

# Praesto Consulting UK Ltd v HMRC: input tax credit - a focus on substance and reality

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Case Comment

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## Subject

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## Other related subjects

Company law

## Keywords

Business purpose; Directors; Fees; Input tax; Legal services; VAT

## Cases cited

Praesto Consulting UK Ltd v Revenue and Customs Commissioners [2019] EWCA Civ 353; [2019] S.T.C. 724; [2019] 3 WLUK 149 (CA (Civ Div))

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### \*B.T.R. 378 Introduction

*Praesto Consulting UK Ltd v HMRC (Praesto CA)*<sup>1</sup> concerned a claim for an input tax credit in relation to legal services supplied to a company. The person subject to the legal proceedings was, however, the director of the company, rather than the company itself. How did this affect the VAT position?

Mr Ranson was a former employee of Customer Systems plc (CSP). He resigned and set up Praesto in direct competition with CSP as it was also a consultancy business in the same field. On 4 November 2009 solicitors acting for CSP wrote a letter before action to Mr Ranson (who was identified as the proposed defendant). It alleged that Mr Ranson had breached his contract of employment and fiduciary duties owed to CSP. Notably, the letter also referred to the possibility of "further matters warranting claims against you and/or against Praesto". However, Praesto was never in fact formally joined as a party. Praesto paid the legal fees relating to Mr Ranson in civil proceedings brought by CSP. Praesto then claimed an input tax credit totalling £79,932 in its VAT return, and HMRC issued a notice of assessment (the assessment which was the subject of this appeal) in order to recover the input tax claimed.

In summary, the basis of the assessment against Praesto was HMRC's conclusion that the legal fees were not incurred by Praesto for the purposes of its business. Praesto maintained that they had in fact been incurred for the purposes of its business, as the reality was that CSP was pursuing both Mr Ranson and Praesto, even if Praesto was never formally joined as a party.

In the first instance, the First-tier Tribunal (FTT) held in favour of Praesto, holding that the economic reality was such that services had been supplied to Praesto and that there was a direct and immediate link between the services supplied and the taxable activities of Praesto.<sup>2</sup> The Upper Tribunal (UT)<sup>3</sup> reversed this decision, holding that not only had the services not been supplied to Praesto, but the case of *Finanzamt Köln-Nord v Becker (Becker)*<sup>4</sup> applied such that there was no such direct

and immediate link. The majority in the Court of Appeal found in favour of Praesto for the reasons given by the FTT. Sir Terence Etherton MR dissented.

This case note will set out the findings of the Court of Appeal, before commenting on the wider implications (or lack thereof in a practical sense) of the case. \*B.T.R. 379

### The decision of the Court of Appeal

In the Court of Appeal, Lord Justice Hamblen gave the following judgment. First, as in the lower courts, it was held that there were two issues to be determined: did the FTT err in law in concluding that the invoices related to services supplied to Praesto (Issue 1); and did the FTT err in law in concluding that the services supplied by Sintons, the firm of solicitors instructed by Mr Ranson and Praesto had a direct and immediate link to Praesto's taxable activities (Issue 2)?<sup>5</sup>

It was noted regarding Issue 1 that it was hardly surprising that the evidence relating to this was not as extensive as it might have been, as it was raised shortly before the FTT hearing.<sup>6</sup> The judgment goes on to find that, despite the FTT making no express finding of a contractual relationship between Sintons and Praesto, the findings made (such as instructions being given throughout on behalf of Mr Ranson and Praesto, Sintons acting on behalf of both regarding the litigation, both parties being clients of Sintons and all work completed on behalf of both parties) clearly established such a relationship.<sup>7</sup> The UT had ignored "a number of critical findings made by the FTT".<sup>8</sup>

It was also held that the contractual relationship reflected the economic reality, as the FTT had found that the reality was that Sintons acted on behalf of *both* parties, "in relation to what was effectively litigation brought against both of them by a trade competitor".<sup>9</sup> The fact that Praesto was not joined as a party and the invoices were addressed to Mr Ranson were things to be taken into account by the FTT in reaching their conclusion, but they were not to be considered as legal bars to the conclusion reached.<sup>10</sup>

As a matter of economic reality, there were "good reasons for the FTT reaching the conclusion which it did".<sup>11</sup> This includes that the FTT found Praesto were the main target of the litigation (as a result of their profits which CSP sought to claim), and that the real value of the claim was against Praesto's profits and seeking to put Praesto out of business.<sup>12</sup>

It was held that there was no proper basis for a further argument advanced by HMRC (that if the FTT's findings meant there was a legal relationship, they had erred in their assessment and come to an "irrational and perverse conclusion"<sup>13</sup>). It was held that the FTT was entitled to reach the conclusions that it did with the material before it.<sup>14</sup>

It was consequently held that the appeal should be allowed on Issue 1.

