[2011] UKUT 498 (TCC)

Appeal number: FTC/85/2010

VAT – Bad Debt Relief – Solicitors acting on instructions of insurance companies – insured party registered for VAT – invoice for VAT element of fees rendered on insured party Bad Debt Relief claimed in respect of unpaid VAT.

UPPER TRIBUNAL
(TAX & CHANCERY CHAMBER)

SIMPSON & MARWICK

Appellant

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Respondents

Tribunal Judge: LORD DRUMMOND YOUNG

Sitting in Edinburgh on 17 June 2011

W.J. Wolffe, QC, for the Appellant

K. Campbell, Advocate, for the Respondents

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[1] The appellants, Simpson & Marwick, Solicitors, have appealed against a decision of the Commissioners for Her Majesty's Revenue and Customs to assess them in the sum of £322,843 of Value Added Tax in accordance with section 73 of the Value Added Tax Act 1994. The appellants had reclaimed that amount by way of bad debt relief in respect of VAT periods running from the period 1 May to 31 July 2004 to the period 1 February to 30 April 2007. The amount at issue was ultimately agreed at £216,862.36.

[2] The appeal was heard by the First-tier Tribunal, who rejected it and held that the appellants had been properly assessed in the amended sum of £216,862.36. The appellants have now appealed to the Upper Tribunal.

Material facts

[3] The material facts, which were not in dispute, were stated by the First-tier Tribunal as follows. The appellants are a firm of solicitors practising in Edinburgh. They have been registered for VAT since 1 April 1973. The greater part of their practice relates to the provision of legal services in respect of insurance claims. In such matters, they are instructed by insurance companies, but they also have a professional responsibility towards the insured person. Prior to 1 January 1985, they sent their fee notes to the insurers who instructed them with the expectation that the insurers would pay VAT on all their fees and outlays as well as the fees and outlays themselves.

[4] Immediately prior to February 1985 the Commissioners of HM Customs and Excise reached an agreement with the British Insurance Association and other bodies connected with insurance in respect of such fees and outlays. A direction was published in the Journal of the Law Society of Scotland in February 1985 in the following terms:

"**Legal services in insurance claims**

The Commissioners of HM Customs and Excise have agreed with the British Insurance Association and other insurance bodies that policy-holders who are registered for VAT can count as input tax VAT incurred on legal services supplied to them in connection with an insurance claim relating to their business.

From 1st January this applies whether the solicitor is instructed by the policy-holder or by the insurer on his behalf and whether or not in practice the proceedings are controlled by the insurer. It has also been agreed that, normally, such legal services are supplied to the policy-holder not the insurer even where the insurer exercises his right of subrogation to pursue or defend a claim in the name of the policy-holder".

[5] Supplementary information was given in the issue of the Journal of the Law Society of Scotland that appeared in March 1985 in the following terms:

"VAT on legal fees-insurance claims

The Society has received the following letter from the Secretary-General of the British Insurance Association.

'HM Customs and Exercise have reviewed the application of VAT to legal services in relation to insurance claims. Following discussions with the BIA, Customs have extended their view that such services are normally supplied to the policyholder to encompass claims in which the insurance company exercises its right of subrogation. Furthermore, and for lawyers' invoices issued on or after 1st January 1985, Customs have agreed that if the claim relates to the policyholder's business then legal services supplied to the policyholder are for the purposes of that business and, if registered, the policyholder can recover the VAT incurred - subject of course to the normal rules for input tax deduction.

The insurance company will therefore indemnify the policyholder in respect of an amount net of VAT. Where such a policyholder is partially exempt, for example a bank, the policyholder will not be able to recover all the VAT as input tax. The insurance company will therefore have to indemnify the policyholder in respect of an amount which will include some VAT. This VAT will not be recoverable from Customs by the insurance company. If, however, the insurance does not relate to the policyholder's business and/or the policyholder is not registered for VAT, the insurance company will indemnify the policyholder in respect of an amount which will include VAT. This VAT will not be recoverable from Customs by the insurance company.

