[2019] UKFTT 0440 (TC)

VAT—Input tax—Professional fees incurred in pursuing litigation—Whether a general overhead of the business or whether attributable to particular exempt supplies

FIRST-TIER TRIBUNAL
TAX CHAMBER

TC07254

Appeal number: TC/2018/05245

BETWEEN

NEWMAFRUIT FARMS LIMITED **Appellant**

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

TRIBUNAL: JUDGE CHRISTOPHER STAKER

Sitting in public at Folkestone on 18 June 2019

Tim Brown, counsel, for the Appellant

Fatouma Yusuf, litigator of HM Revenue and Customs' Solicitor's Office, for the Respondents

DECISION

INTRODUCTION

1. The issue in this appeal is whether the Appellant can deduct as input tax the VAT that it has paid on professional fees incurred in bringing litigation. The Appellant contends that these professional fees were a cost component of its economic activities as a whole. HMRC contend that they were linked to a specific exempt supply.

BACKGROUND

2. The Appellant is a fruit farming and packaging business based in Kent.

3. In January 2018, the Appellant submitted to HMRC a Notification of Errors in VAT Returns form in respect of periods 03/15 to 01/17. A covering letter to the form explained as follows. The Appellant had accumulated profits for which it did not have an immediate use, and in order to earn interest on its cash reserves had lent them on a short term basis to unconnected third parties. The Appellant subsequently had to bring legal proceedings when the loans were not repaid. As a result of these proceedings, the Appellant had been able to recover partially the loan capital but was unable to recover any interest. In its VAT returns the Appellant had not claimed as input tax the VAT it had paid on professional services in connection with those legal proceedings. The Appellant now wished to do so.

4. In February 2018, the Appellant submitted a further Notification of Errors in VAT Returns form in respect of period 11/17.

5. Following certain exchanges between the parties, on 15 May 2018 HMRC issued a decision rejecting the claim for input tax, on the ground that the Appellant had not shown how the input tax claimed was directly linked to its other taxable supplies.

6. The Appellant requested a review of this decision. On 13 July 2018, HMRC issued a review decision upholding the 15 May 2018 decision. The review decision concluded that the claimed input tax was not recoverable because the legal fees incurred were linked to an exempt supply (the making of loans). It concluded also that in any event, the legal fees were not a general overhead of the Appellant's business and were not linked to any taxable supply made by the Appellant.

7. The Appellant now appeals to the Tribunal.

THE EVIDENCE OF MR NEWMAN

8. The witness statement of Mr Melvyn Newman, Chairman of the Appellant, states amongst other matters as follows.

9. In 1997 the Appellant engaged a Mr Derek Peter as a consultant and engaged Green & Peter, a firm in which Mr Peter was a partner, as the company's accountant and advisor. Mr Peter became finance director and finally company secretary. In 2006, he was appointed as a director of the Appellant.

10. By the late 2000s, the Appellant had accumulated significant cash reserves, and was looking for opportunities to invest these until such time as opportunities arose to expand the Appellant's business. In 2004 Mr Peter introduced Mr Newman to a Mr Alan Pither, a property entrepreneur. This led to the Appellant providing Mr Pither with finance for a property development in Kent. The Appellant subsequently participated in other investment opportunities with Mr Pither.

11. Mr Newman says that in 2014 he discovered financial irregularities, after which Mr Peter's engagement was terminated. Mr Newman says that he formed the view that money invested by the Appellant was being siphoned off and used for other purposes by Mr Pither, and that he considered that the Appellant had been defrauded. The Appellant brought legal proceedings against Mr Pither and Mr Peter. The Appellant had to borrow a significant sum of money from a bank to finish off the property investments it had entered into with Mr Pither, and shortage of cash caused the Appellant to record its first ever loss.

12. HMRC did not wish to cross-examine Mr Newman, and he did not give oral evidence.

THE DOCUMENTARY EVIDENCE

13. The documentary evidence includes certain loan agreements (some of which are unsigned) naming the Appellant as one party, and variously naming AMP Consultants Limited ("**AMP**"), Mr Pither, Priory Homes (Norfolk) Limited, and Priory Homes (Kent) Limited as the other party. Also in evidence are a number of documents relating to the legal proceedings referred to in paragraph 11 above (the "**High Court proceedings**"). These include an interlocutory judgment given on 9 December 2016 by Mr Martin Chamberlain QC sitting as a Deputy High Court Judge, *Newmafruit Farms Ltd & Ors v Pither & Ors* [2016] EWHC 2205 (QB) (the "**2016 judgment**").

