAT Tribunal (20,800): *Rainbow Pools London Ltd*

3.3.2 Conversion project

A company applied for VAT registration and appealed against HMRC's refusal. It claimed that it intended to make zero-rated supplies of major interest grants in dwellings which it created by converting non-residential parts of buildings. HMRC concluded that it would only make exempt supplies because the projects did not fall within Sch.8 Group 5 Item 1(b) VATA 1994.

The point at issue was that the dwellings were to be created in the loft space of existing blocks of flats. HMRC argued that the buildings were already residential. The company countered that the parts of the building that were being converted into dwellings were not residential within note 7 to Group 5 or, if they were, they had not been occupied as such within the last 10 years.

The notes to Group 5 provide:

(7) For the purposes of item 1(b) … a … part of a building is "non-residential" if-

(a) it is neither designed, nor adapted, for use-

(i) as a dwelling or number of dwellings, or ….

(b) it is designed, or adapted, for such use but-

(i) it was constructed more than 10 years before the grant of the major interest ; and

(ii) no part of it has, in the period of ten years immediately preceding the grant, been used as a dwelling … .

(8) References to … a non-residential part of a building do not include a reference to a garage occupied together with a dwelling.

(9) The conversion, … of a non-residential part of a building which already contains a residential part is not included within item 1(b) … unless the result of that conversion is to create an additional dwelling or dwellings.

The appellant argued that the wording of notes 8 and 9 suggested that loft spaces were capable of being non-residential parts of residential buildings. Garages had to be specifically brought within the definition of a "residential part", and loft spaces were not included in that; and note 9 clearly contemplates the possibility that a mainly residential building such as a block of flats could contain non-residential parts. As the effect of the conversion project was to create new dwellings in the loft spaces, note 9 appeared to confirm that the work was zero-rated within Item 1(b).

HMRC's counsel argued that the roof and roof space were integral to the building, and were therefore integral to the residential use of the building. It would be artificial to treat them as a separate part of the building when they were an essential part of the residential occupation of all the leaseholders.

The Tribunal agreed with the trader. The initial impression was that the empty roof spaces, which did not fall within the leasehold rights of any of the occupants of the buildings below, were non-residential. The wording of note 9 strengthened the impression that this should qualify for zero-rating, and the decision of the Court of Appeal in the *Jacobs* case confirmed it. The appellant should be registered for VAT and in

consequence should be allowed to recover its input tax incurred in the project.

VAT Tribunal (20,810): *Merlewood Estates Ltd*

3.3.3 Cottages in grounds of care home

A family partnership arranged for the construction of seven self-contained cottages in the grounds of a large house which was used as a care home. They claimed that the supply of construction services to them, and the supply of major interests in the buildings by them, would be zero-rated as the buildings were dwellings.

HMRC ruled that the supplies would be standard rated because of planning conditions which prohibited the disposal of the cottages separately from the care home. This contravenes note 2(c) Group 5 Sch.8:

"*the separate use, or disposal of the dwelling is not prohibited by the term of any covenant, statutory planning consent or similar provision;*"

The appellant argued that:

(a) that there was no prohibition on the separate use of the building: condition (c) is expressed in the alternative "separate use, or disposal", and since the separate use was not prohibited the condition is satisfied; and

(b) in any event the covenant not to dispose of the freehold separately was not a prohibition on the disposal of the cottages because (i) the separate disposal of long leases was not prohibited, and (ii) the covenant was subject to certain exceptions.

It was accepted that the other conditions of Note 2 were satisfied (self-contained accommodation with no internal access and constructed in accordance with planning consents).

The Tribunal considered in detail the meaning of the words and the comma in Note 2(c). It came to the same conclusion as other previous Tribunals that the condition is failed unless both separate use and separate disposal are permitted. The terms in the law could be clearer, but the meaning is certain: failing either condition means that the result is not a dwelling.

However, the Tribunal agreed with the appellant's second argument that the planning consent did not prohibit separate use or separate disposal. It forbade disposal of the freehold interest separate from the freehold of the main house, but that did not prevent the grant of leasehold interests. HMRC's attempt to argue that the legislation implied the disposal of the freehold interest was examined in detail and rejected. The disposal of a major interest lease would be a zero-rated supply, because the buildings were dwellings.

VAT Tribunal (20,775): *JFB & FR Sharples*

3.3.4 Village hall

A village association arranged for the construction of an addition to the village hall. If it was a self-contained annexe, the construction could be zero-rated; however, HMRC ruled that it was an extension of the existing building and failed the tests in Notes 16 and 17, Group 5 Sch.8 VATA 1994.

The Tribunal considered the meaning of the law and decided that it was possible for a construction to be an extension and an annexe at the same time. If the subject of the case had been an annexe but not an extension, the Tribunal believed that it would have been zero-rated because it satisfied the conditions of Note 17; however, it was an extension as well as an annexe, and was therefore excluded from zero-rating by Note 16(b).

HMRC's representative indicated that if HMRC had been approached at the planning stage, it might have been possible to agree plans which were acceptable to them as giving rise to an annexe and not an extension. That might help others in the future, but was of no assistance to the appellants.

VAT Tribunal (20,746): *Abercych Village Association*

3.4 Input tax claims on land

3.4.1 Letting instead of selling

HMRC have issued a Brief and an Information Sheet to clarify the VAT position where a house builder decides to let a new house instead of selling it. The Information Sheet explains the principles of the cases of *Briararch* and *Curtis Henderson* (High Court 1992) which established that:

- the supply of a major interest in the house by the housebuilder after the expiry of the letting was still a zero-rated supply, because it was the first grant of a major interest by the person who had constructed the building;
- the supply of the minor interest was exempt and triggered a clawback under reg.108 SI 1995/2518;
- that clawback had to be calculated on a just and reasonable basis.

The Information Sheet is interesting in that it appears to mix together clawback under reg.108 with partial exemption calculations under reg.101. Reg.108 does not appear to have a de minimis test in it, but the Information Sheet suggests that a builder who lets out a house instead of selling it should carry out a "simple check for de minimis" in accordance with the following example:

A fully taxable house builder recovered £20,000 input tax on a house that he expected to sell for £300,000. After the end of the tax year he decides to defer the sale by letting for two years and so becomes partly exempt. A simple check for de minimis is:

£20,000 input tax x 2 year lease/10 year economic life = £4,000 exempt input tax

The £4,000 of exempt input tax is de minimis because over the tax year it does not exceed £7,500 or 50 per cent of his total input tax. The builder has no need to adjust the VAT previously recovered on his VAT returns. If the input tax was incurred over more than one tax year, the de minimis test should be applied to the input tax incurred in each of the tax years separately.

As the intention has changed after the end of the tax year (particularly if the input tax was incurred over more than one tax year) this appears to be an application of reg.108 rather than reg.101 and reg.106.

The Information Sheet goes on to explain how a reg.108 clawback should be calculated. The following points are important:

- the clawback applies in the period in which the intention changes (generally from "wholly taxable sale" to "partly exempt letting and partly taxable sale"), which may be before the actual exempt letting takes place;
- the clawback adjustment is a one-off calculation, which does not change if the facts turn out not to be as expected (e.g. the amounts received for letting or sale are higher or lower than those used in the calculation);
- the clawback is the difference between the input tax that was recovered (usually 100%) and the input tax that would have been

recovered at the time the input tax was originally incurred using the partial exemption method in operation at that time, had the revised expectation of use (usually residual) been in force at that time.

HMRC say that "*A large house builder is likely to be already operating a partial exemption method, but a small house builder may not. If a house builder was not already operating a partial exemption method then he must apply the standard method unless he obtains HMRC approval to apply a special method instead.*"

HMRC then go on to suggest an alternative calculation that they will "exceptionally allow" for a clawback adjustment in place of the standard method. An example of this is given, but there is no example of the standard method.

A calculation based on the values of supplies is normally fair and straightforward provided it is based on reasonable estimates and valuations:

Estimated eventual sale value/
Estimated eventual sale value plus estimated short let premiums and rents

Example: house builder preparing a clawback adjustment using values

A house builder expects to sell two houses for £500,000 each. The input tax recovered during the tax year was £50,000. After the end of the tax year the decision is taken to rent them for a period of three years generating estimated rental income of £200,000. The house builder makes no other supplies.

£50,000 input tax incurred x £1,000,000/£1,200,000 = £41,667 recoverable input tax

£50,000 input tax previously recovered – £41,666 = £8,334 to be repaid to HMRC

The peculiar point about this is that the clawback is supposed to be measured as at the time when the input tax was originally recovered. The "alternative calculation" uses future supply values, which seems fair and reasonable; but the standard method would use the residual recovery rate for the period in which the input tax was incurred. It seems likely that in many of the cases affected, that residual recovery rate would have been 100% – if the housebuilder only made taxable supplies in the period in which the input tax was incurred, and the exempt letting income is some time in the future, the "clawback" would be the difference between 100% recoverable (attributable to the original fully taxable expectation) and 100% (now residual, but with a recovery rate of 100%). There would therefore be no clawback under the standard method unless the housebuilder was already receiving exempt income at the time that the input tax was incurred. It may be that HMRC are assuming that the housebuilder has made no supplies at all in the past, so there is no "T over T plus E" calculation to use for residual recovery.

The Information Sheet points out that the standard method may not be fair and reasonable for a housebuilder because supplies may happen irregularly. There would then be periods when there were no taxable sales but only exempt letting: no residual input tax would be deductible. It may therefore be sensible for a housebuilder who expects to incur exempt input tax to consider suggesting a special method to HMRC.

The Information Sheet includes a more complex example in which the housebuilder is supposed to be working out a clawback adjustment and restricting current and future input tax.

A house builder who constructs six new dwellings over a period of three years incurs the following input tax:

VAT period	*Year to March 2007*	*Year to March 2008*	*Period 06/08*	*Period 09/08*	*Total*
Input tax	*£150,000*	*£70,000*	*£5,000*	*£25,000*	*£250,000*

In August of 2008 he lets the properties for two years, retaining the intention to then sell the properties.

Simple check for de minimis

By the number of years against a set period of ten years the exempt use would be 20 per cent. This would produce a de minimis result in only the period 06/08 so full calculations are needed.