The procedure for UK solicitors' services will depend on whether or not the policyholder is registered for VAT and whether the claim appears to relate to his business or private activities. If the policyholder is registered and can recover VAT from Customs, the solicitor is obliged under the VAT regulations to address a tax invoice to him. This will request payment of an amount equal to the VAT and it will state that the balance of the account will be settled by the insurance company. A copy of the invoice will be sent to the insurance company endorsed to indicate that the policyholder has been asked to pay the VAT amount and that the insurance company should settle the balance. If the policyholder is not registered for VAT and/or cannot recover the VAT from Customs, for example because the claim does not relate to his business, and the Solicitor will address his invoice to the policyholder and send it to the insurance company for settlement. Copy invoices sent to insurance companies for settlement will be endorsed to the effect that they are not tax invoices and care should be taken at VAT on supplies to policyholders is not counted as input tax by the insurance company' ".

[6] From 1 January 1985 the appellants issued their fee notes in duplicate in cases where the policyholder was registered for VAT. The principal fee note claiming payment only of fees and outlays was sent to the insurer. A duplicate was sent to the policyholder, who was asked to pay only the VAT on fees and outlays. In the covering letter it was made clear that the insured person would not be out of pocket because they should be able to recover as input tax VAT that they were being asked to pay. That procedure has been followed until the present. It was the practice of the appellants to follow up any unpaid VAT periodically and, if payment could not be achieved by sending reminders, to claim VAT bad debt relief. On every quarterly VAT return there would have been a separate sheet which identified the VAT bad debt relief claim. Such claims were all accepted.

[7] Between 1985 and 2007 HM Customs and Excise, and latterly HMRC, visited the appellants approximately every three years to carry out an inspection of their VAT records and procedures. The sheet that accompanied each quarterly return identifying the VAT bad debt relief would have been available for inspection. At no time did HMRC ever challenge the procedure that was followed for claiming VAT bad debt relief. It was never suggested that, when the firm made a claim for relief because a policyholder who was registered for VAT had failed to pay or had become insolvent, the firm should call upon the insurer to satisfy the VAT that was due.

[8] On 13 June 2007 Karen Ross, an officer of HMRC who had carried out an inspection of the appellants' records in 2003, made a further visit to their premises. In the course of her inspection she raised queries about the firm's method of claiming bad debt relief. In particular, she suggested that the appellants had been incorrectly calculating relief in that they had claimed the full relief on the invoices which showed a "VAT only" amount. The following day the appellants' finance manager telephoned HMRC's National Advice Service to ask whether they could reclaim bad debt relief on unpaid "VAT only" invoices. The advice given by the Advice Service was that, provided that the firm had followed the conditions of VAT Notice 700/18, the full amount of any "VAT only" invoices could be reclaimed under the bad debt relief procedure. On 19 June 2007 HMRC wrote to the appellants in relation to bad debt relief, and enclosed a copy of VAT Notice 700/18, with particular reference to paragraph 3.13. That paragraph was in the following terms:

"**What if my customer pays everything but the VAT?**

If your customer refuses to pay the VAT charged, or you did not charge VAT when the supplies were made but issued supplementary invoices to recover the VAT from your customer, the claim to relief is limited to the VAT element of the total debt. For example if you originally charged £100 which your customer paid, and you unsuccessfully attempt to recover the £17.50 VAT charge originally omitted, you are only entitled to claim the VAT fraction of £17.50 as bad debt relief".

On 27 June 2007 the appellants' finance manager again telephoned HMRC's National Advice Service to ask whether a VAT registered business making an insurance claim is able to reclaim the VAT that it is charged when the insurance company only pays the net value. He was advised that the VAT registered business "can claim this as normal".

[9] The appellants have claimed bad debt relief on sums totalling £379,346.70 over the VAT periods from April - July 2004 to April - July 2007. HMRC formed the opinion that the appellants' entitlement to bad debt relief was limited to 7/47 of that figure. On one February 2008 HMRC issued an assessment to the appellants for the difference rounded down to £322,843 plus interest. That sum has since been reduced to £216,862.36. The issue in the present proceedings is whether that assessment was properly made.