14. The 2016 judgment indicates as follows.

(1) The High Court proceedings were originally brought on 26 November 2015 by the Appellant only against Mr Pither only, and the claim was "for repayment of loans made between April 2009 and February 2014" (at [2]).

(2) In a re-amended defence, Mr Pither admitted that the Appellant had advanced certain funds for various developments but did not admit other allegations made by the Appellant, and Mr Pither also advanced a number of defences (at [4]).

(3) On 9 May 2016, the Appellant made an application for an order striking out all or part of Mr Pither's re-amended defence, and/or for summary judgment on all or part of the claim (at [1] and [5]).

(4) On 22 July 2016, a without notice application was made by the Appellant, Priory Homes (Kent) Ltd (in administration) and Priory Homes (Norfolk) Ltd (in administration). In a decision on that application, Jay J ordered that the latter two companies be added as claimants and that Mr Peter, AMP and two other companies be added as defendants. Jay J also granted a worldwide freezing injunction and disclosure order against Mr Pither, Mr Peter and AMP, tracing orders against the other two defendants, and permission to amend to advance claims in deceit, breach of fiduciary duty, dishonest assistance, conspiracy, breach of contract and unjust enrichment against the defendants (at [8]).

15. The Tribunal has been provided with a copy of a witness statement of Mr Newman dated 25 July 2016, which was apparently submitted in support of the application for a freezing injunction referred to in paragraph 14(4) above.

16. The 2016 judgment was an interlocutory decision on the application referred to in paragraph 14(3) above. It thus appears to deal with the claims against Mr Pither only. It deals with 30 discrete sums of money claimed by the Appellant in the proceedings. These sums are referred to in the 2016 judgment as "rows". Each of these rows was a sum of money claimed to have been lent by the Appellant (see in particular the summary at [108]). The 2016 judgment dismissed the Appellant's claims in respect of some of the rows on the ground that the sums in

question were owed by AMP rather than Mr Pither. It granted the Appellant summary judgment in relation to certain of the rows. It dismissed the application for summary judgment in relation to other rows, on the basis that there were triable issues in relation to the sums in question.

17. The claimants in the High Court proceedings subsequently made an application to add two additional defendants to those proceedings, and to extend the existing freezing injunction to those new defendants. The Tribunal has been provided with the Appellant's skeleton argument dated 15 December 2016 for the hearing of that application.

18. The Tribunal has also been provided with "Re-Re-Amended Particulars of Claim" in the High Court proceedings, dated 27 March 2018. In this document, there had now been added an additional claimant (Newmafruit International Limited, a company associated with the Appellant), as well as two additional defendants, Green & Peter (a firm), and Green & Peter (UK) Limited. It is not clear exactly when this additional claimant and these additional two defendants were added.

19. The Tribunal has also been provided with an "Agreed Case Summary" for the hearing of the High Court proceedings, setting out the issues in the case. The bundle index states that this was for a mediation scheduled for January 2019.

20. At the hearing Mr Brown stated that the High Court proceedings had been settled. He said that the terms of the settlement were confidential, so that documentary evidence of the settlement could not be provided to the Tribunal.

APPLICABLE LEGISLATION

21. Article 168 of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (the "**Directive**") relevantly provides as follows:

> In so far as the goods and services are used for the purposes of the taxed transactions of a taxable person, the taxable person shall be entitled, in the Member State in which he carries out these transactions, to deduct the following from the VAT which he is liable to pay:
>
> (a) the VAT due or paid in that Member State in respect of supplies to him of goods or services, carried out or to be carried out by another taxable person ...

22. Section 31(1) of the Value Added Tax Act 1994 ("**VATA**") provides that a supply of goods or services is an exempt supply if the goods or services are of a description for the time being specified in Schedule 9 VATA.

23. Group 5 of Schedule 9 VATA specifies various items relating to finance, including "The making of any advance or the granting of any credit" (Item 2) and "The management of credit by the person granting it" (Item 2A).

THE APPELLANT'S SUBMISSIONS

24. At the hearing, Mr Brown for the Appellant accepted that the appeal would fail if the Appellant made a zero rated supply of loans, and if there was a direct and immediate link between the professional fees in respect of which input tax is claimed and that zero rated supply. Mr Brown acknowledged that the Appellant needed to demonstrate either that there was no supply of loans, or alternatively, if there was such a supply, that there was no direct and immediate link between the professional fees and that supply. Mr Brown further conceded that

the Appellant needed in any event to establish that there was a direct and immediate link between the professional fees and the Appellant's economic activity as a whole.