The house builder estimates that the dwellings will sell for £300,000 each in two years time. The rental income in the interim will be £1,500 per month per house. So expected sales values gives a taxable use of:

£1,800,000/(£1,800,000 + £216,000) x 100 = 89.29%

So an exempt proportion of 10.71%.

Applying this to the input tax amounts

Year to March 2007 – £150,000 x 10.71% gives an adjustment due of £16,065. This must be entered into the VAT account for period 09/08 when the intention changed. Although this year is not technically a longer period (as no exempt input tax was incurred before or during the year) HMRC are content for this year to be considered as a whole to save the cost of splitting it into periods and analysing each separately.

Year to March 2008 – £70,000 x 10.71% gives an exempt input tax amount of £7,497. This is under £7,500 and so de minimis. No adjustment is needed for this year.

Period 06/08 – this period was de minimis by the simple check and will clearly be so again. No adjustment is needed for this period.

Period 09/08 – the input tax incurred in this period is residual in the period as there has been exempt use in the period. As the only supplies made in the period are exempt rentals the standard method would allow no input tax deduction. This result is plainly unfair as we know that the final taxable use will be almost 90 per cent. A special method will be needed to allow a fair deduction of input tax.

As noted above, HMRC appear to assume that there are no supplies of any sort up to August 2008. If there were any taxable supplies in the past, and no exempt letting, then the standard method would appear to require no clawback for the years to March 2007 and March 2008, because the residual recovery rate was 100% at that time.

The final section of the Information Sheet includes the following “Q&A”:

- *How is a clawback adjustment accounted for?* On the VAT return for the period in which the intention changes.

- *Can a house builder base his clawback adjustment on 'years'?* HMRC are not in favour of this because it requires an estimate of the "useful life of the building". They prefer only to use years for the simple de minimis test, and then they assume that the useful life is 10 years. In *Briararch*, the adjustment was calculated using years, and the full length of the major interest leases was included – not just the first 10 years after the building was built.
- *How should a house builder determine the 'values' for his clawback adjustment?* Reasonable expectations at the time of the change of intention. Evidence should be retained to show the basis of the calculation.
- *What happens if a house builder changes his intention from making a short let followed by a sale to simply making a sale?* Payback under reg.109 is the reverse of clawback.
- *What happens to costs that relate directly to the letting or sale of the new dwelling?* These are directly attributable to exempt supplies and the input tax is irrecoverable.
- *What happens if buildings fall under the Capital Goods Scheme?* This is relatively unlikely because the builder would have had to have incurred £250,000 in VATable costs on an individual dwelling. However, if this is the case, the CGS will apply.

Revenue & Customs Brief 44/08; Information Sheet 07/08

Following the issue of Revenue & Customs Brief 44/08 and Information Sheet 07/08, a number of industry representatives asked HMRC whether it would be possible to avoid any clawback of input tax under reg.108 SI 1995/2518 by making a grant of a major interest in the dwelling to a connected person before any exempt letting took place. The essential issue was whether this would be regarded by HMRC as an abuse of rights, because it would clearly be a transaction inserted to obtain a tax advantage (if there would otherwise be a clawback).

HMRC have now clarified that they would not see such an arrangement as abusive, as long as it only ensured deduction and retention of input tax on the costs of constructing new or converted dwellings. If it extended to achieve recovery on normally blocked costs such as repairs and maintenance, it might be challenged.

The reason for this helpful view is that HMRC regard the policy objective of the legislation as being to give relief for the VAT on the costs of constructing new dwellings or converting other buildings into them. A transaction which is inserted to prevent clawback of such input tax therefore achieves the policy objective rather than defeating it.

R&C Brief 54/08

3.5 Other land problems

Nothing to report.

4. INTERNATIONAL SUPPLIES

4.1 E-commerce

4.1.1 E-services

HMRC have published the latest in their regular series of exchange rate summaries for traders using the special registration scheme for electronically delivered services (quarter to June 2008). They have also published a special Information Sheet which advises a change in the VAT rate for Portugal from 21 per cent to 20 per cent with effect from 1 July 2008 for electronically supplied services.

Information Sheets 05/08, 06/08

4.2 Where is a supply of services?

4.2.1 Property-related services?

A UK company provided services to an American company which was two steps above it in a wholly-owned American corporate group. The company between them was a UK intermediate holding company. The services were considered by HMRC to relate to land, but the location of the land could not be identified specifically; the basic place of supply in s.7(10) VATA 1994 would therefore apply, and the UK subsidiary would have to charge VAT to its American parent. An assessment for £607,749 was issued in 2003 relating to the period 1 May 2000 to 31 December 2002; subsequent to that the company accounted for output tax under protest, and submitted a repayment claim for £1,094,235 in May 2006 covering the period up to March 2006. The Tribunal considered an appeal against the assessment.

The company argued that the services were within art.9(2)(e) 6th Directive (now art.56) rather than art.9(2)(a) (now art.44). There was no written contract between the US parent and the appellant, nor was there any correspondence or documents passing between them evidencing the services to be performed. Counsel suggested that there were multiple supplies falling under the following five headings: Finance Management, which operated daily; Project Management and Transaction management, both of which were ad hoc; Facilities Management, which was ongoing, and Blue Sky thinking. The fact that some of the facilities management activities were outsourced showed that they were separate and separable from the others.

HMRC's argument was based on the principle confirmed by the ECJ in the *Levob* case that it was necessary to consider whether elements in a supply were so closely linked that they formed, objectively, a single, indivisible economic supply, which it would be artificial to split. HMRC believed that what the company did for its parent fell within that principle.

The Tribunal identified the following four issues:

1. Are Customs correct in contending that there were overall composite continuing supplies as opposed to separate continuing supplies;

2. If there were composite continuing supplies, did such supplies fall within the activities in the third indent of Article 9.2(e), or did such supplies go beyond the third indent or beyond Article 9.2(a);

3. If there were not composite continuing supplies but separate continuing supplies were there five separate streams or were there fewer and, if so, what were those streams;

4. If there were separate streams, in respect of each stream did that stream either fall within the third indent of Article 9.2(e) or within 9.2(a)?

The Tribunal decided that it was necessary to consider what the customer (the holding company) wanted in return for the consideration paid. This was not the same as the appellant's counsel's list of five services: rather, "*It seems to us therefore that the supplies obtained by AETRSCo for the payments to the Appellant formed three broad categories : the performance of those management functions which AETRSCo had delegated to the Appellant including approval of lease transactions; the provision of advice, information and support to the local business units in relation to real estate; and the provision to AETRSCo itself of reports, information and recommendations.*"

These supplies were so closely linked together that it would be artificial to split them. The supplies did not relate to specific properties, so they did not fall within art.9(2)(a); however, the common feature of the supplies was "management", which did not fall within art.9(2)(e). The Tribunal therefore decided that they fell within art.9(1), and dismissed the appeal.

VAT Tribunal (20,744): *American Express Services Europe Ltd*

4.3 International supplies of goods

4.3.1 Postal imports

The negligible value limit below which postal imports are not liable to customs duty is to increase from €22 (£18) to €150 (£105) with effect from 1 December 2008. HMRC have issued a press release to emphasise that this applies to customs duty only, not to VAT or excise duty. Misleading statements have apparently been posted on the internet suggesting that Christmas shopping by post will be subject to the new limit and will be totally tax-free if it is left until December. Royal Mail are as keen as HMRC for the public to be aware of the actual rules.

The VAT limit remains £18 as set out in SI 1984/746 Sch.2 Group 8 Item 8.

HMRC Press Release 7 August 2008

4.3.2 New Notice

HMRC have issued a new version of Notice 725 *The Single Market*. It explains:

This notice has been restructured and rewritten to improve readability. Section 14 gives additional guidance about supplies to diplomatic missions, consulates, international organisations and NATO visiting forces which did not appear in the previous edition. Various paragraphs have also been updated to include details of Member States which joined the EU on 1 May 2004.

Notice 725

4.4 European rules

4.4.1 Polish rules too restrictive

Polish VAT rules provided that repayment claims should normally be met by the authorities within 60 days. However, this was extended in the first year of trading to 180 days, unless the trader made a "security deposit" of approximately €62,000. A claimant appealed to the courts, arguing that this infringed the 6th Directive. The dispute was referred to the ECJ, where the court has now agreed with the Advocate-General's opinion that the claimant is right. The measure was disproportionate and undermined fundamental principles of the VAT system, including the right to deduction of input tax. It could not be permitted without a derogation, and Poland had not applied for one.

ECJ (Case C-25/07): *A Sosnowska v Dyrektor Izby Skarbowej we Wroclawiu Osrodek Zamiejscowy w Walbrzychu*

4.4.2 Consultation on invoicing

The European Commission on 24 July launched an online consultation to ascertain the views of businesses on the review of the existing legislation on VAT invoicing. The background is explained by the consultation document as follows:

"*The Commission is required under Article 237 of the VAT Directive*[1] *to present a report to Council by 31 December 2008 on technological developments in respect of e-invoicing, and a legislative proposal if appropriate. As the provisions of the Invoicing Directive (2001/115/EC) which are now contained in the VAT Directive did not fully meet its stated aims of simplifying, modernising and harmonising the conditions laid down for invoicing in respect of VAT, the review on invoicing will go wider than just e-invoicing.*"

The consultation is based on an Invoicing Study to be produced for the Commission. The Commission hopes to receive contributions concerning a selection of the recommendations contained in the Invoicing Study and other recommendations businesses may have.

More information is contained in the consultation document, including a selection of draft recommendations from the invoicing study. Comments should be submitted by 19 September.

http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/consultation_VATinvoicing_en.pdf

4.4.3 Italian amnesty

As expected, the ECJ has given a declaration as requested by the Commission that Italy's failure to check VAT payments amounted to a contravention of the 6th Directive. The Italian authorities had argued that their amnesty for past returns was a measure that led to collection of more tax than they would have obtained otherwise, and was within the latitude for simplification procedures allowed to member states.

The ECJ examined the arguments and held that the Italian rules amounted to a serious distortion of competition. Traders within Italy would be treated differently from each other, and traders in Italy would be treated differently from those in other member states. The amnesty offended the principle of fiscal neutrality and could not be accepted.