The appellants' legal relationship with insurers and policyholders

[10] The major part of the appellants practice consists of providing legal services relating to insurance claims. In such cases the normal procedure is that the appellants are instructed by insurance companies. Nevertheless any court proceedings must be defended in the name of the policyholder, and the appellants have a professional responsibility towards those policyholders. Prior to 1985 the appellants sent their fee notes to insurers with the expectation that the insurers would pay VAT on all their fees and outlays. In February 1985, however, the direction set out in paragraph [4] above was issued. This represented an agreement concluded between HM Customs and Excise and the British Insurance Association. The result of the direction was that, when a policyholder was registered for VAT, the VAT payable on legal fees could be treated as input tax by the policyholder and thus deducted from the VAT payable by the policyholder. The direction went on to state that it had been agreed between Customs and Excise and the British Insurance Association that normally such legal services were supplied to the policyholder and not the insurer even when the insurer exercised its right of subrogation. This was technically incorrect, for reasons discussed in the following paragraph. Nevertheless, the appellants changed their practice to that set out in paragraph [6] above. Duplicate fee notes were issued, the insurer being asked to pay the fees and outlays and the policyholder the VAT. In accordance with the direction this enabled the policyholder to recover the VAT as input tax (which would not have been possible had the insurer paid the VAT).

[11] It was technically incorrect to treat the legal services as supplied only to the policyholder and not to the insurer. This appears from *WHA Ltd* v *Customs and Excise Commissioners*, [2004] STC 1081; [2004] EWCA Civ 559. It is not necessary for present purposes to consider the facts of that case in detail. It concerned motor breakdown insurance, and the critical issue was whether a garage that carried out works to a vehicle pursuant to an insurance policy on the instructions of the taxpayer, a claims handler, made a taxable supply of services to the taxpayer. It was held that there was a taxable supply to the taxpayer, notwithstanding that the vehicle belonged to another person: see in particular paragraphs [37] and [38]. The reason was the very wide definition of "services" used in the legislation (in section 5(2)(b) of the Value Added Tax Act 1994); on that basis, provided that something was supplied to the taxpayer as claims handler, it could be described as "services". The taxpayer received benefit from the carrying out of the repairs, namely satisfaction of its obligations to the insurer to have the repairs carried out and the ability to earn a fee for arranging the repairs, and the work in question was authorized by the taxpayer. The fact that the services were also provided to the vehicle owner did not prevent them from being treated as "supplied" to the taxpayer, who authorized and paid for the work and was rendered the invoice for the work. On that basis, in the case of legal services provided in respect of an insurance claim, it can be said that the services are supplied both to the insurer and to the policyholder. The insurer is in a position analogous to the claims handler in *WHA*; it instructs and pays for the services, and clearly obtains a benefit in that it fulfils its obligations under the contract of insurance with the policyholder. Nevertheless, the operative part of the direction issued in February 1985 was clear, and the appellants complied with its terms, invoicing the insurer for the cost of the services and outlays and the policyholder, if registered, for the VAT.

[12] It is unusual for an insurer to become insolvent, no doubt because the insurance industry is closely regulated. Nevertheless, if the VAT component is invoiced to the policyholder, there is a risk that the policyholder will become insolvent, with the result that the VAT is not paid to the solicitor who provides the services. This in fact occurred in a significant number of cases. The result of the arrangements put in place in 1985 was that the risk of non-payment by the policyholder fell on the appellants. In cases where the VAT component was not paid, the practice followed by the appellants was to claim bad debt relief in respect of the whole of the unpaid VAT. They did so on the basis that the whole amount invoiced was truly VAT, and it should continue to be treated as VAT in the event of non-payment. The Commissioners of Customs and Excise, and subsequently HM Revenue and Customs, were given access to the appellants' books and appear to have acquiesced in the claims for bad debt relief. That changed in 2007, however; at that point HM Revenue and Customs contended that the bad debt relief should be limited to 7/47 of the amount claimed. That proportion is calculated (assuming a VAT rate of 17 1/2%) as the VAT component of the total amount unpaid, on the assumption that the total unpaid amount represented both a net price and a VAT component (calculated as 17 1/2 divided by 117 1/2, which is 7/47). Thus HM Revenue and Customs contend that the unpaid VAT component should be treated in exactly the same way as any other unpaid debt, with both an element of net price and an element of VAT, and bad debt relief should be limited to the VAT component. Thus the non-payment of the appellants' invoices was treated as if the sum unpaid were a normal professional debt, including both a component of net price and a component comprising the VAT on that price.

