TC02374

Appeal number: TC/2011/7226

VAT – input tax denied on invoices for work covering partners' tax reserves & partners' tax returns – appeal allowed in part

FIRST-TIER TRIBUNAL
TAX CHAMBER

MUNDAYS LLP **Appellant**

- and -

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

TRIBUNAL: JUDGE BARBARA MOSEDALE
MRS CAROLINE DE ALBUQUERQUE

Sitting in public at Bedford Square, London on 28 September 2012

Ms J Simpson, Chartered Tax Advisor, of Menzies LLP, for the Appellant

Mrs R Paveley, Officer of HMRC, for the Respondents

DECISION

1. The appellant was assessed to tax of £18,647.00 on 31 January 2011 on the basis that it had over-reclaimed input tax in its returns for the periods 01/07 to 10/10. The assessment was upheld by review dated 15 August 2011 and the appellant appealed against that review decision. The assessment was later adjusted downwards by an amendment dated 1 September 2011 to £18,024.00 to correct an error in the VAT rate used. A further assessment for £750 on the same basis was made on 17 August 2011 in respect of accounting periods 01/08 and 01/09. That assessment was also appealed.

The Facts

2. Evidence was given by Mr Denley, the partner at Menzies LLP who oversaw the client relationship between Menzies LLP and the appellant. Evidence was also given by Mr Pelan, officer of HMRC who conducted the HMRC visit to the appellant and made the decision to disallow the input tax. We found both witnesses to be credible. Mr Pelan could give little relevant evidence as he could only speak to the reason why he disallowed the input tax, so our findings of fact are drawn largely from Mr Denley's evidence and the documents produced to us.

Background

3. The appellant is a firm of solicitors with about 25 partners. It is a limited liability partnership. It employed Menzies LLP to undertake accounting and tax compliance work. It was VAT charged on invoices from Menzies LLP that HMRC considered the appellant had incorrectly recovered as input tax and therefore gave rise to this appeal.

The tax reserve

4. The partners of the appellant have a partnership agreement which regulates the partner's legal liabilities and entitlements as between themselves. Clause 12 of this agreement states:

> "Except as otherwise determined by the Management Board the LLP will retain such proportion of each Partner's share of the Profits in any Accounting Period as the Management Board have taken advice from the Auditors recommend is appropriate to meet that Partner's individual tax liability (if any) in respect of those Profits."

5. The nominated partner of the LLP on behalf of all the partners is liable to file a partnership tax return setting out the profits of the partnership. The partners individually are liable to file personal tax returns, and to pay the tax, arising in respect of them. The figures for each partner's personal return in respect of their income from the partnership is copied from the partnership return.

6. Tax returns are, of course, filed in arrears. The partnership and the partners are liable to report their profits for the tax year which ended the previous April.

7. The effect of Clause 12 of the partnership agreement was that the partnership was entitled to deduct from a partner's current share of the partnership profits an amount estimated to represent that partner's future tax liability on his share of the current partnership profits.

8. Clause 12, we find, is a very normal provision for partnerships. It compelled partners to leave at the disposal of the partnership an amount estimated to be equivalent to their future tax liability on the profits currently being earned by the partnership.

9. Mr Denley gave two reasons why a partnership might insert a clause such as clause 12 into its partnership agreement. Firstly, the money, although credited to each partner's tax reserve account, was cash available to be used by the partnership. It could be likened to a short term interest free loan from the individual partners to the partnership as a whole.

10. Secondly, another reason the clause was often used was to ensure that the partners were forced to put aside sufficient money to discharge their tax liability. Historically, there was a concern that the partners might have joint and several liability for other partners' unpaid tax liabilities. Partners would therefore agree between themselves a sort of self-imposed PAYE system to ensure that the partnership always had the money to pay the tax liability. The appellant is an LLP and there is no longer perceived to be a risk that one partner could be found liable to discharge another partner's tax liability even one arising out of the profits of the partnership. Nevertheless, each partner might still wish to ensure that his partners put aside sufficient to pay their tax liabilities because it might reflect badly on the partnership if a partner became insolvent because he was unable to pay his tax bill. This is particularly the case with a partnership between solicitors.

11. We were given no evidence from the appellant as to the actual reason for the insertion of clause 12 into the appellant's partnership agreement. Whatever was its original or current purpose, however, we find as a fact based on Mr Denley's evidence that the money held in the partners' tax reserve accounts was used by the partnership as working capital and that without it the partnership would be in breach of its banking covenants which required it to self fund working capital up to a certain level.