ECJ (Case C-132/06): *Commission v Italy*

4.4.4 Italian time limits

The Italian rules restrict the deduction of input tax where the input tax claimed has exceeded output tax declared for a given period. A company has objected to this on the basis that it contravenes the 6th Directive, and the Italian courts have referred the following questions to the court:

Does Article 18(4) of the Sixth Directive, given the neutrality of the VAT system, permit the Member States to completely exclude the right to deduct, also in the period following the years concerned, providing only for a refund?

If the answer is in the affirmative, do Article 18(4) and the principle of the effectiveness of the protection of rights arising under the Community legal system impose an obligation on the Member States nonetheless to ensure that those refunds are made within a reasonable period of time?

ECJ (Case C-316/08): *Latex Srl v Agenzie delle Entrate, Amministrazione Dell'Economia e delle Finanze*

4.4.5 Reduced rates

The European Commission has issued a press release containing the answers to some frequently asked questions on reduced rates and the Commission's proposals for extending them into the future (covered in earlier updates).

The UK has not implemented the permitted reduced rates for services under the rules that have been in place for some years (relating to "labour intensive services"), but there has been some discussion of the possibility of applying reduced rates for environmental purposes. The document contains the following comment in this area:

At this stage, more assessment is needed of the impact of reduced VAT rates for environmental purposes, and the Commission awaits the results of studies currently being carried out.

Likewise, the use of VAT rules as a tool in other EU policies needs further reflection and analysis before any in-depth review to rationalise and simplify the current rules.

Why are energy savings and energy efficient materials and appliances not in the present proposal? When will the Commission come up with a

proposal on VAT reduced rates for environmentally friendly goods and services?

Indeed, the current proposal does not include provisions on the use of VAT reduced rates for environmental purposes.

However, it does give Member States the possibility of applying reduced VAT rates to renovation and repair works, with a view tot increased energy-saving and efficiency.

The feasibility of a more far reaching proposal from an environmental point of view is currently being examined by the Commission services, in accordance with the request from the European Council in March 2008 to examine areas where economic instruments, including VAT rates, can have a role to play to increase the use of energy-efficient goods and energy-saving materials.

The results of these analyses will allow the Commission to assess the most cost effective way to promote the production and use of energy-saving materials and energy-efficient appliances and equipment. Those results are expected in the autumn.

Commission Press Release IP/08/1109

The Commission has also issued a proposal to extend the permission to operate reduced rates permanently in certain areas. Once again, this will be permissive rather than mandatory, so it will only have an effect in the UK if the government decides to implement it.

The proposals include the supply and construction of housing, restaurant services (excluding alcoholic drinks), and the list of services that have been included in the past:

- minor repair of tangible movable goods, including bikes but excluding other means of transport. Examples include shoes, clothes, computers, watches;
- cleaning and maintenance services of all these goods—in this case, other means of transports are included;
- domestic care services (for example, home help and care of the young, elderly, sick or disabled);
- all personal care services (including hairdressing and beauty services, for example);
- gardening services; and
- renovation and maintenance services provided to places of worship, cultural heritage and historical monuments, as recognised by Member States.

"*In addition ... the category of pharmaceutical products is widened to cover all absorbent hygiene products, notably including children's nappies.*"

Commission MEMO/08/481

4.4.6 Bailiffs

The ECJ has made an order in relation to a reference from the Slovak Republic for a preliminary ruling on the status of bailiffs. The order makes it clear that bailiffs are acting as independent economic agents even

where they are acting on behalf of a public authority. They are not covered by the exclusion of public authorities from the scope of VAT in art.4(5) 6th Directive.

ECJ (Case C-456/07): *Karol Mihal v Danovy úrad Košice V*

4.4.7 Polish car duty

A Polish trader appealed against an assessment to a national excise duty on new cars on the basis that the duty was similar to VAT and therefore precluded by art.33 6th Directive. The ECJ examined the law and the circumstances of the duty and concluded that it was not similar to VAT. The trader did not have an EU-based right not to pay the duty.

ECJ (Case C-426/07): *Krawczynski v Dyrektor Izby Celnej w Bialymstoku*

4.5 Eighth Directive reclaims

4.5.1 Errors in claims

HMRC have issued a new leaflet about financial penalties that may apply to overseas traders failing to take reasonable care in making repayment applications after 1 July 2008. It gives some guidance on how to avoid penalties, and outlines the new penalty scales for “careless, deliberate, deliberate and concealed” and the discounts for disclosure.

HMRC Press Release 1 July 2008

4.5.2 Italy in breach?

Italian law requires a business which has an establishment in Italy, but which is also established in another member state or outside the EU, to recover Italian VAT incurred on business expenditure of those other establishments through the 8th or 13th Directive procedure rather than by deduction within the Italian VAT system. A single entity which incurs VAT for the purposes of its business activities anywhere in the world is entitled to recover that VAT in the member state in which the VAT is incurred, provided the activities would be taxable if incurred there.

The Commission has applied to the ECJ for a declaration that the Italian rules contravene the 6th Directive.

ECJ (reference) (Case C-244/08): *Commission v Italy*

5. INPUTS

5.1 Economic activity

Nothing to report.

5.2 Who receives the supply?

5.2.1 Loyalty points

HMRC have issued a Brief explaining the current state of the appeal in *Loyalty Management UK*. The Court of Appeal found that payments by LMUK to retailers who redeemed loyalty points were for "redemption services", and the VAT included was deductible as input tax by LMUK.

HMRC maintain that the payments are third party consideration for goods and services supplied by those retailers to individuals; as LMUK does not receive those supplies, it cannot claim input tax. The House of Lords granted HMRC leave to appeal in April, and the Brief states that the Lords have decided to refer questions to the ECJ. It will therefore be some time before the outcome of the litigation is known.

The Brief points out that some redeemers are adversely affected by the Court of Appeal's ruling: they may be supplying zero-rated goods, but they have to account for output tax because redemption services are not a zero-rated supply. The Court's decision is the current law, so they should comply with it and raise VAT invoices for the full amount payable by LMUK. However, they may wish to make protective claims for repayment in respect of possibly overpaid output tax.

Redeemers who supply goods only for points (as opposed to part payment) are also, under the Court's view of the law, making supplies within Sch.4 para.5 (business gifts). HMRC say that they will protectively assess for output tax on that basis (presumably where the cost of the goods exceeds £50).

The Brief also states that HMRC regard the litigation as particular to the facts of LMUK's scheme. Until the litigation is complete, it will not be clear what the correct treatment of other loyalty schemes should be.

Revenue & Customs Brief 46/08

5.2.2 Legal services

A member of a partnership fell out with his partners and was involved in a dispute in the High Court. He subsequently registered for VAT as a sole trader, and claimed input tax deductions in respect of legal fees relating to the dispute. HMRC ruled that the legal services were provided to him and his wife personally and not as a trader.

The Tribunal examined the facts in detail and decided that there were two issues: the identity of the person receiving the supply, and the purpose of the supply – whether it was linked to the business of the person receiving it. As the individual was a partner in a firm, he had the power to bind the partnership in relation to receiving supplies. It was therefore possible that a supply made to him personally was in fact made to the partnership.

The chairman decided that it was not possible to conclude on the issues without more evidence, and adjourned the case part-heard in order to allow the parties to provide more information. There were at least two different disputes between the partners, and it was possible that expenses incurred in one or more of them would have the sufficient connection to the business of the partnership to justify deduction.

VAT Tribunal (20,729): *Graham Langran*

5.3 Partial exemption

5.3.1 Claims by educational establishments

Prior to 1997, when the Committee of Vice-Chancellors and Principals (CVCP) guidelines were withdrawn, many Higher Education Institutions chose to determine their recoverable input tax using a simplified partial exemption method described in the guidelines as the CVCP method. Recoverable input tax was calculated as a fixed percentage of the output tax payable on certain taxable supplies (referred to as "tunneled" supplies). For some HEIs, the "tunnels" did not deal with all taxable supplies and these HEIs had the option to agree additional "tunnels" to reflect these other supplies. Alternatively, they could agree their own special method instead, using a different basis from the CVCP method.

Two Oxford colleges made claims in 2004 for substantial amounts of overhead input tax that they said was not allowed for in the "tunnelling" method. Initially Customs used the cap to deny the claims, but as the dispute progressed it became apparent from other litigation that the cap would be unlikely to be effective. The Tribunal hearing *Wadham College Oxford and Merton College Oxford* (20,233): therefore proceeded on different grounds.

The starting point of the decision was a discussion of the effect of agreeing a special method. It is well-known that a special method cannot be imposed or varied retrospectively; on the face of it, the colleges were trying to do this. However, the Tribunal reached the following conclusions:

- the CVCP guidelines did constitute a special method that had been allowed or approved by HMRC, and which could not therefore be retrospectively altered;
- nevertheless, a claim could succeed in principle because it was not about changing the method – it was about calculating the amount of tax properly claimable under the method, where the method had been misunderstood or misapplied.

That potential misunderstanding lay in the vagueness of the method and the explanation that was given for it. It was not clear whether the flat rate input tax allowances under the CVCP method were intended only to give credit for input tax directly attributable to the "tunnelled" activities, or also for a proportion of any residual input tax that was used to make all the supplies of the college. The Tribunal held that, in principle, it was possible to revise the amount claimed under a special method retrospectively; however, it also held that the "tunnelling percentages"

appeared to be intended to allow for residual input tax as well as directly attributable input tax, and no further VAT could be claimed in respect of those activities.

The Tribunal did find that there were other taxable activities which were outside the "tunnels", and for which it appeared that no allowance for input tax had yet been made. Some additional recovery was due in respect of those areas. The decision discussed how such recoveries might be calculated (effectively filling in the gaps in the special method – whether the standard method should be used, or something "fair and reasonable") but left the amount to be agreed between the parties.

HMRC have now issued a brief to explain their approach to similar claims made by HEIs following this decision. They say that they conclude that an HEI operating the CVCP method would only be entitled to claim further input tax if:

- it made taxable supplies not covered by the tunnels in the CVCP method
- there was no agreement as to how input tax on these taxable supplies would be recovered

Any entitlement to claim further input tax should be calculated using an appropriate methodology based on the use of the costs incurred.

