

  
**Lexis®PSL Tax****VAT—restitution and interest**

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**STOP PRESS:** *The Supreme Court has granted both HMRC and the taxpayer permission to appeal the Court of Appeal's judgment in the Investment Trust Companies case. In addition, HMRC announced in June 2015 that it is seeking permission to appeal the Littlewoods decision to the Supreme Court. HMRC does not regard the judgment in Littlewoods as having wider application and will continue to ask for a stay of other compound interest claims already lodged. It will also refuse new claims until the conclusion of the litigation.*

*References:*

*HMRC Brief 9/2015*

*Littlewoods [2015] All ER (D) 225 (May)*

*Investment Trust Companies [2015] STC 1280*

This Practice Note discusses the law of restitution and its application in the context of overpaid VAT. It also discusses a taxpayer's EU law rights to receive interest on VAT repayments.

For information on the application of the law of restitution in the context of direct tax, see Practice Note: Overpaid direct tax and restitution.

**Restitution**

Where a person is enriched at the expense of another (eg where the first person receives money from the second by mistake), and the enrichment is unjust, the law of restitution may be engaged to reverse the unjust enrichment. This is an area of law that is still developing, with a number of questions yet to be authoritatively decided by the courts.

*References:*

*Westdeutsche Landesbank Girozentrale v Islington London Borough Council [1996] 2 All ER 961*

In the context of taxation, the law of restitution is relevant where tax has been paid that was not due. In the context of VAT, an example is where:

- a taxable person (A) makes a supply to another person (B)
- HMRC, A and B all regard the supply as a taxable supply

- B pays an amount (say, of 100) to A representing VAT on the supply
- A accounts to HMRC for output tax of 100 and deducts an amount representing directly attributable input tax (say, of 25)
- A pays HMRC the net amount of 75, and
- B is unable to deduct the amount it paid to A (ie the 100) in whole or in part (because it either is not a taxable person or makes exempt supplies)

and it subsequently transpires that the supply made by A to B was in fact exempt with no VAT payable on it.

In such a case:

- A (the taxpayer) has accounted to HMRC for VAT that was not due, and
- B (the tax bearer) has paid A an amount in respect of VAT that was not due

and the following questions arise:

- is A entitled to recover anything from HMRC?
- if so, how much is A entitled to recover?
- is B entitled to recover anything from A?
- if so, how much is B entitled to recover?
- is B entitled to recover anything from HMRC directly? and
- if so, how much is B entitled to recover?

### **VATA 1994, s 80**

The position between A and HMRC is clear. A has brought 100 into account as output tax when no output tax was due. It is, therefore, entitled (subject to applicable limitation periods) to recover that amount from HMRC under section 80 of the Value Added Tax Act 1994 (VATA 1994).

*References:*

*VATA 1994, ss 80(1), 80(2A)*

However, HMRC is entitled to set against that amount the 25 A deducted. This is because A deducted the amount on the basis it was directly attributable to a taxable supply when the supply was in fact exempt. It was, therefore, an over-deduction.

*References:*

*VATA 1994, s 81(3)*

The amount HMRC is required to refund to A (whether by way of credit, payment or repayment) is, therefore, only 75.

Because A has passed the economic cost of the overpaid VAT to B, HMRC would only repay the 75 to A if (broadly) A puts in place arrangements to refund the 75 to B.

*References:*

VATA 1994, ss 80(3), 80A

VAT Regulations 1995, SI 1995/2518, regs 43A–43G

VAT Notice 700/45, para 9

### **VATA 1994, s 80—exclusivity**

The statutory regime under VATA 1994, s 80 was first enacted as section 24 of the Finance Act 1989 (before being consolidated into the VATA 1994). It came into force on 1 January 1990, before the House of Lords delivered its judgement in *Woolwich* (in which it introduced a new cause of action under the law of restitution for any taxpayer who had overpaid (direct) tax to the Inland Revenue pursuant to an unlawful or ultra vires demand).

*References:*

*Woolwich Equitable Building Society v IRC [1992] STC 657*

Because of this chronology, *Woolwich* claims and (following *Deutsche Morgan Grenfell*) mistake-based restitution claims have, historically, not been as important in relation to VAT as they have been in relation to direct tax.

