VAT focus

Praesto Consulting: VAT on legal services

Speed read

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. The Court of Appeal in *Praesto Consulting UK Ltd v HMRC* [2019] EWCA Civ 353 held that, under issue 1, the tribunal can look at the economic reality of the supply; and issue 2 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.

Max Schofield
3PB Barristers
Max Schofield is a commercial barrister at 3PB Barristers, London. He specialises in VAT litigation with an interest in VAT rates and liability. Email: max.schofield@3pb.co.uk; tel: 020 7583 8055.

The facts in Presto Consulting

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.

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 to respond to these letters and to advise generally.

In mid 2010, CSP commenced proceedings 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, which 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.

CSP was 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, which claimed an input tax credit for the VAT on the invoices, which was refused by HMRC.

At the First-tier Tribunal, 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'.

The Upper Tribunal 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.

At the Court of Appeal, the two issues that arose were whether the FTT had made errors of law in concluding that:

- Issue 1: the invoices related to services supplied by Sintons to Praesto; or
- Issue 2: 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'.)

Hamblen LJ set out the legal framework under the Principal VAT Directive (PVD) 2006/112/EC, VATA 1994, and the VAT Regulations, SI 1995/2518. He noted that 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 VATA 1994 s 24 as the previous tribunals, the court stated that:

> '[I]n 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.

Issue 1: the 'to whom requirement'

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.

Issue 2: the 'purpose requirement'

In relation to issue 2 as to the purpose requirement, 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.

The court criticised the UT's reliance on the case of *Becker* (Case 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 the use in a tender process of confidential information that was obtained by bribery. 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.

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. Charges resulted from the Zeebrugge ferry disaster and were brought against both the employees and P&O. The tribunal held that both the individuals 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'.

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 strange, 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 the case 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.

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.

The dissenting judgment

In the dissenting judgment, Master of the Rolls, Sir Terence Etherton required the direct and immediate link to be established in light of the objective content of the supply (per *Becker*). In the dissenting judgment, there is some cross-over of the two issues ('to whom' and 'purpose') but a number of objective factors were identified, including the following:

- Sintons advised and it was decided that the invoices would be addressed to Mr R alone.
- 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.
- None of the invoices specified work done for Praesto.
- There was no evidence of boardroom minutes addressing the significance of the claim against Mr R for the company.

Furthermore, the subjective belief of Mr R that CSP was looking to put Praesto out of business did not establish the requisite objective direct and immediate link to Praesto's economic activities.

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.

Analysis

The majority judgment in this case does little to clarify the VAT treatment of legal services to companies and their members. With use of the terms 'real risk' and 'reasonable fear', the point is unclear at which a litigation arising out of separate proceedings becomes directly and immediately linked to the business's activities.

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 Ltd v HMRC* [2015] UKFTT 671 concerned VAT on legal services relating to the defence of a sole director against charges of false accounting. 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 as the litigation was *primarily* in the director's interests.

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. 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.

These tests are similar to the case of *Kingsnorth Developments Ltd* [1994] VTD 12544 which was reported around the same time as *P&O* and asked what was the first and foremost reason for engaging in legal services. In answer, it held that although 'the expenditure on those services was for the benefit of the company … in any ordinary use of language the legal services were supplied for the defence and benefit of [the director]'.

In *Robert Welch Designs Ltd* [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 its ability to continue trading and the solicitors' invoices were addressed to the named majority shareholders only.

In *Robert Welch*, the company was unable to demonstrate the required level of reciprocity between itself as payer and the solicitors, 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.

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's hesitant warning in *Telewest Communications* [2005] EWCA Civ 102 at para 83).

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.

Conclusion

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

One should continue to start by asking 'to whom' the supplies are made. However, 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.

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 advisers, 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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- Cases: *Praesto Consulting UK v HMRC* (20.3.19)