A claim would also have to be made before the transitional period for capping expires on 31 March 2009. HEIs which are uncertain about whether they have enough evidence to back up a claim should consult their LVO.

Revenue & Customs Brief 34/08

5.3.2 Refusal of special method

A bank had agreed a special method which treated 15% of general business overheads as attributable to instalment credit business (exempt and therefore irrecoverable). This had been agreed between the Finance Houses Association and Customs. In 2000 Customs put forward the view that the whole of the business was really the provision of exempt finance, so overhead recovery should be restricted further.

While negotiating to maintain the 15% recovery, the bank decided that this was in fact not sufficiently generous. It applied to change the method to one based on numbers of transactions: each HP sale involved one taxable transaction (the sale of the goods) and one exempt transaction (the financing), so overhead recovery should be 50%. Customs refused, and the company appealed.

At the Tribunal, neither party could justify the previously agreed special method as fair and reasonable. The flat rate method was arbitrary, while the number of transactions did at least relate the costs to activities. The Tribunal commented that it was not allowed to substitute a different special method for the one proposed by either party: it was satisfied that the one supported by Customs (a variation on the existing method which produced a recovery of about 13%) was not fair and reasonable, and the one supported by the taxpayer was, so it allowed the appeal.

The Court of Session has overturned this. It held that there was no findings of fact in the Tribunal's reported decision on which it could reasonably have reached the conclusion that it did. The effect was

therefore that the appeal should have been dismissed and HMRC's preferred method applied, because it was not open to the Tribunal or to the court to propose a different method from either of those before it; if the taxpayer believed that the result was not fair, it should issue a special method override notice and commence arguments with HMRC about the "use" of input tax in the business.

Court of Session: *HMRC v The Royal Bank of Scotland Group plc*

A company provided domestic repair and building maintenance services to the public, together with intermediary services to providers of finance to the company's customers. It received exempt commission in respect of these intermediary services, but believed that it did not incur any costs in relation to them so it recovered all of its input tax in full.

After a control visit, an officer suggested that an apportionment was required and some disallowance of input tax would follow if the standard method was used. The company was invited to suggest a special method if it believed that the disallowance was unfair. Residual input tax would include advertising expenditure, which the company thought was mainly aimed at generating taxable income. VAT on professional fees would also be subject to apportionment.

The company proposed a special method based on "processes" which were identified as making up a finance-backed transaction. The various processes involved in the transaction were allocated points, and the weighting of these points suggested that 7/42 of the overheads relating to such sales should be disallowed. HMRC argued that there was no evidence that the proposed method produced a fair result: the allocation of points to processes was arbitrary and incapable of verification.

The Tribunal agreed that the standard method did not appear to produce a satisfactory result, but also agreed that the proposal could not be justified on the basis of evidence. The appeals against the decision to refuse the special method, and a consequent assessment based on the application of the standard method to the company's input tax, were dismissed.

VAT Tribunal (20,743): *Laura Anderson Ltd*

An investment management company had individual clients who were charged taxable fees and unit trust clients who were charged exempt fees. The standard method of partial exemption produced overhead recovery of about 20%. The company proposed a special method based on directly attributable costs, rather than on turnover, which would have produced a recovery of about 76% (or 57% if building costs were ignored). HMRC refused, and the company appealed.

The Tribunal considered first whether the standard method did not give a fair result. The main argument for the taxpayer was that the number of clients was more representative of the work done for them – and therefore the incidence of costs – than the fees earned. There were just 5 unit trust clients but far more individuals. It was more appropriate to consider the allocation of other costs as a guide to the apportionment of overheads.

The Tribunal agreed with HMRC that this was not convincing. Fees were charged by the company in proportion to the value of the clients' holdings, not on a fixed basis per client. It seemed reasonable to treat costs as incurred in proportion to fees when fees were calculated in this way. As

fees were charged in proportion to value, it seemed likely that effort was expended in the same proportion and so would costs be.

In addition, the Tribunal considered whether the proposed special method might give a more fair and reasonable result. The chairman commented that a large element of the costs directly attributed to taxable activities related to an outsourced depositary function, which the Tribunal thought would distort a cost-based apportionment.

Costs were awarded to HMRC.

VAT Tribunal (20,780): *McInroy & Wood Ltd*

5.3.3 Flawed assessment

The Scottish Tribunal heard an appeal by an individual university against an assessment raised in relation to its recovery of input tax under a method of splitting VAT on expenses between business and non-business activities. The chairman opens his description of the facts with the following surprising paragraph:

"*Matters were brought to a head by an ill considered letter from an officer of the Respondents, Mr Kennedy which made various erroneous assumptions and assertions for which apology had to be made and appears to have been a letter sent to all, or at least all Scottish Universities. It not only demanded a variety of answers to matters with which this University was not concerned but it goes on to say that in relation to information requested "I appreciate that this may appear onerous". It then goes on to demand a prompt response because the writer was "mindful of the time limits for raising an assessment". The next matter was a meeting between Mr Hannah* [the HMRC officer dealing with the university] *and Mr Crozier also of RCB Partnership, on 27 January 2004. At that meeting the way in which business/non-business adjustments had been made up until that time was raised by Mr Hannah who expressed some misgivings. He requested much further information an attitude in which he has persisted throughout.*"

The decision goes on later to describe the way in which the HMRC officer proceeded:

"*Mr Hannah did not impress the Tribunal as being an officer capable of sensible or selective application of general principles to particular cases. He was, on the evidence before the Tribunal a person who concentrated almost obsessively on detail making many demands for information about matters which could happily have been accommodated by a general approach. During the course of his inspection, which persisted for a substantial period of time, he had admittedly requested copies of over 600 purchase invoices from which he asked various questions about the use of the VAT charged such as "who used the new bike shed? Where were new carpets installed? Who was using a refuse skip hired by the Appellant?" Relevant or not such an approach is significantly indicative of a mindset.*"

A method of apportionment had been agreed in 2000; Mr Hannah did not think it was appropriate, and in June 2004 he proposed to raise assessments for 2001/02 and 2002/03. Later he reluctantly agreed that the agreed method could not be retrospectively withdrawn for those years, but he persisted in arguing that a revised method proposed by himself should be used for 2003/04 unless an alternative method could be agreed. Although this was before the end of the university's tax year, the agreed

method had nevertheless been in use up to that point for 10 months of the year. When an assessment was raised in April 2005 to adjust the recovery to Mr Hannah's preferred basis, the university appealed on the grounds that the assessment amounted to a retrospective withdrawal of the agreed method.

The Tribunal reached the unusual decision that the assessment had not been made to best judgement. It had been raised for the wrong reasons (to retrospectively alter the agreed method, rather than as an honest and objective attempt to collect the right amount of tax).

The Tribunal also considered that the method proposed by the officer was too crude fairly to reflect the complicated trading position of the university. The appeal was allowed with costs, and the parties were encouraged to go away and discuss a better method for the future – possibly with the involvement of a different HMRC officer.

VAT Tribunal (20,728): *The University Court of The University of Dundee*

5.3.4 Wrong method

A company started in business providing childcare and workplace nursery services. The directors actually provided management consultancy and human resources consultancy as well as childcare vouchers. The National Advice Service was consulted about the recovery of VAT on expenses, and the appellant claimed that misleading advice was given that suggested all its input tax could be recovered. Accordingly, it claimed everything, and appealed against an assessment and misdeclaration penalty.

The Tribunal agreed with HMRC that it had no jurisdiction in relation to a misdirection appeal, and therefore had to dismiss the main appeal. The question of misdirection was relevant to the question of reasonable excuse for misdeclaration, and the Tribunal decided that there was none. The director had chosen to ignore correct written advice given by HMRC in January 2002 and instead to follow incorrect advice obtained by his accountant over the telephone in October 2002 on the basis of incomplete information. The director had also failed to take appropriate action when a Customs officer pointed out the problem and invited him to suggest a partial exemption method. The appeals were dismissed.

VAT Tribunal (20,793): *Kidease Ltd*

5.3.5 Reg.109

The Wellcome Trust, a medical research charity, purchased the freehold and leasehold interests in a building in June 1998 for £16m plus VAT. On 17 June 1998 the trust notified Customs of a waiver of exemption in respect of the building, even though (according to the Tribunal decision) the trust was not registered for VAT until 1 January 2000. The building, which had formerly been occupied by the security services, was demolished from February 1999 onwards. An adjoining property was purchased for the trust's use in November 1999. This building was demolished from April 2001 onwards.

Around July 2004 a new building was completed, construction having commenced around April 2001. This construction work qualified for zero-rating because the result was an annexe that satisfied the conditions of Notes 16 & 17 Group 5 Sch.8; but it was attached to another building, owned by the trust, which had been opted to tax, so it was also covered by that option.

The decision is not entirely clear about what happened next, which is a pity. It refers to a lease and leaseback arrangement that was entered into on 1 April 2003 after a decision in October 2002 by the Governors; it appears that this is the basis for a claim to recover input tax on the purchase of the security services' building, plus later expenditure on the property, under reg.109 on the basis that there was a change of intention from partly taxable/partly exempt/partly non-business use to an intention to make a fully taxable supply.

HMRC disagreed: they ruled that input tax was not recoverable under reg.109 if the property had been purchased for non-business purposes at the time. They also argued that the input tax from 1998 was now capped. In due course they accepted that input tax incurred since 1 January 2000 was being claimed under reg.29 and allowed it, but maintained that the earlier VAT was irrecoverable and could not be adjusted.

The trust argued that it would have been eligible to claim all the VAT on the cost of the building at the time if Customs had then accepted that the *Lennartz* approach could apply to buildings. As Customs did not accept that, it was excessively difficult for them to exercise what turned out later to be a right enforceable under the 6th Directive. In the Tribunal, HMRC argued that *Lennartz* had not been raised by Wellcome at any point from 1998 to 2005, so it did not appear to have occurred to them that they might make such a claim.