The First Tier Tribunal's decision

[13] The First Tier Tribunal held that the position taken by HMRC was correct, and that the appeal must accordingly fail. They considered the terms of section 36 of the Value Added Tax Act 1994, read in the context of section 19 of the same Act, which indicates the meaning of "consideration". The latter section indicated that, because there was a single "supply" of services, the "consideration" was the aggregate of fees and the VAT thereon. Section 36, however, only provided for bad debt relief on "the outstanding amount" of the consideration written off. On that basis, the appellants were limited to claiming the VAT portion of the amount written off, which was 7/47 of the total consideration. That was the limit of bad debt relief. A similar approach had been taken by the VAT Tribunal in. *AW Mawer & Co* v *Commissioners of Customs and Excise*, [1986] VATTR 87. The appellants had founded on a further decision of the VAT Tribunal, that in *Palmer t/a R & K Engineering* v *Customs & Excise Commissioners*, MAN/92/724, but that case was distinguished on the ground that it arose out of a mistake made by Customs & Exercise; in the present case, by contrast, there had been no mistake on the part of HMRC. An argument was presented for the appellants based on the European Convention on Human Rights. On this, the Tribunal held that there had been a single supply and the insurance company had already paid 40/47 of the consideration. The bad debt therefore only pertained to 7/47 of the consideration, and that proportion had been allowed on the part of the total debt that was not paid. I should record at this point that it is clear from the decision of the First Tier Tribunal that the arguments presented on behalf of the appellants were less developed than those presented to me.

The parties' submissions

[14] For the appellants it was submitted that the relevant provisions of the Value Added Tax Act 1994, notably section 36, ought to be construed in accordance with the general principles of the law of the European Union, and also in accordance with rights under the European Convention on Human Rights. In particular, section 36 ought to be read in such a way that it is compatible with both EU law and the provisions of the Convention; that followed both from section 3 of the Human Rights Act 1998 and decisions in the European Court of Justice, notably *Wachauf* v *Bundesamt fuer Ernaerung und Forstwirtschaft*, [1991] 1 CMLR 328, at paragraphs [17]-[19], and *Hauer* v *Land Rheinland-Pfalz*, [1980] 3 CMLR 42, at paragraphs [15]-[17]. It was accepted that the approach taken by HMRC was consistent with previous tribunal decisions, in particular *AW Mawer & Co* v *Commissioners of Customs and Excise, supra*. Nevertheless, none of those decisions was binding on the Upper Tribunal, and the question of whether the present assessment was compatible with the appellants' rights under the European Convention on Human Rights had not been addressed in them. Moreover, the decision of the VAT Tribunal in *Palmer t/a R & K Engineering* v *Customs & Excise Commissioners, supra*, indicated that the provisions of section 36 of the VAT Act can be read in such a way as to favour the taxpayer's case. Moreover, the appellants' contention that they should not be required to bear VAT that was not paid by the final consumer of their services was inconsistent with the basic principles of the VAT regime, in particular article 11(C)(1) of Directive 77/388/EEC; that was clear from the decision in the European Court of Justice in *Elida Gibbs Ltd* v *Commissioners of Customs and Excise*, [1996] ECR 1-5339 (Case C-317/94) (an important case that does not appear to have been cited to the First Tier Tribunal). It was further submitted that the assessment made on the appellants infringed article 1 of the First Protocol to the European Convention on Human Rights, in that it did not strike a fair balance between the general interest and the appellants' property rights. The taxpayer had incurred bad debts that consisted entirely of VAT, but on HMRC's view bad debt relief would only be available for 7/47 of the amount of such VAT, a result that was disproportionate.

[15] The argument for the respondents was based on the terms of section 36 of the Value Added Act 1994. That section was, it was submitted, clear in its terms. Where a claim is made for relief for a bad debt, the amount of the claim that is allowable by way of relief is the VAT chargeable by reference to the amount of the total debt that remains outstanding. The amount due is calculated by reference to the VAT fraction of the outstanding amount. In this connection, counsel emphasized that the transaction involves a single supply for VAT purposes, although payment is made partly by the insurer and partly by the policyholder. That meant that the two elements in the transaction, the price and the VAT, should be treated as a unity. Moreover, it is the policyholder who is the defender in any legal proceedings and is accordingly the person who is liable in the first instance to satisfy any decree pronounced by the court. That meant that HMRC were entitled to treat the supply of services as made to the policyholder, and that was in fact recognized in Notice 701/36, at paragraph 5.2, which stated that supplies of legal services in connection with insured claims are made to the insured party and not to the insurer. Treating the policyholder as the recipient of the supply is significant for a policyholder who is VAT-registered, because such a policyholder can claim back the input tax. This was consistent with the decision in *WHA Ltd* v *Customs and Excise Commissioners, supra*, where it was