The invoices from Menzies LLP

12. The appellant employed Menzies LLP to undertake a number of accounting and tax related functions. It was employed, amongst other things, to:

- prepare the partnership tax return;
- calculate the retention of money from each partner's drawings under clause 12;

- prepare the partners' individual tax returns.

13. Menzies LLP did not deliver a single invoice to the appellant covering all its services. In order to help the then chief executive partner at the appellant to relate each invoice to the services provided, and in order to agree a fee, it was agreed that dealing with individual partners' tax returns and calculating their tax reserves would be dealt with on a single invoice headed "partners' personal tax returns" and billed at the rate of £900 per partner per year. The invoices themselves were not broken down between the partners: this was merely a method of calculation of the charge.

14. For completeness, we mention that these invoices did not include work rendered in respect of two of the partners, as for those partners, Menzies LLP was not instructed to prepare their tax returns or calculate a tax reserve for them. As the position of these partners has no relevance to this appeal, we do not mention it again.

15. We accept on the evidence we had that this figure of £900 in respect of the partners (about 23) represented work carried out by Menzies LLP on the instructions of the appellant and could be broken down as follows into its component parts:

(a) Preparation of monthly tax reserve for deduction from drawings from the partnership;	£150
(b) Production of partnership drawings schedule based on tax estimates;	£75
(c) Meeting with individual partner to collect personal information;	£55
(d) Provision of partnership profit information to tax manager to enable the partnership tax return to be prepared;	£150
(e) Advising company accountant of amounts of tax to pay on behalf of partner from the tax reserve held in partnership books (paid twice a year);	£260
(f) Reconciliation of partnership tax reserves in accounts to payments and reserve carried forward;	£150
(g) Preparation of partner's tax returns.	£115

These costings totalled £955 but Menzies agreed to bill only £900 per partner.

16. We accept that most of the work carried out at (g) related to the partners' earnings from the partnership. Only four partners had earnings from outside the

partnership and these were fairly minor. We also accept that, because of this, only £115, a small part of the £955 per partner costings, related to the partners' individual tax returns because completion of them was therefore very straightforward, comprising little more than copying the figures over from the partnership tax return.

17. It was the appellant's case that only heads (c) and (g) (totalling £170) related to the preparation of the partners' individual tax returns and the rest of the work related to the tax reserve held in the partnerships' bank account.

18. We find that items (a), (b) and (f) related to work in respect of the partners' tax reserves held by the partnership under clause 12 of the partnership agreement and used as working capital.

19. We find that item (d), as explained to us by Mr Denley, related to the preparation of the *partnership* tax return, as it comprised transmission of partnership accounting information to the tax manager charged with compiling the partnership tax return.

20. We find items (c) and (g) related to preparation of the partners' personal tax returns.

21. We find item (e) related to payment of the partners' personal tax liability out of the tax reserve.

22. We find that the second assessment related to invoices from Menzies LLP for ad hoc advice given in relation to the re-calculation of the partners' tax reserves when a partner joined or left the partnership. We will refer to this as item (h).

23. HMRC's case is that as a matter of fact items (a)-(g) all related to the preparation of the partners' tax returns.

24. We have found that items (a), (b), (f) and (h) related to the partners' tax reserve accounts held under clause 12 of the partnership agreement. This reserve was, we find, nothing to do with the preparation of the partners' personal tax returns. The reservation was calculated on the basis of estimated future tax liability on current profits: that calculation was irrelevant to the preparation of the tax returns which were prepared on a historic basis using the partnership's accounts relating to the previous tax year. Indeed, it was most unlikely that the estimate would be an 100% accurate estimate of liability, and even if it was, that could only be ascertained by properly preparing the partnership tax return based on the partnership's accounts. The estimation of the liability must have been prepared before either the partnership tax return or the partnership year end accounts could have been prepared and therefore could not depend on them.

25. Indeed, it follows that the work charged by Menzies LLP in any one of the invoices at issue, in so far as it related to items (a), (b), (f) and (h) would have referred to work in relation to the current tax year while work relating to items (c), (d), (e) and (g) would have related to work carried out in relation to a previous tax year.

26. Therefore, we find that items (a), (b), (f) and (h) did not relate to the preparation of the partners' tax returns. It related to the tax reserves.

The parties' cases

27. In brief, the appellant's case was that £785 of the £955 per partner costings (approximately 82% of the figure assessed) was input tax of the partnership and the remaining amount of £170 (of £955) was de minimis and in accordance with HMRC's guidance should not have been disallowed.