HMRC relied on the ECJ's decision in *Waterschap Zeews Vlaanderenm v Staatssecretaris van Financien* (Case C-378/02): a Dutch water authority was not entitled to make a claim for input tax on a building which it had purchased for entirely non-business purposes and later changed to taxable business use. Originally HMRC had argued that this disallowed the reg.109 claim in its entirety, but at the hearing they conceded that a proportion might be allowable if evidence was produced to show a change from exempt business intention to taxable business intention. They held to the view that a change from non-business to business did not justify any recovery.

HMRC also pointed to the fact that Wellcome had claimed zero-rating for the construction work. This was based on an assertion that the intended business use of the building was less than 10% at the time of construction.

From the evidence, the Tribunal concluded that the intention at the time of the original purchase of the property (on which the initial recovery and the possible adjustment of the £2.8m VAT depended) was partly business, partly non-business. As a result, Wellcome would have been entitled to claim under *Lennartz* at the time, and if Customs had refused to meet that claim, they could have appealed. Even though Customs' view was that *Lennartz* did not apply to services, the property purchases amounted to goods, and the Tribunal was not satisfied that it was excessively difficult for Wellcome to make a claim at the time of purchase. Accordingly, the cap applied to any reg.29 claim made in respect of the purchase.

The Tribunal did not believe that reg.109 could be used in conjunction with *Lennartz* to recover all the tax at a later date. The decision agreed with HMRC that there had to be a change in intention from exempt business use to taxable business use, and a change from non-business to business did not trigger reg.109. HMRC had accepted during the hearing that some reg.109 payback would be due, and the parties were invited to go away and discuss the amount of that. To that extent only the appeal was allowed.

VAT Tribunal (20,731): *The Wellcome Trust*

5.3.6 Capital goods used for the business?

In the case of *JDL Ltd*, the UK Tribunal and High Court held that the sale of cars that were used by a car dealer as demonstrator vehicles was to be excluded from the "T over T plus E" calculation under reg.101(3)(a) as "the sale of capital goods used in the business". A recent decision of the ECJ (*Nordania Finans A/S and another v Skatteministeriet* Case C-98/07) suggests that this is not correct in European law.

The case concerned a vehicle leasing company which sought to include the sale of leased vehicles in its partial exemption calculations. The Danish tax authorities took the view that they were capital goods used in the business and ruled that the sale proceeds should be excluded. The Danish courts referred questions to the ECJ.

The Court considered that the purpose of the legislation which excluded the sale of capital goods was to remove distortions from the recovery of input tax. The list of items to be excluded covered transactions of an unusual or one-off nature which would not reflect the ordinary incidence of input tax in the business. The sale of the leased cars was a fundamental and regular part of the lessor's business, and it should therefore not be excluded.

HMRC have updated their internal manual on partial exemption to take account of this. The new comment is available on their website, but they have not yet issued a Revenue & Customs Brief to draw people's attention to it. Surprisingly, the statement does not refer to JDL or to the obvious parallels to demonstrator vehicles. It says that:

- the sale of ex-leased assets should generally not be excluded from apportionment calculations because they are not “capital assets”;
- where a special method has been agreed with specific provisions to exclude the value of ex-lease sales, the method will be followed because it must reflect a view that the inclusion of such sales will be distortive;
- those leasing businesses which rebate the whole of the sale price of ex-lease assets to the customer should not include the sale value, because there would be double-counting – once as taxable lease rentals and once as sale proceeds.

This last comment depends on the treatment used for the rebate of rentals. Presumably a credit note could be issued to accompany the rebate “with VAT” – in that case, there would be no double counting, and the sale should be included in sales because the taxable rentals would be reduced by a matching amount.

www.hmrc.gov.uk: PE5350

This is an important area and it is surprising that a separate announcement has not yet been made in a Revenue & Customs Brief – a change in an internal manual does not give it much publicity.

5.4 Cars

Nothing to report.

5.5 Business entertainment

Nothing to report.

5.6 *Non-business use of supplies*

5.6.1 Charity fundraising

Charities have to divide the VAT on their expenses into:

- business and non-business;
- taxable business and exempt business.

Until the case of *Church of England Children's Society* (High Court 2005), VAT relating to fundraising was generally regarded as wholly irrecoverable because fundraising was not a business activity. That case established that the *Kretztechnik* principle could apply: general fundraising supported the whole of an entity's activities, and the VAT in relation to it was therefore an overhead of the whole of those activities. Some of it could therefore be recovered, to the extent that it was used to make taxable supplies.

In 1995, Oxfam had agreed a method of apportioning VAT between business and non-business on a costs basis. Those costs (VAT-exclusive) which were exclusively used in business activities and those costs which were exclusively used in non-business activities were expressed as a percentage ("B over B plus non-B") and this was applied to expenses which were partly for business and partly for non-business purposes. The method was put on a formal basis by the issue of a direction from Customs in 2000.

Following the *CofE* case, HMRC accepted that Oxfam were entitled to apply the formula to fundraising costs as well as the other costs already treated as "pot". Some £2.5m was repaid to the charity as a result. However, Oxfam argued that there was a further effect of the decision which HMRC had not taken into account. Previously, the expenditure on fundraising had been included in "non-B" in the formula: now it should be excluded altogether, producing a higher percentage to be applied to a larger residual amount of VAT. The business proportion would rise from about 75% to 85% or 90%.

HMRC argued that this no longer produced a fair and reasonable result, and they said that they were entitled to revisit the formula. The agreed method included the proviso that the agreement would not apply if there was a significant change in the way the business operated, and HMRC contended that this significant change in the understanding of the law triggered that get-out. In May 2006 HMRC issued a notice withdrawing approval of the agreed method, and no replacement has yet been agreed.

Oxfam argued that the approved method, formally agreed by HMRC in a document, constituted a binding contract from which HMRC could not retrospectively resile. Now that a proper understanding had been established of the way in which the rules ought to operate, the method should be merely mechanical. This was the result in a number of other cases such as *GUS Merchandising Corporation* in respect of retail schemes and *The Labour Party* in respect of partial exemption methods.

The Tribunal discussed this proposition in great detail, and draws an important distinction. Retail schemes and partial exemption are provided for in statute. There is no statutory detail on the business/non-business split. The situations are therefore not comparable, and it is not right to assume that Oxfam's agreement was binding in the same way as it was for

GUS and *Labour*. The negotiations which led to the formal document in 2000 did not appear to be the agreement of a contract but rather the ratification of an existing practice. In short, the Tribunal agreed with HMRC that they were entitled to consider the voluntary disclosure as a new claim which was subject to the principles of being fair and reasonable, rather than being required to make a repayment on the basis of a mechanical formula.

The Tribunal was not satisfied that the repayment claim was fair and reasonable. It would appear to create a recovery of some 85% of the VAT on fundraising expenditure, which appeared inconsistent with statements in the annual report that 80% of donated income was used for the relief of poverty (generally involving non-business activities). The appeal was therefore dismissed.

VAT Tribunal (20,752): *Oxfam*

5.6.2 Non-business use of building

The Whitechapel Art Gallery was the subject of an important case in 1986. It displays art for free admission, but also makes taxable supplies of souvenirs and opted rent. The Tribunal and High Court held that it could not recover all of its input tax: the free display of art is not a business activity and does not give rise to an entitlement to input tax.

Now it has been the subject of another important decision. The gallery is undergoing refurbishment work, much of which is zero-rated. The charity reclaimed input tax in respect of the balance under the *Lennartz* principle, and HMRC refused. They argued that *Lennartz* required the acquisition or creation of a new asset for use in the trade (as was also the case in *Seeling* and *Wollny*); this refurbishment project improved an existing asset, but it did not create a new one.

The Tribunal did not accept this argument. *Lennartz* was clearly concerned with expenditure for the lasting benefit of the business, but it did not require the creation of a new asset. The refurbishment project was very substantial and might cost more than pulling the building down and starting again; in the interests of fiscal neutrality, the claim would succeed.

VAT Tribunal (20,720): *Whitechapel Art Gallery*

5.7 Bad debt relief

Nothing to report.

5.8 *Other input tax problems*

5.8.1 Novation

A company took over the hire purchase agreements of an associated company and claimed input tax in relation to the assets. HMRC ruled that no consideration had been given and disallowed the claim. The company entered into a novation agreement with the financiers who were the creditors under the hire purchase agreements, creating a new contract.

The appellant was not represented. It is interesting that both the HMRC counsel and the chairman comment that "[the original company] *would have paid VAT when entering into the agreement and would presumably have reclaimed any VAT it paid on an initial payment and the subsequent instalments thereafter*". In general VAT is charged and claimed on the initial provision of the goods under an HP agreement; only on a lease is there VAT on the instalments. It therefore seems likely that the VAT on these goods would have been dealt with entirely by the original purchaser, and there would be no further VAT incurred on instalments by the transferee (a stronger argument than HMRC actually put forward).

Apart from not turning up at the hearing, the appellant's main problem was a lack of evidence. It appeared that their case was based on the feeling that the transferor company had not claimed the right amount of VAT, but no proper documentation had been produced to back up such a contention, and the argument was clearly not well expressed.

The Tribunal agreed that the novation only involved the transferee taking on the obligations of the transferor to pay future instalments, and it had not incurred any input tax in relation to the supply of the assets before that time. The appeal was dismissed and costs were awarded to HMRC.

VAT Tribunal (20,759): *Swan Plant Ltd*

5.8.2 More carousels

The Tribunal refused to admit two witness statements out of a batch of six witness statements that were served by HMRC after the appeal had been listed for hearing. The chairman commented that missing trader appeals were complex and threatened to swamp the appeals system unless there was tight case management. It was normal for cases to be listed for hearing only once all the evidence had been submitted. In this case, the Tribunal was not satisfied that there were good enough reasons for HMRC to have submitted some of the evidence so late, so they would have to argue the case without it.

VAT Tribunal (20,796): *Europeans Ltd*

A trader submitted repayment claims for three one-month return periods in 2006. HMRC subjected them to extended verification, and the company in time withdrew some of the claims. However, it stood by some of the claims and appealed against an assessment to recover some of the tax. HMRC argued that the director "knew or ought to have known" that the transactions were part of a contra-trading exercise involved in a MTIC fraud.