held that within a single supply that might be more than one person who benefited from the contracts that were the subject of that supply. Reliance was further placed on the decision of the VAT Tribunal in *AW Mawer & Co* v *Commissioners of Customs and Excise, supra*, where solicitors acting on instructions of insurers issued a VAT invoice to the policyholder which was not paid because the latter company was insolvent. It was held that the solicitors were only entitled to deduct bad debt relief amounting to the proportion of the invoice that corresponded to the then rate of VAT, 15%. That case had been followed in a number of other Tribunal decisions. *Palmer* could be distinguished because the taxpayer in that case had suffered an obvious disadvantage because of errors by Customs & Excise in dealing with his registration application. Thus the domestic case law supported HMRC's approach. So far as the Convention was concerned, it was submitted that article 1 of the First Protocol was only relevant to the payment of taxes in cases where the taxpayer was compelled by the state's action or inaction to bear a disproportionate and excessive burden. In the present case no disproportionate or excessive burden was imposed on the appellants; they only suffered a loss in the situation where the insured party paid neither the appellants nor HMRC, and in such a case the appellants would be able to claim 7/47 by way of bad debt relief. That was a proportionate response to such cases.

The underlying problem

[16] The appellants' failure to recover the full amount of unpaid VAT by way of bad debt relief arises out of two sections of the Value Added Tax Act 1994. First, section 36 deals with bad debts. So far as material, it provides as follows:

"(1) Subsection (2) below applies where --

(a) a person has supplied goods or services... and has accounted for and paid VAT on the supply,

(b) the whole or any part of the consideration for the supply has been written off in his accounts as a bad debt, and

(c) a period of 6 months (beginning with the date of the supply) has elapsed.

(2) Subject to the following provisions of this section and to regulations under it the person shall be entitled, on making a claim to the Commissioners, to a refund of the amount of VAT chargeable by reference to the outstanding amount.

[(3) In subsection (2) above 'the outstanding amount' means --

(a) if at the time of the claim no part of the consideration written off in the claimant's accounts as a bad debt has been received, an amount equal to the amount of the consideration so written off;

(b) if at that time any part of the consideration so written off has been received, an amount by which that part is exceeded by the amount of the consideration written off

and in this subsection 'received' means received either by the claimant or by a person to whom has been assigned a right to receive the whole or any part of the consideration written off.]"

The purpose of this section is that, when a bad debt is written off, the taxpayer who made the relevant supply is entitled to a refund of the amount of VAT chargeable on the part of the debt that is not paid. Secondly, section 19 deals with the value of the supply of goods or services, and in particular the meaning of "consideration" in provisions such as section 36. The material subsection is subsection (2), which provides:

"If the supply is for a consideration in money its value shall be taken to be such amount as, with the addition of the VAT chargeable, is equal to the consideration".

Thus when goods or services are supplied for money consideration, it is assumed that the total consideration represents both the net price and the VAT that is chargeable.

[17] It follows from the terms of section 19 that the consideration for a supply of goods or services, and the corresponding debt owed by the customer to the supplier, is taken to comprise two components: the net price and the VAT exigible on that price. The supplier pays the VAT element to the tax authorities and, in the standard case where the customer is solvent and pays its debt to the supplier, the supplier is reimbursed by the customer. If the consideration for the supply is not paid at all, whether owing to insolvency or simple default, the supplier can claim bad debt relief on the VAT component; if VAT is at 17 1/2%; that entitles the supplier to a refund of 7/47 of the total consideration. If only part of the consideration is unpaid, bad debt relief is limited to the VAT component of the amount unpaid; that appears from section 36(3)(b). That is clearly quite fair because the amount received by way of bad debt relief is the VAT component of the unpaid consideration. The result is thus tax-neutral as far as the supplier is concerned; the bad debt relief exactly balances the unpaid VAT.

