

VAT: Claiming input tax on legal services benefitting a taxpayer company and its director

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The *Praesto Consulting* decision

1. A taxpayer may recover input VAT on a taxable supply of goods or services if: (1) those goods or services were supplied *to the taxpayer*, and (2) they were used, or to be used, *for the purpose* of its business.
2. The application of this test raises difficulties where the taxable supply – for example, the conduct of litigation in the context of legal services – can be seen as benefitting the company *and* its director. The Court of Appeal has clarified that, in those circumstances: (i) under the first limb, the tribunal can look at both the contractual and the economic reality of the parties and the supply and (ii) limb two requires "a *direct and immediate link*" to the taxable person's economic activity as a whole, which in the context of legal services may be as broad as a real risk of litigation: *Praesto Consulting UK Limited v HMRC* [2019] EWCA Civ 353.

3PB's Analysis

3. **The facts.** Mr R was an employee of a computer software consultancy company ("CSP"). In 2009, Mr R resigned from CSP to set up a competing company, Praesto (the appellant), as its sole director.
4. In late-2009, CSP sent a letter before action to Mr R alleging various matters such as breach of contract and breach of duties of confidentiality owed to CSP. Two days later, CSP sent a letter before action to Praesto also alleging various matters including inducement to breach restrictive covenants. Both Mr R and Praesto instructed Sintons solicitors ("Sintons") to respond to these letters and to advise generally.
5. In mid-2010, CSP commenced proceeding against Mr R. CSP claimed damages by

reference to lost business, which was to be estimated by reference to the accounts of Praesto or an account of profits of Mr R. However, no proceedings were issued against Praesto who was therefore not a party. Later, in November 2011 at the outset of the trial, CSP's counsel indicated that they would seek to join Praesto in any trial of quantum or remedy if Mr R lost on liability.

6. CSP were successful in the High Court but subsequently lost in the Court of Appeal. Sintons then issued eight invoices relating to the litigation dated between 2011 and 2013 that were addressed to Mr R only. The descriptions of the work done made no mention of Praesto but were all paid by Praesto.
7. Praesto claimed an input tax credit for the VAT on the invoices which was refused by HMRC.
8. **In the FTT** Praesto was successful on the basis that Mr R's instructions to Sintons had been on behalf of both Mr R and Praesto. The services were supplied to Praesto just as much as if it had been a party; it could be viewed as a party in the proceedings "*in all but name*".
9. **The UT** (Judge Herrington and Judge Greenbank) allowed HMRC's appeal. The FTT had failed to make a finding as to whether Praesto was contractually entitled to the legal services, which amounted to an error of law, and if services were supplied to Praesto they were not for the purposes of its business.
10. **The Court of Appeal.** The two issues that arose were whether the FTT had made errors of law in concluding:
 - 10.1. that the invoices related to services supplied by Sintons to Praesto; or
 - 10.2. that the services supplied by Sintons had a direct and immediate link to Praesto's taxable activities.

(Although not found in this case, these limbs are sometime referred to as the 'to whom requirement' and the 'purpose requirement'.)

11. Hamblen LJ set out the legal framework under the 2006/112/EC VAT Directive, the VATA 1994, and the VAT Regulations 1995 and noted the formal requirements for exercising the right to deduct included that the invoice bear the full name of the customer (Art.226 and Reg.13). Applying the same test from s.24 of VATA as the previous tribunals, the Court stated that "*in order to recover VAT input... it is necessary for a taxable person to show (1) that the VAT was paid on the supply to him of goods or services and (2) that the goods or services are used or to be used for the purpose of his business*". A supply will be treated as being used "*for the purpose of the business*" if there is "*a direct and immediate link*" between the supply and one or more output transactions or the taxable person's economic activity as a whole.
12. In relation to issue (1) of 'to whom', the Court found that there was a joint retainer of Sintons and that both Mr R and Praesto would have been jointly liable for the fees. This was deemed to be the contractual and the economic reality of the relationship as the litigation was "*effectively*" brought against both of them such that Praesto had a "*reasonable fear*" of the litigation. The appeal on issue (1) was allowed.
13. In relation to issue (2) as to purpose, the Court found that there was a direct and immediate link between the services supplied by Sintons in the litigation against Mr R and the taxable activities of Praesto.
14. The Court criticised the UT's reliance on the case of Becker [2013] C-104/12. That case concerned the legal fees in defending Mr Becker, the sole shareholder of a construction company, against criminal proceedings relating to using confidential information that was obtained by bribery, in a tender process. The lawyers acted for both Mr Becker and his company and addressed the invoices to the company. The CJEU held that the proceedings were brought solely against Mr Becker in his personal capacity even though proceedings against the company would have been possible. In Praesto, the Court said that the real risk of destruction for Praesto (following a