On Issue 2, the findings of fact of the FTT were set out with regard to why the FTT had held there was a direct and immediate link between the services supplied by Sintons and Praesto's taxable activities. In particular, it was stated that the litigation was effectively brought against Mr Ranson and Praesto, with phase 1 of the litigation to establish a breach of fiduciary duty \*B.T.R. 380 against Mr Ranson, and phase 2 being to pursue Praesto for all profits made as a result of that breach.<sup>15</sup> These "knock on effects"<sup>16</sup> for Praesto were not present in *Becker*<sup>17</sup> (which was considered to be directly on point and therefore binding in the UT).<sup>18</sup>

Moreover, there was no suggestion in *Becker*<sup>19</sup> that a finding of criminal liability on the part of Mr Becker might lead to proceedings against the company (and therefore, any benefit to the company of the successful defence by Mr Becker was necessarily indirect).<sup>20</sup>

The FTT had further held that the factual circumstances bore a resemblance to the case of *P&O Ferries (Dover) Ltd v CC&E (P&O)*<sup>21</sup> (as *P&O* had formed the view that the success or otherwise of the possible prosecution of the company depended largely on the outcome of the prosecution against the individual employees).<sup>22</sup> In *P&O* it was found that the legal services in question were used for the purpose of the Company's business, which was directly analogous to the position of Praesto as the

consequence of a finding of liability against an individual would lead to a real risk of proceedings against the company with "disastrous consequences for its business activities".<sup>23</sup>

It was therefore held that the UT had been incorrect not to distinguish *Becker* and that the FTT had made the correct decision in doing so (as the benefit was not "merely incidental" as the UT had found).<sup>24</sup>

Finally, it was held that the "only remaining question" was whether there was a direct and immediate link between the services supplied by Sintons and Praesto's taxable activities. It was held that the FTT had applied the right legal test, as it had regard to "all the circumstances surrounding the transactions at issue", looked for an objective link, and found that "objectively the reason Praesto obtained Sinton's services was to limit any liability arising from its taxable activities".<sup>25</sup>

In concluding, it was held that in light of *Becker*,<sup>26</sup> it is likely that in many cases a company which pays the legal fees for the defence of proceedings brought against a director will *not* be entitled to credit for VAT input tax charged in relation to those fees: however, the FTT was "entitled to decide otherwise".<sup>27</sup> The facts of this case were unusual as ordinarily in such proceedings, a claim is brought against both the individual and the company (which consequently renders it likely that there would be no issue as to the entitlement of the company to claim recovery of VAT). It was held that the FTT had understandably focused on substance and reality.<sup>28</sup>

Hamblen LJ accordingly held that he would allow the appeal. \**B.T.R.* 381<sup>29</sup>

Lord Justice Haddon-Cave agreed with the judgment of Hamblen LJ, holding that the FTT findings of fact were "clear, unequivocal and directly relevant to the issues in question".<sup>30</sup> Haddon-Cave LJ further stated that he had read with care the dissenting judgment and disagreed with it, as the analysis would "inevitably draw this Court into seeking to go behind the findings of fact in the first instance tribunal".<sup>31</sup> It was not open to the Court to speculate post hoc as to the chances of Praesto being successfully sued by CSP, as this would cut across the findings of the FTT that if CSP had been successful against Mr Ranson, Praesto would have been joined.<sup>32</sup>

In contrast, Sir Terence Etherton MR held that he would have dismissed the appeal. Applying *Becker*, the critical legal principles were that there must be a "direct and immediate link" between the particular input transaction and one or more output transactions giving a right to deduct, or the costs of the services are part of the taxpayer's general costs and have a direct and immediate link with the economic activity as a whole, and that the direct and immediate link must be established objectively in light of the content of the supply.<sup>33</sup>

Sir Terence Etherton MR held that these conditions were not satisfied: the relevant invoices were addressed to Mr Ranson and Praesto was not a defendant. The judgment goes on to state that he would regard it as at best "highly speculative" whether any application to join Praesto could possibly have succeeded.<sup>34</sup> Moreover, the FTT had not attempted to analyse the likelihood of a claim for an account of profits succeeding against Praesto.<sup>35</sup>

Etherton MR disagreed that the UT was not open to find as it did. This was because the issue was a legal one, not one of fact, and secondly, on a proper analysis, he did not consider that any of the findings of fact of the FTT precluded the UT's finding in favour of HMRC.<sup>36</sup>