*References:*

*Deutsche Morgan Grenfell Group v IRC [2007] STC 1*

In any event (and disregarding the VAT mini one stop shop (MOSS) provisions for present purposes), VATA 1994, s 80(7) makes it clear that the regime under VATA 1994, s 80 provides for an exclusive remedy for the refund of overpaid VAT.

Concurrent claims under common law (eg the law of restitution) for repayment of overpaid VAT are, therefore, barred.

*References:*

*Littlewoods [2015] All ER (D) 225 (May)*

For more information on the regime under VATA 1994, s 80, see Practice Note: VAT overpayments and under-deductions.

For more information on *Woolwich* claims and mistake-based restitution claims, see Practice Note: Overpaid direct tax and restitution.

For more information on MOSS, see Practice Note: VAT treatment of electronically supplied services.

### **Supplier and recipient**

The position between A and B depends in the first instance on the precise terms of the contract between them. If, for example, the contract provides expressly for A to repay to B any amount representing VAT previously paid by B to A where it is shown, after the payment, that the VAT in question was not due, A would be liable to repay



*References:**Investment Trust Companies [2015] STC 1280*

- not only the 25 (using the notional numbers used in the example in this Practice Note), but also
- the full 100 it paid in the period (referred to as the 'dead period') in relation to which A itself was time-barred from making a claim under VATA 1994, s 80

The tax bearer sought to recover the amounts under:

- the law of restitution, and
- alternatively, applicable EU law

That HMRC was enriched by 75 was uncontroversial. The question was whether HMRC was also enriched by the balance of 25.

If no mistake had been made, ie if the supply to the tax bearer (B) had been treated as exempt rather than (mistakenly) as taxable from the outset, the taxpayer (A) would not have accounted for any output tax on it, but it would not have been able to deduct any related input tax (the 25) either. In other words, it would have been out of pocket by 25.

If HMRC were required to pay 75 to the taxpayer under VATA 1994, s 80, and 25 to the tax bearer by way of restitution, the taxpayer would be better off (in that it would not be out of pocket by the 25), and HMRC would be worse off, than if no mistake had been made.

This cannot be the right result, and in *ITC*, the Court of Appeal held that HMRC could not have been enriched by more than 75.

*References:**Investment Trust Companies [2015] STC 1280*

That such enrichment was unjust (resulting as it did from a mistake) was uncontroversial. However, where the 75 has already been repaid by HMRC to A pursuant to a claim under VATA 1994, s 80, and in turn by A to B, the unjust enrichment would already have been reversed.

As for any VAT that was paid to HMRC in the dead period (in relation to which A is time-barred from making any claims under VATA 1994, s 80), the question arises as to whether, because the 75 was paid to HMRC not by B but by A, HMRC's enrichment can be said to have been at B's expense.

In *ITC*, the Court of Appeal held that, in the context of VAT, the tax bearer (B) had a sufficient economic connection with HMRC so that HMRC could be said to have been enriched at the tax bearer's expense where the VAT in question should never have been paid.



### *References:*

*Reemtsma, Case C-35/05*

*Danfoss, Case C-94/10*

The tax bearer's or HMRC's position in the example cited in this Practice Note is, therefore, *prima facie* the same as under domestic law—the tax bearer is entitled to make a claim for the 75 against HMRC in relation to the dead period, but the 25 is recoverable against the taxpayer alone.

For more information on European principles generally (including the principles of fiscal neutrality and effectiveness), see Practice Note: VAT—European legal principles.

### **Change of position**

In the example cited in this Practice Note, it is clear that A was enriched (by 100) at B's expense, and that such enrichment was unjust (resulting as it did from a mistake). In the case of a claim by B against A, the question is whether A could raise any defences.

A may claim change of position on the basis of having accounted to HMRC for the entirety of the 100 (by way of output tax).

However, because it has retained a benefit—the amount it mistakenly deducted as input tax directly attributable to a taxable supply—the defence would not apply in relation to the retained amount (the 25).

### *References:*

*Investment Trust Companies [2015] STC 1280*

Alternatively, A may claim that if it had known that its supply to B was exempt, and that it was not entitled to deduct the 25, it would have passed the cost of the non-deductible input tax on to B in the form of higher prices, and that because it has lost the opportunity to do so, its position has changed. Whether such defence would succeed would depend on the precise facts.

### **Mismatch between claims**

There may be circumstances where A's ability to claim against HMRC is narrower than B's ability to claim against A, eg where the time limit for bringing a claim against HMRC for overpaid VAT is shorter than the time limit for bringing a civil action against A (with the result that B could obtain repayment from A, but A cannot in turn obtain a refund from HMRC).