28. HMRC's case was that all of the £900 per partner fee related to personal liabilities of the partners and was therefore not input tax of the business and had been incorrectly reclaimed by the appellant and was properly assessed by HMRC. Further, the £170 was not de minimis and in any event the Tribunal had no jurisdiction in respect of HMRC guidance.

The law

29. Businesses can only recover VAT if it is input tax. Input tax is defined in s 24 VATA as follows:

> "Subject to the following provisions of this section, 'input tax', in relation to a taxable person, means the following tax, that is to say –
>
> (a) VAT on the supply to him of any goods or services;
>
> …..
>
> being … goods or services used or to be used for the purpose of any business carried on or to be carried on by him."

30. It was not suggested that s 24(1) did not properly implement the Principle VAT Directive. So the appellant needs to show that the VAT on the invoices at issue was charged on services which were for the purpose of the appellant's business as a firm of solicitors.

31. HMRC rely on the decision of the CJEU in *Midland Bank plc* C-98/98 [2000] STC 501. In that case the appellant bank received services from solicitors of legal advice in a negligence action taken against the bank in respect of financial services it had provided to a client. The CJEU stated that input tax had to have a direct and immediate link to an output tax transaction to be recoverable. As that required the input tax to be a cost component of the output tax transaction, services related to an unanticipated negligence action did not have a direct and immediate link to the supply of financial services out of which the negligence action arose.

32. The facts of that case are not closely analogous to the facts of this appeal. The appellant is not claiming that the invoices at issue reflect services rendered to it which have a direct and immediate link to any particular service rendered by the appellant. It is claiming it has a direct and immediate link to the business' general overheads. In *Midland,* it was accepted that the legal services had a direct and immediate link to the bank's general overheads: the dispute arose because the bank was partly exempt but

the services which gave rise to the tort action were taxable. That is simply not an issue here.

33. What *Midland* does show is that unanticipated, consequential costs incurred by a business do have a direct and immediate link to the business' general overheads (This is also shown in the case of *I/S Fini H C-32/03).*

34. Perhaps the most analogous cases are those where a company has sought to recover legal costs incurred by it in a criminal action against a director. The High Court has said that legal costs of defending a sole trader would only be recoverable if the offence "relates directly" to the trading activity: *Rosner* [1994] STC 228 (not cited to us). It is clearly of benefit to a company if its director is not found guilty of a crime and not sent to prison: but that does not make legal costs incurred in defending him a business expense:

> "[230] …Benefit…cannot be the test…"

35. The appellant points out that HMRC accepted in writing that £750 of the £900 per partner charge was a business expense for direct tax purposes. However, we place no store on this as whether something is input tax is a matter of the law contained in the Principle VAT Directive which law is not necessarily the same as that under the Taxes Acts, nor was HMRC's decision necessarily correct nor would HMRC be bound by it in relation to VAT when it was clearly given in a direct tax context.

Is the preparation of the partnership return a business expense?

36. Miss Paveley, on behalf of HMRC, effectively accepted that tax advice on the submission of the partnership tax return was input tax of the business as she said HMRC did not seek to disallow it.

37. We agree that preparing a partnership tax return is an inevitable consequence of carrying on a business in partnership and is therefore part of the partnership's business' general overheads and recoverable in full by a fully taxable business (or otherwise in accordance with the normal rules governing partial exemption), in much same way that the costs of litigation are part of a business' general overheads as in *Midland.*

38. Therefore, that element of the invoices which related to the preparation of the partnership returns (item (d)) would, if comprising a single supply to the appellant, be input tax of the appellant's.

Is the preparation of individual partners' returns a business expense?

39. We have found items (c) and (g) related to preparation of the individual partners' returns.

40. It was clearly of benefit to the partnership as a whole that the partners properly filed their tax returns and on time, but, for the reasons given in *Rosner,* benefit is not

the test. The test is whether it was for the purpose of the business. And that means, as per *Midland,* that it must have a direct and immediate link with the business.

41. While, on the facts of this case, virtually all of the partners' tax liabilities arose directly out of their trading as partners in the appellant, it cannot be said that filing personal tax returns of its partners was a business purpose of the partnership, nor even a consequential business expense as in *Fini* or *Midland.* The expense was not incurred in order to carry out the business of trading as solicitors nor did it arise out of the partnership's trade as solicitors. Tax on the individual partners' share in the profits is merely an inevitable consequence of being in a profitable trading partnership but it is not a liability of the business: therefore expenses incurred in making the necessary returns and payments in respect of it are not business expenses.