25. The Appellant submits that it did not make an exempt supply of loans.

(1) First, the Appellant argues as follows. The High Court proceedings (which were ultimately settled) led to the Appellant recovering only part of the capital loaned, but none of the interest, and because of this, the Appellant received no consideration for the funds loaned. Even if the loan agreement provided for consideration to be paid by the borrower in the form of interest, this was in fact not paid by the borrower, so that there has been a total failure of consideration. The provision of goods or services without consideration is not a supply.

(2) Secondly, it is argued that the borrowers never had any intention of abiding by the loan agreements, so that there never was any genuine agreement.

26. The Appellant argues that if there were no loan agreements, then the High Court proceedings cannot have been linked to the making of loans, and the proceedings were rather for the general purpose of recovering assets of the Appellant.

27. In the alternative, the Appellant submits that even if it did make an exempt supply of loans, the professional fees incurred in the litigation had no direct and immediate link to those loans. This is said to be because the High Court proceedings were brought not just against the persons to whom the loans had been made, and were not confined to claims based on the loan agreements. Rather, in those proceedings various claims were made against various defendants including for deceit, breach of fiduciary duty, dishonest assistance, negligence and/or conspiracy. On this basis, it is argued that the effect of the High Court proceedings was generally to protect the Appellant's business against the conduct of others, and to protect and recover assets belonging to the Appellant's business.

28. In either case, the Appellant further submits that there was a direct and immediate link between the professional fees and the Appellant's business activities as a whole. It is said that it is in a business's interests to pursue those who have perpetrated a fraud against it and to recover sums which are assets of the business, especially when this is in order to repay amounts it had to borrow from financial institutions to continue trading when the loans were not repaid. On that basis, the services supplied by the lawyers in pursuing the litigation are said to be part of the Appellant's overheads generally and cost components of its products (reliance is placed on *Kretztechnik AG v Finanzamt Linz* (C-465/03) EU:C:2005:320, [2005] 1 WLR 3755 at [36]).

THE HMRC SUBMISSIONS

29. HMRC submit that the loan agreements were supplies for consideration, the consideration being the agreement by the lenders to pay interest on the loans. These supplies were made at the time that each loan agreement was entered into. The characterisation of the supply is determined at the time of supply, and does not change as a result of subsequent events. Defaults on the loans do not retrospectively alter the fact that the loans were exempt supplies.

30. Upon the loans going into default, the legal proceedings were brought to recover the loan capital and outstanding interest. The professional fees paid to conduct that litigation were therefore directly linked to the loan agreements. The fact that recovery of the amounts due under the loan agreements would benefit the business as a whole is immaterial, since it is only the immediate supply to which any input is a cost component that matters. The Appellant has not demonstrated any direct or immediate link to its normal taxable supplies. Because the professional fees were linked to an exempt supply, the input tax cannot be recovered.

31. Even if the Tribunal were to accept the Appellant's argument that there was no exempt supply on the ground that the Appellant received no consideration, it would still be the case that there is no direct link between the legal fees and any taxable supply.

THE TRIBUNAL'S FINDINGS

Findings of fact

32. This Tribunal makes findings of fact on a balance of probability, based on the evidence before it.

33. The purpose of these findings of fact is to determine a question relating to the Appellant's VAT liabilities, a question that is in dispute between the Appellant and HMRC. The Tribunal makes no findings in relation to the merits of the claims advanced by the Appellant in the High Court proceedings. This Tribunal has no jurisdiction to do so, and the High Court proceedings were brought against persons who are not parties to the present appeal. The merits of the High Court proceedings are not material to the present appeal. The right of a taxable person to deduct as input tax the VAT paid on professional services incurred for the purposes of litigation does not generally depend on whether the taxable person wins or loses that litigation. It will rather normally depend only on the subject matter of the litigation and the claims made in it.

34. On the evidence before it, the Tribunal finds that the Appellant commenced High Court proceedings on 26 November 2015, originally against Mr Pither only, "for repayment of loans made between April 2009 and February 2014". Subsequent amendments were made to the particulars of claim to include additional parties and claims. By 27 March 2018, the litigation included all of the parties and claims contained in the "Re-Re-Amended Particulars of Claim".

35. The Appellant has not presented sufficient evidence to establish its claims (1) that in the settlement it recovered only part of the capital loaned but none of the interest, and (2) that the borrowers never had any intention of abiding by the loan agreements.