finding of liability against Mr R) was not present in Becker and it was therefore distinguishable. The "*benefit to the company from a successful defence [of Mr Becker] was necessarily indirect.*"

15. Instead, the Court found similarities with the older case of P&O Ferries [1992] VATTR 221 where P&O sought to recover input tax on legal fees for seven employees on criminal charges resulting from the Zeebrugge ferry disaster brought against both the employees and P&O. The Tribunal held that both the individual and P&O were clients of the solicitors with the company "*as principal*" and that the funding of the seven individuals "*can be seen as serving the purposes of the business*" as "*the conviction of even one of the individual employees would have caused severe damage to the public perception of the Company's business*".
16. The Court drew parallels with P&O stating that it too was "*a case in which the consequence of a finding of liability on the part of the individual was a real risk of proceedings being successfully brought against the company with disastrous consequences*". This is somewhat strangely worded as in P&O (unlike Praesto or Becker) proceedings had been issued against the company as well and, in P&O, the court said that it was not comparable to cases of small one-man companies as P&O was a large global business with distinct business interests from the individuals.
17. The Court concluded that there was a direct and immediate link as there was a "*real risk*" of the claim against Praesto being brought by CSP if breach of fiduciary duty by Mr R was first established such that the FTT came to the correct decision.
18. **Dissenting Judgment.** Master of the Rolls, Sir Terence Etherton dissented by requiring the direct and immediate link to be established in light of the objective content of the supply (per Becker). In the dissenting judgment, there does seem to be some cross-over of the two issues ('to whom' and 'purpose') but the objective factors identified included:
 - 18.1. Sintons advised and it was decided that the invoices would be addressed to Mr R alone;