42. Indeed, we do not understand the appellant to really be suggesting the contrary. Their case is that the amounts were de minimis and should therefore be allowed. We consider this below. But as a matter of law, we find that the items (c) and (g) would not, even if supplied as a single supply, be input tax of the appellant's.

43. Item (e) related to the actual payment, out of the reserves and if necessary other funds, of the partners' tax liabilities. For the same reasons given in paragraph 41, we do not accept that this was a purpose of the partnership business and for that reason it would not, even if supplied by itself, be input tax of the partnership.

Is the calculation of the tax reserves held by the partnership and used as working capital a business expense?

44. Items (a), (b), (f) and (h) we have found related to the holding by the partnership of the partners' tax reserve accounts.

45. We have found as a fact, on the evidence that we had, that the partnership relied on the partners' tax reserve accounts to fund part of its daily working capital. We find that having working capital is essential to the business and therefore keeping the tax reserve accounts was directly and immediately linked to the business.

46. We assume, as the appellant did not prove otherwise, that clause 12 had a dual purpose, and it existed not only to provide the partnership with working capital but ensure that the partners kept back enough money to pay their liabilities. If so this second purpose would be of benefit to the partnership but we do not think that this by itself could be described as a purpose of the business, any more than the preparation of the partners' tax returns or payment of their liability could be said to be a purpose of the business.

47. Therefore, the work at (a), (b), (f) and (h) had dual purpose. One purpose (keeping the tax reserves as working capital) was a purpose of the business and the other (ensuring the partners could pay their tax) was merely a benefit to the business but without being a purpose of the business within the meaning of s24 VATA. In these circumstances, however, it seems to us that a single payment with dual business purpose/business benefit is nevertheless entirely input tax. In other words, the fact

that a single payment with business purpose is also, for a different reason, of benefit to the business without that reason strictly being for its business purpose, does not prevent the entirety of the single payment being input tax.

48. The work at (a), (b), (f) and (h) therefore, if supplied separately, be input tax of the appellant's business.

Single supply and apportionment

49. The assumption underlying the appeal is that Menzies LLP's invoices related to a single supply of services. It was certainly invoiced as such and it was not suggested that it was wrong for Menzies LLP to invoice in this way.

50. If the various pieces of work had been supplied as separate services, the appellant would be entitled to reclaim the VAT on items (a), (b), (d), (f) and (h) as input tax.

51. But as it was a single supply of services, the appellant seeks to rely on s 24(5) VATA which provided at the time:

> "where …services supplied to a taxable person…are used or to be used partly for the purposes of a business carried on by …him and partly for other purposes, VAT on supplies…shall be apportioned so that so much as it referable to his business purposes is counted as his input tax."

52. The appellant asked HMRC to allow them to recover a proportion of the tax shown on the invoice to reflect the agreement they reached with HMRC over the direct tax position. HMRC refused on the basis that none of the work reflected in the invoice was recoverable.

53. We have concluded that the work in respect of the tax reserves and the partnership tax return was for the purpose of the business of the partnership and therefore under s 24(5) the single supplies covered by the invoices do fall to be apportionment and that part relating to (a), (b), (d), (f) and (h) recovered as input tax.

54. We recognise that s 24(5) does not reflect the Principle VAT Directive, but in accordance with the normal rules, the UK Government is not able to rely on its own failure to properly enact the Directive and therefore the appellant may rely on s 24(5) and retain that proportion of the VAT charged on the invoices which relates to work at (a), (b), (d), (f) and (h).

55. Therefore, to the extent that the assessment relates to VAT charged and recovered in respect of items (a), (b), (d), (f) and (h), the appeal is allowed.

Incorrect description on invoice

56. The invoices simply described the services provided as "partners' personal tax returns". It is therefore not surprising HMRC disallowed the VAT as not being in put

tax of the partnership. However, our decision means that we have found this description to be inaccurate. For the reasons already explained, matters (a), (b), (d), (f) and (h) were not in respect of the partners' personal tax returns.

57. HMRC did not raise a case that what was in effect a misdescription of the services on the invoices would prevent the appellant recovering VAT that would otherwise be its input tax as input tax. Bearing in mind HMRC in any event have a discretion to accept alternative evidence of input tax (VAT Regulations 1995 SI No 2518 Regulation 29(2)), as HMRC did not raise the point, we do not consider it.