Applicable legal principles

36. It is well established that a supply will be treated as being "used for the purposes of the taxed transactions of a taxable person" within the meaning of Article 168 of the Directive if either:

(1) there is "a direct and immediate link" between the supply and one or more taxed output transactions; or

(2) there is "a direct and immediate link" between the supply and the taxable person's economic activity as a whole.

(See, for instance, *Praesto Consulting UK Ltd v HM Revenue and Customs* [2019] EWCA Civ 353 ("***Praesto***") at [28]; *Finanzamt Koln-Nord v Wolfram Becker*, C-104/12, EU:C:2013:99 ("***Becker***")).

37. However, where a supply is used by a taxable person for the purposes of an exempt transaction, the taxable person is not entitled to deduct the input tax paid on that supply (see *BLP Group plc v Customs and Excise Commissioners*, C-4/94, EU:C:1995:107, [1996] 1 WLR 174).

38. The Appellant therefore appropriately makes the concessions referred to in paragraph 24 above.

39. The making of a loan is an exempt supply by virtue of s 31(1) VATA and Item 2 in Group 5 of Schedule 9 VATA.

Application of legal principles to the facts

40. The Appellant's first submission is that there has been no supply of loans.

41. At the hearing Mr Brown, when asked by the Tribunal, accepted that the Appellant's case in the High Court proceedings was that the loan agreements were valid and legally enforceable. Indeed, Mr Brown accepted that the Appellant was in the High Court proceedings in fact suing on the loan agreements. It is therefore difficult to see how the Appellant can now argue before this Tribunal that there were no loan agreements.

42. In any event, in the present appeal proceedings, the Appellant's own case is that there were formal written loan agreements, and that the Appellant performed its obligations under those loan agreements by advancing sums to the borrowers. On ordinary principles, a contract comes into existence upon the acceptance of an offer, rather than upon performance of the terms of the contract by the parties. At the point in time when a loan agreement has been entered into and the funds have been advanced by the lender to the borrower, there is "an agreement between the parties for reciprocal performance", providing for payment by one for a supply received by the other (see *Airtours Holidays Transport Ltd v Revenue and Customs* [2016] UKSC 21 at [48], [55] and [57]). By that point there has been a supply of a loan. The fact that a borrower subsequently defaults on a loan agreement would not retrospectively undo the existence of the loan agreement or the fact of the supply.

43. Whatever may have been decided in the High Court proceedings, had they been pursued to finality, this Tribunal is satisfied for purposes of the present appeal, based on the evidence before it, that the Appellant made an exempt supply of loans. The Appellant's first submission is therefore rejected.

44. The Appellant's second submission is that even if there has been an exempt supply of loans, there is no direct and immediate link between the professional fees incurred in the litigation and that supply.

45. In considering this question, the Tribunal must determine whether the professional fees were objectively a component of the price of the supply of the loans, having regard to all the circumstances surrounding the transactions at issue, and having regard to economic and commercial realities (see *Praesto* at [30], [57(2)] and [60], quoting *Becker* at [19]-[23]).

46. The Tribunal takes into account that the Appellant is not generally in the business of providing loans, and that its business is fruit farming and packaging. However, the Tribunal sees no reason in principle why the question whether there is a direct and immediate link between an input and an exempt supply should depend on whether the taxable person regularly makes such exempt supplies, or only exceptionally.

47. The Appellant argues that in this case, the legal fees were incurred years after the loans had been made, such that there is a temporal disconnect between the two. However, legal proceedings by a lender against a borrower who defaults on a loan will by definition occur only some time after the supply of the loan has been made, and depending on the term of the loan, may be many years after the loan has been made. Furthermore, if there is otherwise a direct and immediate link between the supply of a loan and legal proceedings, the Tribunal does not see how this will be affected by the passage of time alone.

48. The Appellant then relies on the statement in *Becker* at [31] that a causal link cannot be considered to constitute a direct and immediate link, and that it is necessary for there to be a legal link. In this respect, the Tribunal considers as follows.

49. When a lender supplies a loan, the lender will need to administer the loan until the borrower's obligations are finally discharged. The administration of a loan will involve, for instance, checking that repayments have been made on time and in the correct amounts, chasing the lender in the event that repayments are in arrears, and ultimately, bringing legal proceedings in the event that a default is not remedied. All of this administration is a cost component of the supply of the loan itself, and the expected costs thereof are typically factored into the supplier's determination of the interest rate at which the supplier is prepared to make the loan, which is in practice the price for which the loan is supplied.

50. Therefore, a lender's costs of bringing legal proceedings against a borrower for breach of a loan agreement is a cost component of the supply of the loan itself, and there is a direct and immediate link between such costs and that supply.