As usual, the Tribunal examined the background to the transactions in great detail, and concludes that the directors did not have the means of knowing that the transactions were fraudulent. The appeal was therefore allowed in principle. However, some of the invoices that were the subject of one of the claims had not been paid, so the input tax would be repayable six months later; the claim was reduced by the Tribunal by £30,000 and as a result only 90% of the trader's costs were awarded.

The Tribunal rejected the appellant's counsel's assertion that contra-trading was "a flawed concept". A knowing contra-trader would have input tax refused.

The chairman also commented on the fact that more than 20 lever arch files of evidence were provided, but only 6 or 7 referred to in the case. He demanded that the material presented to the Tribunal should be restricted to that which would be relevant to a decision, on pain of costs sanctions.

VAT Tribunal (20,781): *Brayfal Ltd*

5.8.3 New manual

HMRC have published a new "reverse charge manual" which sets out details of the reverse charge for "carousel-prone goods". It covers the basic principles of the reverse charge procedure; the reverse charge sales list (RCSL); interaction with accounting schemes and procedures; and the consequences of failure to adhere to the relevant procedural requirements.

www.hmrc.gov.uk/manuals/vatrevchgmanual

6. ADMINISTRATION AND PENALTIES

6.1 Group registration

Nothing to report.

6.2 Other registration rules

6.2.1 Online form

HMRC have announced improvements to their online VAT registration form. These changes are intended to reduce the number of errors made when completing the form, and so could help reduce processing times for VAT registration applications. Details of the changes are given below.

Every screen now has a sub-heading advising that certain questions must be answered. Each question that must be answered is now marked with an asterisk.

The content of help pages and error messages have been reviewed and improvements to content made. Where it has been possible, design changes have been made to improve accessibility to the service for those users with visual impairment.

In addition, changes have been made to the following screens:

About the business

The 'Business Phone number' field has been renamed as 'Contact telephone number'. You must complete this field.

The Yes/No declaration for 'Do you have a trading name' has been removed.

Business involvements

A new check box has been added: 'Tick if trading'. This should be ticked if the business is currently trading.

Business activities

The drop-down trade descriptions have been changed to the SIC 2007 classifications. You can find information about the SIC 2007 classifications on the Office for National Statistics website.

Business accounts screen

A new free text box 'Reason for receiving repayments' has been added. If say that you expect the VAT on purchases to regularly exceed that on taxable supplies, you must also complete this box to tell us why.

Three new boxes have been added for the business bank account. Two ask for further details about the account - these are 'Name of bank' and 'Name of account'. The third new box is called 'Reason' - if you leave any of the four bank detail boxes blank, then you must fill in this box to tell us why.

Date of registration screen

The format of the 'Date exceeded threshold' box has been changed to 'MM/YYYY'.

Value of supplies screen

A new check box has been added where you must declare whether the business makes any sales or purchases to or from other European Union countries.

Applicant's personal details

Two new fields have been added to ask for additional personal information – 'Home telephone number' and 'Date of birth'. You must provide your date of birth.

Type of registration

The current screen has a single option 'I am making or intend to make taxable supplies' which has been split into two statements to avoid any confusion. These are 'I am making taxable supplies' and 'I intend to make taxable supplies'.

HMRC Press Release 3 July 2008

6.3 Payments and returns

6.3.1 Interest concession goes

Following a direct tax case (*Wilkinson v HMRC*), HMRC have concluded that their power to give effect to extra-statutory concessions is more limited than they previously thought. Finance Act 2008 s.160 accordingly contains an enabling power to allow for existing ESCs to be put into legislation by Treasury Order; in the meantime, HMRC are reviewing existing concessions and some may be withdrawn.

One of the first to go is the practice of not charging interest on errors of up to £2,000 which are voluntarily disclosed. The practice is set out in Notice 700/43, and appears to be based on the principle that such an error could be corrected through the VAT account without being disclosed to HMRC at all – in that case, no interest would arise. However, from 1 September onwards, any voluntary disclosure which requires an assessment of additional tax will carry an interest charge in the normal way.

It will still be possible to avoid an interest charge if errors are corrected through the VAT account, and the increase in the limits for such corrections means that larger amounts can be avoided in this way.

Revenue & Customs Brief 38/08

6.3.2 Updated notice

HMRC have issued an updated version of Notice 700/12 *Filling in your VAT return*. It cancels and replaces the January 2001 version, and includes Update 1 (April 2004), Update 2 (July 2008) and Update 3 (September 2008).

Notice 700/12

6.4 Repayment claims

Nothing to report.

6.5 Timing issues

6.5.1 New Notice

HMRC have published a revised (August 2008) version of Notice 731. It has been rewritten to make the rules of the cash accounting scheme clearer. The only changes of substance are new accounting rules for cheques, credit card payments and payments collected by third parties.

6.6 Records

6.6.1 Updated notice

HMRC have issued an updated version of Notice 700/45 *How to correct VAT errors and make adjustments or claims*. This includes the remarkable statement that "*This notice has been restructured to improve readability, but the technical content has not changed from the January 2000 edition*". That seems a waste of time and effort in a year in which the rules on correcting VAT errors have changed significantly.

Notice 700/45

6.7 Assessments

6.7.1 Time limits

Two companies entered into a prepayment scheme similar to that considered in *BUPA Purchasing Ltd*. The idea was that:

- up to 31 December 1997, supplies of drugs and prostheses made by hospitals to in-patients were zero-rated;
- the law was to be changed from 1 January 1998 to bring them within the healthcare exemption;
- it was thought that a hospital that prepaid for the future supply of large quantities of drugs, paid for in December 1997 but delivered as and when needed after January 1998, would be able to recover the input tax in December 1997 on the basis that the onward supplies were at that time zero-rated;
- the connected company which received the prepayment would be able to recover input tax when it paid third party suppliers for the later delivery of the goods because it had already accounted for output tax on the supply to the hospital in December 1997.

In *BUPA*, it was held that the scheme was ineffective not because of abuse of rights but because the prepayment for unspecified future supplies did not create a tax point. There was no supply in December 1997, so there could be no input tax claim.

In the present case, the prepayment amounted to £10m, and the hope and expectation was that this would lead to a recovery of 7/47 of that. The scheme was in fact very poorly implemented, as described in the decision, but the VAT was recovered. A control officer then carried out some investigations but was replaced; there was a hiatus in the enquiry and assessments were only raised shortly before the three-year deadline after the return period.

The issue before the Tribunal was therefore whether any evidence of facts necessary for the raising of the assessment had come to light in the twelve months leading up to its issue. If not, it would be out of time. There is a useful summary of the legal issues in relation to this argument in the decision:

65. A number of legal points arise on the proper application of section 73(6). In short they are that:-

- *our enquiry must be as to whether evidence of facts, sufficient in the opinion of the Commissioners to justify the assessments, was obtained in the relevant 12-month period, and that the question is not whether the Tribunal, with or without the benefit of hindsight, would have regarded the pre-existing evidence as sufficient to justify the assessments;*
- *it is only evidence of facts and not the revelation of some new interpretation of the law that can justify assessments beyond the two-year period and thus under section 73(6);*

- *it is evidence of facts justifying the actual assessments made and the grounds for those particular assessments that is relevant, and ignorance of facts, or indeed knowledge of facts that might have justified assessments on some different ground from the one on which the assessments were made, is all irrelevant;*
- *in the period 1997-2000 it was generally believed that the duty of the Commissioners to exercise "best judgment" in making assessment was a more onerous duty than has subsequently emerged to be the correct understanding in the light of later court decisions;*
- *similarly, it was generally believed in the period 1997-2000 that it was not possible, once assessments had been made on one ground, for the Commissioners to vary the grounds subsequently, and this strict view has more recently been held to have been misconceived;*
- *that we should decide whether we should judge the hesitation of the Commissioners in making assessments in this case by reference to the earlier standards generally assumed to prevail in relation to "best judgment" and varying the grounds on which assessments were made, or whether we should apply the tests as now understood in the light of later case law decisions;*
- *whether the assessments in the present case were made under section 73(1) or section 73(2) and whether, if they were made under section 73(2), the "best judgment" duty is irrelevant; and*
- *whose knowledge of facts is significant in this enquiry, or whether for instance, only the knowledge of the particular "decision maker", ignoring evidence obtained by other officers, is of significance.*

The decision contains an exhaustive examination of "who knew what when" and comes to the conclusion that HMRC had plenty of evidence a year before they raised the assessment. As a result, the appeals were allowed.

It appears that the company that received the prepayment has also reclaimed the output tax that it charged. HMRC stated in advance that this would be repaid if the appeal against the input tax assessment was dismissed, but they would consider refusing on the grounds of unjust enrichment if the appeal was allowed. This was commented on at the start of the decision but left for discussion between the parties. The Tribunal chairman added "*Furthermore, and somewhat perversely, it remains possible that notwithstanding that the scheme undertaken by the two Appellants to pre-pay for drugs and prostheses failed on substantive grounds, and on our count could have been faulted on six or seven grounds, the Appellants might gain more from failure than they would have gained from total success*."

VAT Tribunal (20,778): *St Martin's Healthcare Limited; St Martin's Medical Services Limited*

6.7.2 No appealable decision

An unrepresented trader appealed to the Tribunal about the “refusal” by HMRC of a repayment claim relating to June 2006. HMRC stated that they had not refused the claim in the letter complained of, dated 25 February 2008 – the letter clearly stated that no decision had been taken, and verification was continuing. As no decision had been taken, the Tribunal had no jurisdiction. The only course of action was to apply for judicial review in the High Court. HMRC argued that the case was frivolous or vexatious and applied for costs.

The chairman agreed with HMRC that the Tribunal had no jurisdiction in the case. The letter was clear in its terms, and the appellant did not pursue the line that a decision had actually been taken in spite of that. Such an argument would have required witnesses and evidence. It was not for the Tribunal to comment on whether a delay of two years was unreasonable.

On the other hand, the Tribunal did not consider the appeal to be vexatious or frivolous, and declined to make an award of costs. The difficulties of jurisdiction caused problems for lawyers, let alone unrepresented taxpayers. The appeal was simply struck out, and the appellant will have to wait for a decision (apparently deferred pending the prosecution of the supplier in the disputed transaction, which may happen in the spring of 2009).