- 18.2. Mr R was the defendant not Praesto. The FTT's description of Praesto as 'a party to the proceedings in all but name' is not a term of art or a legal expression or a meaningful statement of fact;
- 18.3. none of the invoices specified work done for Praesto;
- 18.4. it was an obvious inference that they were addressed to Mr R so that he could recover his costs from CSP were he to be successful in the litigation;
- 18.5. there was no evidence of boardroom minutes addressing the significance of the claim against Mr R for the company.
19. Furthermore, in the original proceedings, the claim for an account of profits was limited to Mr R; it was only at the trial that any suggestion of an application to join Praesto was made and only in regard to the unpursued cause of action of knowing receipt. The subjective belief of Mr R that CSP were looking to put Praesto out of business did not establish the requisite objective direct and immediate link to Praesto's economic activities.
20. The Master of the Rolls concluded that the decision of the FTT would effectively allow the services invoiced to Mr R so that he can recover the costs from successful litigation from CSP to also be used to reduce Praesto's output tax liability, which would be wrong in law.
21. **Analysis.** The majority judgment in this case does little to clarify the VAT treatment of legal services to companies and their members. Beyond the use of the term "real", the point at which a risk of litigation arising out of separate proceedings becomes directly and immediately linked to the business' activities, is unclear.
22. It is fair to say that the recent FTT decisions relating to legal fees and the direct and immediate link align more closely with the dissenting position. Substantia Invest Limited v HMRC [2015] UKFTT 0671 concerned VAT on legal services relating to the defence of a sole director against charges of false accounting.
23. The Tribunal concluded that for input tax to be recoverable on legal fees incurred by a business defending an individual, the offence (in the litigation) must be directly referable to the purpose of the business. Even though the liberty and reputation of the director was a benefit to the one-man company, it is indirect and not sufficiently close as the litigation was primarily in the director's interests.
24. When applying this to Praesto, the litigation would surely be deemed to have been primarily in Mr R's interest as he was the named party even if Praesto were concerned with the outcome. The offence would also not be directly referable to the purpose of the business as the causes of action in the letters before action were different as between Mr R and Praesto.
25. These tests are similar to the case of Kingsnorth Developments Ltd [1994] which was reported around the same time as P&O. Here, the Tribunal asked what was the first and foremost reason for engaging in legal services. In answer they held that although "*the expenditure on those services was for the benefit of the Company and added value to the business of the Company [...] in any ordinary use of language the legal services themselves were supplied for the defence and benefit of [the director]*".
26. In Robert Welch Designs Limited [2015] UKFTT 431, regarding legal proceedings involving a company and the majority shareholders against a minority shareholder, the Tribunal found that the majority shareholders were recipients rather than the company. The legal fees related to an unfair prejudice action and involved valuations of the company (on a more direct basis than the speculative accounts in Praesto). There was also a finding of fact that the majority shareholders believed their conduct of the legal proceedings was for the benefit of the company. As in Praesto, the company indicated that the sums involved would have threatened their ability to continue trading and the solicitors' invoices were addressed to the named majority shareholders only (rather than the company).
27. In Robert Welch, the company was unable to demonstrate the required level of reciprocity between itself as payer and the solicitors as providers of the services despite the economic

interests of the shareholders and the company being “*intertwined, if not identical*” where they are treated “*as, in effect, a single party with one common interest*”. This language is comparable with the assertion in *Praesto*, that the company was a party in all but name, upon which the Court of Appeal placed much emphasis.

28. **Economic reality.** There are two further (minor) points that a reader can take from *Praesto*. First, it is only a mild exaggeration to say that “*commercial and economic reality*” is deployed in virtually every contentious VAT scenario regardless of its efficacy or adequacy as a test in the framework of VAT or legal certainty generally (see Arden LJ in *Telewest Communications* [2005] EWCA Civ 102).

29. Second, the test of commercial reality is proving to be subjective and anything but black and white; there can be multiple economic and commercial reasons within and outside of a contract. The majority in *Praesto* adopted the reasoning of the FTT that “*the reality of the situation*” was that Sintons acted for both Mr R and *Praesto* in litigation that was effectively brought against both of them. The Master of the Rolls disagreed with that reality; as argued by HMRC in the UT, there was no actual benefit to *Praesto* in Mr R winning the case.

Impact of the Decision

30. As we keep one strabismic eye on an appeal to the Supreme Court, we can ask: what can we take from *Praesto*?

31. One should continue to start by asking ‘to whom’ are the supplies made but it must be appreciated that the test of commercial and economic reality can be applied such that the names on the

invoices or on the contractual documents become part of a multifactorial assessment.

32. When asking about the purpose, it seems that a ‘real risk’ of litigation may be enough to amount to a direct link with a company’s economic activity. This is troubling for tax advisors who should not be required to predict the outcome of complicated legal hypotheticals. There was even some *obiter* disagreement between the judgment of the Master of the Rolls and Hamblen LJ as to the prospects of joining and recovering from *Praesto* as a third party had CSP been successful. If the link is founded on a mere ‘risk’ of requiring services and there is disagreement as to the chance of said risk, one would not be criticised for thinking there is not a sufficiently direct and immediate link to the activity of the business.

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This article intends to state the law at the date indicated above. Although every effort is made to ensure accuracy, this article is not a substitute for legal advice.

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