51. However, the Appellant contends that in the this case, some of the defendants in the High Court proceedings were not parties to the loan agreements, and the claims made in the High Court proceedings were not all based on the loan agreements, but encompassed also other claims including deceit, breach of fiduciary duty, dishonest assistance, negligence and conspiracy.

52. The Tribunal does not consider that the existence of a direct and immediate link between the costs of legal proceedings and the supply of a loan is confined to circumstances where the litigation is against a party to the loan agreement, and where the claim in the litigation is founded directly on the loan agreement itself. As a matter of economic and commercial reality, in the event of a default on a loan, a lender might seek to recover the principal and interest due under the loan agreement by means of litigation against persons who were not parties to the loan agreements, but who are said to have been involved in some way in the circumstances leading to the lender's loss, and against whom the lender claims to have a cause of action for compensation for that loss. An example, to give just one, would be a claim in professional negligence against a financial adviser who is said to have negligently advised the lender that the borrower was credit worthy. The Tribunal considers that it is part of the administration of a loan generally, as described in paragraph 49 above, for the lender, in the event of a default, to bring whatever legal claims it can against whichever parties it can, in respect of the losses flowing therefrom. Irrespective of the defendant against which a claim is brought, or the legal basis for the claim, if the claim is seeking, one way or another, compensation for losses said to have been sustained through entering into a loan agreement upon which the borrower subsequently defaulted, then the costs of the litigation have a link with that loan that is for present purposes legal, and not merely causal.

53. The Appellant then contends that some of the claims in the High Court proceedings were completely unconnected to the loan agreements. At the hearing, Mr Brown contended that even if some of the professional fees incurred in the High Court proceedings were directly and immediately linked to the supply of the loans, then part of the fees should be apportioned to the Appellant's taxable supplies on the basis that they were unconnected with loans and therefore a general overhead of the Appellant's business.

54. However, Mr Brown did not take the Tribunal through all of the detailed particulars of claim in the High Court proceedings, in order to itemise which ones were said to be unrelated to the loans.

55. Having considered the 27 March 2018 "Re-Re-Amended Particulars of Claim", it appears to the Tribunal that, with one exception referred to below, all of the claims in the High Court proceedings against all of the defendants related in one way or another to loans made by the Appellant, and that each of the claims was, one way or another, seeking to recover losses claimed to have been suffered as a result of failure to repay the loans and interest.

56. The one exception appears to be a claim that the Appellant was overcharged for the services of Mr Peter and Green & Peter. However, the Tribunal notes as follows. The 25 July 2016 witness statement of Mr Newman claims at paragraphs 107-108 that Mr Newman became aware of the overcharging in about May 2014. Despite this, the High Court proceedings were originally brought some 18 months later in November 2015 against Mr Pither only. An application for Mr Peter to be added as a defendant was made only on 22 July 2016, some 8 months after that, and the first reference to Green & Peter as a defendant in the documents before the Tribunal is found only in the 27 March 2018 "Re-Re-Amended Particulars of Claim". Furthermore, the claims of overcharging for the services of Mr Peter and Green & Peter were not necessarily added at the same time that Mr Peter and Green & Peter were added as defendants. It is not at all clear exactly when this claim was added. Paragraphs 107-108 of Mr Newman's witness statement seem to be describing a chronology of events rather than claims being made in the proceedings, and paragraph 6 of that witness statement which sets out a summary of the main points does not mention this claim at all. Indeed, paragraph 6.5 of that witness statement describes the Appellant's losses as "the sums still outstanding on its lending".

57. The Tribunal is not satisfied on the evidence before it that the claim for overcharging was unconnected with the claims relating to the loans. Furthermore, even if the claim for overcharging was unconnected with the claims relating to the loans, the Tribunal is not satisfied on the evidence that the proportion of the professional fees spent on the overcharging claim was more than *de minimis*. The Tribunal does not consider that there needs to be any apportionment of the professional fees as suggested by Mr Brown.

58. The Tribunal therefore finds that the professional fees were directly and immediately linked to the making of exempt supplies of loans.

59. It is therefore unnecessary to consider the Appellant's third submission, to the effect that there was a direct and immediate link between the professional fees and the Appellant's business activities as a whole.

CONCLUSION

60. The appeal is dismissed.

RIGHT TO APPLY FOR PERMISSION TO APPEAL

61. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

DR CHRISTOPHER STAKER
TRIBUNAL JUDGE

RELEASE DATE: 08 JULY 2019