VAT Tribunal (20,779): *First Class Communications*

6.7.3 Fairness of assessment

A company offered company formation services online. For some time it treated its supplies as partly zero-rated in respect of the sale of printed matter (the articles and memorandum of association of the company). HMRC had accepted that treatment for a number of years, but in 2005 they issued a ruling that the supply was a single compound standard rated supply of services. An appeal against this decision was dismissed by the Tribunal in 2006 (19,461).

That hearing only related to the liability decision, but an assessment followed; the company appealed against that as well, citing a number of grounds:

a. The Respondents in raising the assessment have not done so in accordance with the exercise of best judgement and / or have acted wholly unreasonably.

b. The Respondents have failed to have any regard to the comments made in the Decision of the Tribunal in MAN/05/0232, "The Respondents had not raised any assessment against the Appellant. Were they to do so, the guidelines, would, of course, be very much of greater importance. We should add that Mr Puzey (Counsel) accepted that Mr Vibrans (Appellant) had acted in good faith". In doing so they have acted contrary to judicial guidance, opinion and direction.

c. The Respondents having received a decision from the Tribunal as to the treatment of supplies by the Appellant have sought to enforce the direction upon the Appellants so as to have retrospective effect, a consequence of which is to implement unequal treatment and to be punitive to the Appellant.

d. The Respondents have failed to have any regard to their own published guidance and the issue of the disputed assessments have unilaterally and retrospectively sought to change the basis of tax treatment of the supplies made.

e. The Respondents have ignored relevant and material facts extant at the time of the assessment, including issued guidance and Business Brief 14/94, thereby acting unfairly and prejudicially to the implementation of a fair and proper system of tax collection.

f. Issue estoppel should act to preclude the Respondents assessments being raised.

At the hearing, the appellant restricted these arguments to the main objection that the assessment was unfair (the first ground), but used the next four complaints as reasons for that unfairness. The company had complied with published guidance, and Customs had not ensured that its competitors would be subject to the same ruling. It was therefore suffering a distortion of competition.

HMRC contended, and the Tribunal accepted, that the appeal could not succeed. The assessment was clearly raised to best judgement on the basis of the Tribunal's decision about the liability of supplies. The appeal attacked the decision to raise an assessment at all, possibly on the grounds of misdirection or unreasonableness. These were matters over which the Tribunal had no jurisdiction.

HMRC applied for costs on the basis that the appeal was frivolous: once the arguments had been reduced to (a) on the above list, it was clear that it could not succeed. The Tribunal accepted this argument as well.

VAT Tribunal (20,765): *Company Registrations Online Ltd*

6.7.4 Mark-up disputes

A partnership ran a restaurant and party venue. A Customs officer formed the view that they were underdeclaring their income from various sources and raised an assessment to cover three issues:

(1) £17,870 VAT on undeclared sales determined by a weighted mark up exercise.

(2) £6,618 VAT on undeclared miscellaneous income from phones, gaming and cigarettes machines.

(3) £18,120 VAT on undeclared admissions charges for late night events.

At the Tribunal, the trader vigorously defended the correctness of the accounts, and persuaded the Tribunal that the records were more reliable than the mark-up exercise. The Tribunal reduced the assessments as follows:

(1) No under-declaration of sales by the Appellants during the disputed periods.

(2) The assessment for VAT on miscellaneous income is reduced to £1,245.

(3) The assessment for VAT on admission charged is reduced to £64.53.

The chairman stated that this was not a criticism of the assessing officer, who had had good grounds at the time for suspecting that the returns were

incomplete. Much of the problem had arisen because the trader, or the trader's accountants, had not provided information that the officer had requested; much of the evidence which led to the reduction of the assessments was not provided until the hearing.

VAT Tribunal (20,784): *Ian Robert Clarke & Vivien Doris Clarke t/a The Mongolian Bar*

Another trader was assessed because there were a very high level of "no sale" entries in the till rolls. The Tribunal was satisfied that there was evidence of suppression of sales, but that the assessment did not make sufficient allowance for genuine "no sales". The assessment was reduced from £13,091 to £7,374; in spite of the partial success in reducing the assessment, the appellant was not awarded any costs because of the finding of suppression of sales.

VAT Tribunal (20,763): *Paul John Morris & Maxine Smith*

6.8 Penalties and appeals

6.8.1 Changes to appeals procedures

The Chartered Institute of Taxation has issued a response to HMRC's consultation about the transfer of functions from the Commissioners and VAT and Duties Tribunals to the new unified tribunal system due to come into being on 1 April 2009.

The Institute comments on the need for the review procedure to be independent of the original decision and makes a number of detailed recommendations. It also protests that the withdrawal of the discretionary power of the VAT Tribunal to award interest at an appropriate rate means that some small businesses are likely to be out of pocket even if they win their appeals.

www.tax.org.uk/attach.pl/7044/8332/TribunalsJune08consultation final160708.pdf

6.8.2 Updated manual

HMRC have issued a new manual "VAT Civil Penalties – updated guidance" which brings together information and advice about all civil penalty and interest measures available or likely to be encountered. It covers the circumstances in which a civil penalty is appropriate, as well as those in which HMRC is liable to a "penalty" i.e. payment of repayment supplement.

HMRC Release 7 August 2008

6.8.3 Successful default appeals

A company asked for its VAT return stagger to be varied from 30 November 2007 to 31 December 2007. The accountant believed that HMRC had agreed to a four-month period from 1 September 2007, but HMRC believed that they had approved a three-month period to 30 November 2007 as before and a one-month period after that to change the date.

HMRC sent a letter on 2 November which stated that the change had been approved, but it also said that "*you may receive a VAT return form under the old arrangements. If this happens you must complete the return form and send it to the VAT Central Unit in Southend-on -Sea together with any payment due by the due date specified on the form*". The chairman considered this to be ambiguous, in that the return form for November 2007 had already been received by the time the approval letter arrived. It was therefore not clear whether the approval letter superseded it. There was a reasonable excuse for believing that the four-month period had been approved by HMRC in accordance with a very specific request sent by the appellant.

The chairman commented that the same point had arisen in a number of previous appeals and the chairmen of the earlier Tribunals had complained each time about the ambiguity of the approval letter. In spite of that the wording is almost identical to that considered in a 1995 case.

VAT Tribunal (20,722): *PTE plc t/a Physique*

A trader had been in default in respect of December 2004 and March 2005, and was therefore in the surcharge regime. A further default occurred in March 2006, and a liability extension notice was sent to the trader's address as recorded on HMRC's computer on 12 May 2006. However, a change of address had been received by HMRC on 3 May 2006. That meant that the notice was not properly served, as it was not sent to the last known address of the trader.

There were further defaults in another three periods and the trader appealed against them. He argued that he had never received any of the notices and only became aware that the business was in the default regime when HMRC issued a distraint notice.

The Tribunal did not think that it was credible that he had received none of the notices, and ruled that the cash flow difficulties on which he blamed the payment delays were nothing unusual and therefore were not a reasonable excuse. However, HMRC could not rely on the March 2006 notice unless they could establish on the balance of probabilities that it had actually been forwarded to the trader's new address. As no evidence to that effect had been produced, it had to be struck out. As that meant that there were 12 months without a default, the subsequent defaults fell to be charged at reduced rates and were likely to fall within the de minimis level below which HMRC do not collect surcharges.

VAT Tribunal (20,721): *Words Worldwide Ltd*

6.8.4 Unsuccessful default appeals

A trader's book-keeper had difficulty accessing the HMRC website to file a VAT return electronically. According to her written statement, she tried to file during the evening of the deadline date, but could not get onto the website; she finally managed to do so at 10.45pm and pressed the "submit" button, but it did not appear to go through until 1.40 the following morning. The related payment was also received late by HMRC.

The Tribunal commented that it would have been easier to assess the credibility of her evidence if she had been called in person as a witness. On the evidence before them, it seemed more likely that it was possible to submit the return during the evening, but she had failed to do so through an error or oversight. The surcharge was confirmed.

VAT Tribunal (20,713): *Geoffrey John Clarke & Sharon Joy Clarke*

A trader pleaded reasonable excuse on the grounds that he had changed accountants and the sacked firm had refused to hand over the papers to the new agent until threatened with "the accountants' Ombudsman". As a result the relevant return was subject to surcharge. The rate was 15% because of a history of defaults: the trader explained that he had not realised what the earlier surcharges were or why they arose, and he had changed his accountants when he found out.

The evidence of the trader was inconsistent and there was no documentary evidence to back up his assertions. In the absence of such evidence, the Tribunal was not able to find the facts to be as described by the appellant; as a result it was not possible to conclude that he had a reasonable excuse.

VAT Tribunal (20,745): *Nadeem Khokhar t/a Expresso Bar Ltd*

A company failed to make a payment on account on time, apparently because the regular employees were off sick and a temporary finance director was instructing a temporary accounts clerk in procedures with which they were both unfamiliar. There was insufficient evidence before the Tribunal to convince the chairman that the circumstances constituted a reasonable excuse: the sickness had not prevented the preparation of the return itself, and it seemed to be a problem only with input of the instructions to the bank. That did not appear to be a reasonable excuse without some additional explanation which was not forthcoming.

The company also pleaded that the penalty was hugely disproportionate, being a 2% surcharge for 1 day's delay. The Tribunal commented that the regime was harsh, but other Tribunals have considered the question and concluded that it is legal and cannot be replaced or amended by Tribunal decisions.

VAT Tribunal (20,732): *Encase Ltd*

Another company failed to make a payment on account because the accounts clerk responsible for making the transfer "was sidetracked" and failed to contact the bank before the 3.30pm deadline. Not surprisingly, this did not constitute a reasonable excuse.

VAT Tribunal (20,786): *Splendid Hotel Group*

A company had been paying default surcharges at 15% for two years. In spite of this, the cheque accompanying the January 2007 return was dated 27 February 2006 and was rejected by the bank. The company's appeal that this was a genuine error could not constitute a reasonable excuse.

The Tribunal commented as follows:

"*The Commissioners also relied on their Notice 700/50 which states that:*

'Genuine mistakes, honesty and acting in good faith are not accepted as reasonable excuses for surcharge purposes.'

