

Input tax on legal fees

(Lecture B1134 – 11.16 minutes)

Introduction

There is often a thin dividing line between legal fees that relate to the business, and those which are relevant to an individual director, employee or business owner. For example, legal fees might be incurred to defend an employee in a court case, and there is no doubt that an adverse result could impact on the trading reputation of the business. But as a general principle, input tax cannot usually be claimed on the costs of defending a criminal charge against an employee. To quote from HMRC input tax manual VIT13600: "Every case is unique and HMRC will need to think about all the details before reaching a conclusion."

Tribunal success for taxpayer

A well-quoted historical case that went in favour of the taxpayer many years ago related to P&O European Ferries (Dover) Ltd (VTD7846) where the tribunal ruled that input tax could be claimed when the company paid the legal costs of defending a charge of manslaughter against itself and seven employees following the Zeebrugge disaster: "The conviction of any of the employees would have caused severe damage to the public perception of the company's business".

But to balance the books, many other cases have been won by HMRC. Needless to say, HMRC tend to be quite strict in their interpretation of the 'business purpose' test which is crucial to any input tax claim. In reality, past case law has often given unpredictable outcomes.

Praesto Consulting Ltd [2019] EWCA Civ 353 (See case summary above)

This case has now been heard in three different courts – the hearings considered whether input tax could be claimed by the company on the cost of legal fees to defend its sole director against civil proceedings made against him by his former employer Customer Services Plc (CSP). The main issue in dispute was whether the director had removed confidential information when he left CPS and used this to the commercial advantage of his new company. The invoices for the lawyer fees in question were made out to the director personally and also at his home address. Could input tax be claimed by Praesto? As we have seen in the case summary above, the answer was yes.

The legislation and decision

When you have an input tax challenge, the relevant legislation to consider is VATA1994, s24(1) – and the need for expenditure to be for 'the purpose of any business' and only relevant to 'the supply to him of any goods or services' (author underlining – 'to him' being the VAT registered business).

The lawyers had to be supplying services to the company and not the individual director and the expenditure also had to be linked to Praesto's business activities. The FTT decided this was the case and allowed the appeal but the UT disagreed. And although the Court of Appeal ruled in favour of the taxpayer (round 3 so to speak), the margin of victory was 2-1, with one of the judges dissenting because the invoices were made out to the director personally. The other two judges agreed that Praesto had a direct interest in preventing CPS's claim and the legal services therefore related to its taxable services and input tax could be claimed.

Learning points – a balanced approach

Here are three tips about deciding the business/private use issue regarding input tax on legal fees:

1. Fully consider the implications on the business if the court decision goes against the business: will this either reduce or threaten to reduce taxable sales in the future? Will it have such an adverse effect on the company's reputation that its potential business development will be affected?
2. Make a note on purchase invoices as to why the lawyer's letter of engagement is with the individual employee rather than the business. And confirm that all legal fees were paid for by the company rather than the individual director.
3. Review the landmark case considered above that went in favour of the taxpayer many years ago involving P&O European Ferries (Dover) Ltd (VTD7846) and see if there are parallels with your own situation.

Hotel bills

An example of an expense where there is no problem with the invoice being made out to the employee rather than the business relates to hotel accommodation. HMRC accepts that the supply is still relevant to the company, as long as it pays the bill and the overnight stay related to taxable business being carried out by the employee. See HMRC Input tax manual VIT13400

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