The dissenting judgment goes on to state that it cannot be said that there was any direct link between the supply of services in the invoices addressed to Mr Ranson and one or more particular output transactions of Praesto. The FTT's description of Praesto as a "party to proceedings in all but name" is not a meaningful statement of fact: the objective fact was that Praesto was not a party to proceedings.<sup>37</sup> Moreover, the objective link between the services provided and the success of Praesto's business was not direct but indirect and not immediate but consequential—it was also "well established" that the payment of costs by the taxpayer for a service provided to a third party instructed by the taxpayer, which is in the economic interests of the taxpayer, may not satisfy the objective direct and immediate link test (relying on *Airtours Holidays Transport Ltd v HMRC*<sup>38</sup>).<sup>39</sup>

Finally, relying on *P&O* (a non-binding VAT tribunal decision decided many years before *Becker*) was not a useful analogy, particularly as it did not purport to apply the objective direct and immediate link test. \**B.T.R.* 382<sup>40</sup>

*Assessment of the reasoning in the Court of Appeal*

The first thing to note is that the wider impact of this case is somewhat limited. This was captured by Hamblen LJ's judgment, where he stated that:

"I do not consider that the FTT decision establishes *any general proposition, still less a proposition of law, as to the circumstances in which a company will or will not be able to claim VAT in comparable factual circumstances*. The decision turns on the findings of fact made by the FTT in this specific case."<sup>41</sup> (Emphasis added.)

The key facts of this case are clearly unusual and are unlikely to arise often, as there is no real reason why, in the circumstances, Praesto was not also joined as a party to the original proceedings against Mr Ranson. The findings of fact in the FTT make it clear that Praesto was the ultimate target as it was there that the real value of the claim lay. Moreover, the rationale for not including Praesto in the eight invoices subject to HMRC's assessment (despite it having been found that there was a contractual relationship between Sintons and both Praesto and Mr Ranson) is also unusual. The alignment of both of these uncommon circumstances gave HMRC the scope to pursue the argument that the legal fees were not incurred by Praesto for the purposes of its business (where, if just one is removed, the argument would have been significantly less clear).

The majority judgment in the Court of Appeal was both sensible and, in the writer's opinion, correct. On the facts found by the FTT, there was very clearly a contractual relationship between Sintons and Praesto (even if, as commented upon by Hamblen LJ, this was not expressly stated, which perhaps it should have been if only for the sake of clarity). There are also very clearly very good reasons for the FTT finding as it did with regard to economic reality: why was CSP suing Mr Ranson for breach of duty if not to ultimately recoup as much as possible from Praesto, who had profited from the alleged breaches?

It was also correct in the writer's view for the majority in the Court of Appeal to refuse to cut across the findings of the FTT (as the UT's judgment and the dissenting judgment arguably did).

There is however some potential difficulty with the language adopted by the majority in using terminology such as a "*real* risk of proceedings being successfully brought against the company".<sup>42</sup> Whatever is meant by a real risk is not defined: whether a 50 per cent likelihood or a 90 per cent likelihood would be sufficient is left unconsidered. Although the wider implications of this case are limited, it would have been useful if "real risk" had been more accurately outlined, so that if a factually similar case were to arise in the future it could be determined more easily one way or the other without recourse to litigation.

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## Footnotes

- 1 *Praesto Consulting UK Ltd v HMRC* [2019] EWCA Civ 353.
- 2 *Praesto Consulting UK Ltd v HMRC* [2016] UKFTT 495 (TC).
- 3 *HMRC v Praesto Consulting UK Ltd* [2017] UKUT 395 (TCC).
- 4 *Finanzamt Köln-Nord v Becker* (C-104/12) EU:C:2013:99.
- 5 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [33].
- 6 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [35].
- 7 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [36].
- 8 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [39].
- 9 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [40].
- 10 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [41].
- 11 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [42].
- 12 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [42].
- 13 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [45].
- 14 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [46].
- 15 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [49].
- 16 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [50].
- 17 *Becker*, above fn.4, (C-104/12) EU:C:2013:99.

- 18 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [50].
- 19 *Becker (C-104/12)*, above fn.4, EU:C:2013:99.
- 20 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [51].
- 21 *P&O Ferries (Dover) Ltd v CC&E [1992] VATTR 221*.
- 22 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [53].
- 23 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [54].
- 24 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [56].
- 25 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [57].
- 26 *Becker (C-104/12)*, above fn.4, EU:C:2013:99.
- 27 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [59].
- 28 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [60].
- 29 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [62].
- 30 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [65].
- 31 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [69].
- 32 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [70].
- 33 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [75].
- 34 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [79].
- 35 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [81].
- 36 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [84].
- 37 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [85].
- 38 *Airtours Holidays Transport Ltd v HMRC [2016] UKSC 21*.
- 39 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [88].
- 40 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [89].
- 41 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [61].
- 42 *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [54].