In such circumstances, as discussed in Direct claim against HMRC, above, B may claim against HMRC directly rather than proceed against A.

In any event, provided that A is not time-barred from bringing a claim against HMRC because of its own fault, EU law may intervene in A's favour. This would be on the basis that the principle of effectiveness would be infringed if B brought an action against A after the limitation period for bringing a claim against HMRC has expired, with the result that the cost of VAT having been overpaid, an error attributable to HMRC, is borne by A alone.

*References:*

*Banca Antoniana, Case C-427/10*

## **Interest**

As mentioned in EU law, above, where a taxpayer has overpaid VAT, they have a right to repayment of the excess, and HMRC is required to repay the excess to them. This right is a consequence of, and an adjunct to, the rights conferred under EU law.

*References:*

*San Giorgio, Case C-199/82*

The taxpayer is entitled to recover not only the tax levied in breach of EU law, but also any amounts paid to the relevant Member State or retained by the Member State that relate directly to the tax, including any losses constituted by the relevant sums not being available to the taxpayer.

*References:*

*Metallgesellschaft, Case C-397/98 & C-410/98*

It follows from this that the Member State in question would be obliged to pay interest on the amounts collected in breach of EU law. Where the EU does not lay down detailed procedures to give effect to a right derived from EU law, these must be set by individual Member States. This means that it is for the Member State to set the rules on how such interest is to be paid—in particular, the applicable rate and the method of calculation (eg whether simple or compound).

*References:*

*Littlewoods, Case C-591/10*

These rules must comply with the principles of equivalence and effectiveness, and the principle of effectiveness requires that the rules must not be such as to deprive the taxpayer of an adequate indemnity for the loss in question.

*References:*

*Littlewoods, Case C-591/10*

In the UK, the relevant rules in the context of VAT are contained in VATA 1994, s 78. They provide that where a taxable person has overpaid VAT due to an HMRC error (eg HMRC having published guidance or given advice in correspondence that was wrong in law), they would be entitled to claim interest on the overpaid amount at the applicable rate for the relevant period.

*References:*

*VATA 1994, s 78(1)*

The applicable rate is that provided for under section 197 of the Finance Act 1996,



which specifies a simple interest rate.

*References:*

*VATA 1994, s 78(3)*

*Air Passenger Duty and Other Indirect Taxes (Interest Rate) Regulations 1998, SI 1998/1461, reg 5*

As a matter of domestic law, VATA 1994, s 78 lays down an exclusive statutory scheme in relation to interest in respect of VAT overpaid due to an HMRC error. This means that taxpayers would be barred from bringing concurrent claims for interest under common law (such as the law of restitution).

*References:*

*Littlewoods [2015] All ER (D) 225 (May)*

However, when EU law is taken into account, there may be circumstances (such as those in the *Littlewoods* case) where VATA 1994, s 78, in providing only for simple interest, would be held to have the effect of depriving the taxpayer of an adequate indemnity for the loss in question (thus offending against the principle of effectiveness).

*References:*

*Littlewoods [2015] All ER (D) 225 (May)*

In such a case, s 78 would be disapplied, and the taxpayer may then choose between a *Woolwich* claim and a mistake-based claim (whichever best suits their interests) to recover more than simple interest.

*References:*

*Littlewoods [2015] All ER (D) 225 (May)*

Both a *Woolwich* claim and a mistake-based claim are claims in restitution. The aim of such a claim is to reverse the benefit conferred on the defendant (HMRC) rather than to compensate the claimant (the taxpayer) for their loss.

This would ordinarily involve looking at the use value of the enrichment (ie the value of having the use of the amounts in question), which would be determined by looking at the reasonable cost the defendant would have incurred in borrowing the same amounts for the relevant period. As with typical borrowings in the money market, the interest calculated in this way would be on a compound basis.

*References:*

*Sempra [2007] STC 1559*

The use value of the enrichment is measured objectively and is not necessarily the same as the value of the benefits the defendant actually derived from the use of the amounts. The enrichment may not always be worth its market value to the defendant, and where it is not, it may be unjust to calculate the benefit by reference to the value it has to others rather than the value it actually had to the defendant.

*References:*

*Sempra [2007] STC 1559*