The "de minimis" amounts & HMRC's manuals

58. Reverting to items (c), (e) and (g) and the appellant's case that the appeal should be allowed as these amounts are de minimis, we find HMRC's Manual VIT 13700 provided as follows in so far as relevant:

> "**VAT input tax basics: accountancy fees**
>
> A sole trader's or a partnership's accountancy costs generally relate to a number of services provided to the taxpayer by the accountant. These may include:
>
> - General accountancy advice;
> - VAT advice;
> - Income tax advice.
>
> It is arguable that income tax is the responsibility of the sole trader or partner as an individual and is not strictly a business matter.
>
> In order to avoid disputes over small amounts of tax our policy is that VAT on a sole trader's or a partnership's accountancy fees should usually be claimed in full subject to the normal rules.
>
> The only exception to this is where the accountant's fees clearly relate to taxation matters that do not relate to the VAT registered business. An individual might for example be charged significant costs relating to inheritance tax. This would not normally be related to the VAT registration and input tax should not be claimed. Usually, however, a sole trader's or a partner's tax advice can be treated as entirely business related……"

59. In our view, this is concessionary treatment by HMRC and not (and was not intended to be) a correct statement of the law. We read it as a concession. It clearly states "in order to avoid disputes over small amounts…our policy is…" In other words the drafters considered that it was a concession on the true legal position in order to avoid disputes over small sums.

60. It was HMRC's case that the appellant was unable to rely on this as:

- It did not meet the terms of the concession as the invoices were not for small amounts;

- HMRC had refused the claim and the Tribunal could not adjudicate on it.

Jurisdiction

61. Does the Tribunal have jurisdiction to decide this matter?

62. The decisions of the High Court in *National Westminster Bank* [2003] STC 1072 and *Arnold* [1996] EWHC Admin 52 are that the Tribunal does not have jurisdiction to decide whether the appellant meets the terms of a concession. However, the decision of the House of Lords in *J H Corbitt (Numismatists) Ltd* [1981] AC 22 suggests (obiter) that the Tribunal could adjudicate on whether the terms of an extra statutory concession had been met, and the decision of the High Court in *Oxfam* [2009] EWHC 3078 is that this Tribunal does have such jurisdiction. There is certainly CJEU authority that member States must give effect to legitimate expectations where the taxpayer has directly effective rights under the Principle VAT Directive: *Stichting goed Wonen* C-376/02 and *Marks & Spencer* C-62/00. The Upper Tribunal will be considering the matter afresh in the forthcoming cases of *Noor* and *Trade Sale Ltd* in a hearing in December 2012.

63. Therefore, if we were called upon to decide the question of our jurisdiction, we would stay the decision in this appeal until after final resolution of the cases of *Noor* and *Trade Sale Ltd.* But we do not consider it is necessary to stay our decision because it is apparent that, even if we had jurisdiction, the appellant could not succeed.

64. This is because it would have to show itself to be within the terms of the concession and it would have to show that it had relied on the concession to its detriment.

"small amounts"

65. The appellant considered that the concession should be looked at on a per partner basis: the fee was £900 per partner and £170 per partner per year was a small amount.

66. Mr Pelan's case was that £18,774.00 in VAT was not a small amount and so the appellant was not within the terms of this concession. However, the assessments covered a number of years, and it is clear that the concession ought to be looked at on a yearly basis.

67. The concession clearly related to the annual accountancy fee as a whole. Each bill was for (roughly) £20,000 (in other words, 23 multiplied by £900) with VAT varying between 15-20%. We would agree with HMRC, if we had jurisdiction, that the concession was not intended to cover invoices of this size and the appellant cannot rely on it.

Detrimental reliance

68. Further, if this Tribunal does have jurisdiction to adjudicate over whether the appellant has met the terms of an ESC, it seems likely that even under the Principle VAT Directive, in order to establish a claim based on legitimate expectation, the appellant would have to show that it relied on the expectation to its detriment. It is difficult to see any detrimental reliance in this case: all the appellant did was reclaim as input tax VAT which was not all, strictly, as a matter of law its input tax. It has not altered its position to its detriment.

69. Therefore, in so far as its appeal related to VAT incurred on work carried out under heads (c), (e) and (g), it fails and we uphold the assessment to that extent.

70. If the parties are unable to agree on the amount of the apportionment of the assessment, they are at liberty to revert to the Tribunal.

71. 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.

BARBARA MOSEDALE
TRIBUNAL JUDGE

RELEASE DATE: 15 November 2012