[18] In the "normal" case, where the unpaid consideration consists of both net price and VAT, any other rule on part payments could create a problem, in that the supplier would be enabled to attribute the amount it had received to the net price rather than the VAT component, and thus claim bad debt relief on an amount that represents the whole of the VAT component in the supply, as if the consideration had been wholly unpaid. That is plainly not justifiable, because part of the total consideration has been paid and it is only reasonable that that part payment should be reflected in the VAT bad debt relief.

[19] The specialty in the present case is that the unpaid amount consists entirely of VAT and, importantly, is clearly identifiable as consisting entirely of VAT. That is because the unpaid amount is contained in invoices that are for VAT only, as it is only the VAT component that is payable by the policyholders; the net price of the appellants' services is paid by the insurance companies. HMRC's position is that this makes no difference. The rule is set out in section 36 of the VAT Act 1994 at para 20, and the provisions of that section, in particular subsections (2) and (3), must be given literal effect, so that the relief is limited to a notional VAT component in the total amount unpaid. That construction of section 36 is disputed by the appellants, who argue that the invoices that relate only to VAT should be treated according to their terms.

[20] Three connected issues were raised in argument: first, the construction of section 36 of the VAT Act, in the light of section 19; secondly, the impact of the European Directives that set out the basis for the VAT system; and thirdly, the impact of the European Convention on Human Rights. Although the three issues are all interrelated, it is most convenient to deal with them one by one.

The United Kingdom legislation

[21] Section 36(2) entitles a taxpayer to a refund of "the amount of VAT chargeable by reference to the outstanding amount". A number of cases dealing with the construction of section 36 and its predecessors have been heard before the VAT Tribunal. Of these cases, the one that is closest on its facts to the present is *AW Mawer & Co* v *Commissioners of Customs and Excise*, *supra*, decided in 1986, where solicitors acted on the instructions of insurers to bring a claim in respect of a fire at a policyholder's premises. Following the conclusion of the action, they received agreed costs. The defendants' insurers paid the charges and disbursements but did not pay the VAT on these, as the English Rules of Court provided that, where a party to whom costs are to be paid is registered for VAT, that party should not receive payment of the VAT but should itself bear the tax and obtain reimbursement from HM Customs and Excise in its next quarterly return. The solicitors accordingly applied to the nominal plaintiffs (the policyholders) for payment of the VAT. By that time, however, the plaintiffs were insolvent. The solicitors claimed bad debt relief in respect of the whole amount of VAT due from the plaintiffs. Customs and Excise only allowed the claim to the extent of 3/23 of the amount claimed (that being the VAT component of the amount unpaid to the solicitors, assuming VAT at the then current rate of 15 per cent). It was held by the VAT Tribunal that the treatment of the claim by Customs and Excise was correct, as it followed from the exact terms of sections 10(2) and 22(1) of the Value Added Act 1983 (corresponding to sections 19(2) and, broadly, 36 of the 1994 Act). The first of these sections provided that, on a supply for money consideration, its value was to be taken to be such amount as, with the addition of the tax chargeable, was equal to the consideration. The second provided that, for a person liable to pay tax had become insolvent, any claim for a refund of tax should be for a refund of the amount of tax chargeable by reference to the outstanding amount. The result of these provisions was that the claim for relief was limited to the VAT component of the total outstanding amount. The solicitors' services were supplied to the plaintiff and not the defendant, who was not entitled to any tax invoice from the plaintiffs' solicitors. What the solicitors recovered was on behalf of their client, the plaintiffs, and the solicitors had no claim to any payment unless by prior agreement with the client. The result might be unfair, but the terms of the Value Added Tax Act had to be respected. For the solicitors it was submitted that a material factor in the case was that they had accepted the agreed costs in lieu of a solicitor and client bill, and only billed the client with the amount of tax. The Tribunal thought that there was no need to analyze that submission further, because the law was clearly laid down in the Value Added Tax Act. It was accepted that the result was unfair, but the Tribunal considered that there was nothing that it could do about it. Any remedy must lie elsewhere.