Whilst we have reservations about the wording of Notice 700/50, the circumstances which give rise to the genuine mistake being matters which this Tribunal would be prepared to take into account when considering whether or not a default surcharge should be upheld, we have not heard any evidence as to the circumstances which gave rise to this mistake. It is unfortunate that neither Mr nor Mrs Mayor were able to attend the Tribunal to give us some idea of what their circumstances were at the time."

VAT Tribunal (20,733): *Magnumcraft Technology Ltd*

A trader pleaded that late payments by large customers had contributed to his late payments of VAT. He did not appear before the Tribunal, but correspondence that he had submitted to HMRC was examined by the Tribunal. There was no evidence that he was actually short of money on two occasions when the VAT was paid late, and on the third occasion when he was short of money there was no evidence of the reason for that. Insufficiency of funds on its own could not be a reasonable excuse, so his appeal was dismissed.

VAT Tribunal (20,734): *Lansdowne Building Contractors Ltd*

A trader claimed that a series of surcharge liability notices had not arrived. It was also claimed that returns had been filed on time and that payments had been made in such a way that the company could reasonably have expected the money to arrive on time.

The Tribunal examined evidence about the returns and payments and decided that the company was in default in all the periods concerned, and did not have a reasonable excuse or convincing evidence that the notices had not arrived.

VAT Tribunal (20,735): *Sovereign Partners Ltd*

A firm of solicitors was told by its bankers that there would be a new system of making electronic transfers. A trainer came to help the accounts manager understand the new system. While entering the payees of regular bills on the system, the accounts manager made an admittedly "silly mistake" – for the VAT payment, she put the firm's own account number and sort code into the system instead of HMRC's.

She was off sick when the first payment under the new arrangements was made, and it was returned by the Bank of England a few days later. She made an immediate telegraphic transfer to HMRC, but failed to follow up the reason for the payment being returned. Accordingly, HMRC issued a surcharge liability notice and when exactly the same thing happened at the end of the next quarter, a 2% surcharge was levied (£5,500).

The Tribunal accepted all the facts as presented to them, but did not think that there was a reasonable excuse. Reliance on the trainer to check what was done could not be an excuse; the failure to follow up the reason for the failed payment did not appear to be the action of a conscientious trader, although there were mitigating circumstances in the absence through sickness. The penalty had to stand.

VAT Tribunal (20,764): *T G Baynes*

A company used an employee of its accountants for book-keeping and VAT compliance. She normally attended the company's offices on two days a week, and was the only person to hold a key to the filing cabinet in which the accounting and VAT records were kept. The chief executive officer, who owned the company, was the only signatory on the bank account.

The payment for the April 2007 return was made a day late because the CEO was late returning from an overseas business trip. A surcharge liability notice was issued. The return for January 2008 was late because the employee suffered a serious neck injury and did not come to work in the last week of February 2008 when she would have prepared the VAT return. A new financial controller joined the company on 3 March and immediately took steps to correct the VAT position.

The Tribunal held that there were no reasonable excuses. In each case, a reasonably conscientious trader could and would have taken steps to deal with the problem in time. The surcharge of £3,444 stood.

VAT Tribunal (20,787): *Ivis Group Ltd*

A company claimed that its VAT return and enclosed cheque were held up by a postal strike. The Tribunal examined the evidence and found that the postal strike occurred on 4 and 5 October 2007, so a return that was alleged to have been sent by first class post on 28 September should not have been affected. It actually arrived on 12 October.

The Tribunal also noted that the company was in excess of its overdraft limit on 30 September. A substantial credit arrived on 3 October, but it was unlikely that the bank would have cleared a VAT cheque for some £37,000 before that date.

Without a representative for the company present to give further explanations, the Tribunal found that it was more likely that the return and cheque had been posted late. There was therefore no reason not to confirm the surcharge.

VAT Tribunal (20,782): *RGS Insulations Ltd*

A trader pleaded reasonable excuse because the employee responsible for the VAT return had been off sick when it was due. Unfortunately, that sickness had started 3 months before the due date, and could not constitute a reasonable excuse – a conscientious trader would have done something about the situation in time.

VAT Tribunal (20,803): *John Stephenson Property Consultants*

6.8.5 Belated notification

A trader exceeded the registration threshold in April 2006, but HMRC were not informed until 20 August 2007. The first return was prepared for the period from 1 June 2006 to 31 October 2007. HMRC asked for the actual turnover from 1 June 2006 to 20 August 2007 so they could calculate a 10% penalty. The trader failed to answer this letter, so HMRC used the figure for expected annual turnover from the VAT 1, £100,000. This produced a VAT figure rather higher than the actual total for the longer first return period.

HMRC agreed to mitigate the penalty by 25% for cooperation and, after a protest, by another 25%. The Tribunal increased it by a further 20%, commenting that the trader appeared to have tried to put things right when he became aware of the problem, but recognising that there should be some penalty for the failure.

The chairman also noted that HMRC appeared still to be willing to revise the penalty downward again if the trader would only produce actual figures for the late notification period.

VAT Tribunal (20,745): *William Whyte Brydon*

6.9 Other administration issues

6.9.1 Set-off of tax debts

HMRC have issued a brief guidance note on changes to its set-off powers against various tax debts, as introduced in Part 7 of the Finance Bill 2008. The main impact of the changes will be in setting-off some indirect tax repayments against direct tax debts.

For many years HMRC have set-off repayments against outstanding debts within tax systems and between Income Tax and National Insurance Contributions (NICs). The 2006 High Court case *Mellham v Burton* confirmed set-off as a normal business principle.

The new rules allow set-off across a wider range of taxes, and also remove the need to seek authority from taxpayers before the set-off takes place. However, HMRC must still advise the taxpayer in writing what has been done.

HMRC already carry out offsets under existing rules and guidance. They say that the procedure is familiar and not usually controversial, and the new rules will operate in much the same way.

HMRC may make a set-off at any time where an amount is due from and payable to HMRC for the same legal person or entity at the same time.

Where HMRC are obliged to set-off under specific legislation, these continue to take priority. Examples of such set-offs are for NICs, VAT, Landfill Tax, Aggregates Levy and Excise Drawback, and existing HMRC systems support these mandatory set-offs.

Going forward, set-off will be at HMRC's discretion or at the taxpayer's request. Set off is subject to important principles:

- Repayments are set only against established debts, which means quantified debts that are correctly payable either based on a return from the taxpayer or where tax has been assessed and either an appeal has been determined, or the period for appeal has passed.
- Payments are allocated using the framework of existing rules, where the aim is always to allocate to taxpayer's best advantage as outlined in the Revenue's internal manuals.

There will be no monetary limit to the amount set-off, but HMRC may choose not to exercise set-off for small amounts if it is clearly uneconomical or unproductive to do so.

Except in very limited circumstances which are covered by guidance, HMRC will not hold up repayments where they are not already aware of a debt. When pursuing debts, HMRC staff will not in every case check for possible repayments unless they are aware that one is likely. However where staff discover that an overpayment and an outstanding debt exist, they will seek to set one against the other.

HMRC Release 18 July 2008

A company was awarded costs in a Tribunal dispute with HMRC. At the same time, HMRC obtained a county court judgment against the company for £30,500. HMRC applied to the High Court for leave to set the two amounts off. The company argued that they were separate and should not be set off; if that was true, HMRC would contribute the costs in full and would only receive a percentage of their judgment.

The Court did not think that there was any strong reason not to allow offset, and a number of good reasons to allow it. An order to offset was granted.

High Court: *HMRC v Xicom Systems Ltd*

6.9.2 NAO report

The National Audit Office report on the latest set of HMRC accounts has again criticised the levels of error and fraud in the tax credits system. In relation to VAT, whilst acknowledging that HMRC's processing of registrations returned to target in 2008, the NAO notes that the department must strike a balance between tackling criminal activity and dealing with legitimate traders.

In 2007-08, £81.2 billion in VAT was collected and around eight million VAT returns processed. HMRC introduced long-term measures to increase VAT registration performance but, owing to a combination of factors, performance significantly deteriorated during 2007. Performance recovered by January 2008 and continued with 83 per cent of applications processed within the 14 calendar day target in March 2008.

Press Notice 35/08

6.9.3 Agent update

HMRC have published issue 7 of their bimonthly “agent update”. VAT matters include the following, referring to matters which can be “clicked through” on the HMRC Website:

- Penalties clarified for claims for VAT refunds by overseas businesses – View a PDF version of a new leaflet, produced by HMRC, explaining the new penalty regime in relation to claims by overseas businesses for VAT incurred in the UK. Printed copies of the leaflet, designed for SMEs and the self-employed, are also available.
- Revenue & Customs Brief 31/08: set off where right to overdeclared tax is transferred – Read details of a new clause covering set off where right to claim overdeclared tax is transferred.
- Latest issue of VAT Notes published – Read the latest issue of the publication for VAT registered traders, including items on Schedule 10 (Land and Buildings) to VAT Act 1994, employment businesses, and further and higher education.
- Amendment to the VAT exemption for fund management services – Read details of amends to legislation, explanatory memorandum and guidance concerning changes announced at Budget 2008. For businesses wishing to submit claims for overpaid VAT please view the Revenue and Customs Brief 35/08 for more details.
- New leaflet helping tax payers avoid penalties produced (www.hmrc.gov.uk/about/new-penalties/new-penalties.pdf) – View a PDF of HMRC’s new leaflet, ‘Take care to avoid a penalty’, which you can give to clients. The leaflet explains how penalties for incorrect filing will be awarded under the new regime and how to avoid them.

All these items, apart from VAT Notes, have been covered in this or the previous VAT update.

www.hmrc.gov.uk 22 Aug 2008

6.9.4 Security appeals

As usual, traders’ appeals against security requirements are universally unsuccessful. In some of the cases a substantial argument was mounted (i.e. more than the doomed “we cannot afford to pay the security requirement”, which only proves HMRC’s case), but it was never enough to displace the reasonableness of HMRC’s position.

VAT Tribunal (20,724): *Panheat Contracts Ltd*; (20,714): *North (Newcastle) Ltd*; (20,715): *Camp David Ltd*