[22] A similar construction has been adopted, on different facts, in two other Tribunal cases, *Caernarfonshire Fatstock Group Ltd* v *Commissioners of Customs and Excise*, MAN/89/748 (1990), and *Engineering Services (Bridgend) Ltd* v

Commissioners of Customs and Excise, LON/01/161 (2001). In the former case the potential mischief referred to at paragraph [18] above was referred to, and the Tribunal pointed out that if the taxpayer's argument, that it was entitled to a refund of the whole amount of the debt as representing the VAT, were correct, suppliers would allocate receipts firstly to the invoiced amount for goods or services always leaving the VAT element as the last to be paid so that if the customer's business were to fail a higher proportion of the outstanding debt would relate to VAT, thus giving a higher refund. That, it was said, could not be correct, a view with which I respectfully agree. In *Engineering Services (Bridgend)* a similar point was made. In that case the Tribunal stated (at paragraph 19):

"If payment is made of a part of the amount due it is not open to the supplier to allocate that payment to the services rendered and to treat it as free of value added tax, leaving the value added tax element to be paid out of any final payment".

It should be noted that both *Mawer* and *Caernarfonshire Fatstock Group* predated the Human Rights Act 1998, and that in neither of those cases nor in *Engineering Services (Bridgend)* was any reference made to either the European Convention on Human Rights or the European legislation that establishes the scheme of value added tax.

[23] These cases should be contrasted with *Palmer t/a R & K Engineering* v *Customs & Excise Commissioners*, *supra*. In that case the taxpayer applied for registration for VAT purposes, but it took more than a year for his registration to be effected, the registration being backdated. During the intervening period the taxpayer made substantial supplies to a customer, and invoiced it for the price of services without claiming VAT, that being impossible because of the lack of registration at that time. After the taxpayer had been registered he sent a VAT-only invoice to the customer, but the customer was in financial difficulty and subsequently went into receivership; consequently the VAT invoice was not paid. The taxpayer claimed the whole amount of that invoiced by way of bad debt relief. It was held by the VAT Tribunal that, on a proper construction of section 11(2) of the Finance Act 1990 (corresponding to section 36(2) of the Value Added Tax Act 1994), the taxpayer was entitled to bad debt relief on the whole of the unpaid VAT-only invoice. The Tribunal accepted that, notwithstanding that the invoice was for VAT only, the law might deem it to be something else. Nevertheless, the phrase that had to be considered was not merely "the outstanding amount", but rather the full expression used in subsection (2), namely "the amount of tax chargeable by reference to the outstanding amount". The Tribunal continued:

"The purpose of the provisions is to give relief to a trader for the amount of value added tax for which he has accounted to the Commissioners, but which he is unable to recover from his customer. It was pointed out in the *Caernarfonshire Fatstock* case... that a trader cannot simply treat payments first received as being for his own benefit, so as to enhance the apparent amount of the outstanding VAT, and thus to enhance also the amount which he is able to recover by way of bad debt relief if there is any part of the invoice which is unpaid. Payments must be apportioned fairly between those entitled to them. That, however, is not the position here. By reason of the Commissioners' mistakes, the Appellant was in effect prevented from recovering VAT from his customer at the appropriate time, and was forced to attempt to do so at

a later date. By that stage, he was not recovering or attempting to recover any sum due to himself, but a sum the entirety of which was of value added tax which the Appellant was attempting to recover for the Commissioners' benefit.... [T]he blame for his late registration lies not with him but with the Commissioners themselves. In our judgment, the amount of tax chargeable by reference to the outstanding amount is the whole of the VAT-only invoice and the Appellant is entitled to bad debt relief on the entirety of that sum".

[24] That case is similar to the present in that the invoice issued was only for VAT. A specialty of the case was that the need to issue such an invoice arose from the fault of the tax authority. In the present case it cannot be suggested that there was any culpability on the part of Customs and Excise or HMRC. Nevertheless, the VAT-only invoices issued by the appellants were sent because of a specific instruction given by Customs and Excise. While blame cannot be attributed to the tax authority, it was their instruction that was responsible for the issuing of such an invoice. *Palmer* is accordingly in my opinion of some relevance to the present case; the critical feature is that a VAT-only invoice was issued as a result of the actings of the tax authority. That is a material distinction from *Caernarfonshire Fatstock Group* and *Engineering Services (Bridgend)*, although not from *Mawer*. In the present case the mischief referred to at paragraph [18] above cannot arise, because the VAT component is specifically identified in a separate invoice issued to a separate person. Consequently all payments received from an insurer must be treated as payment of the net price of the appellants' services, and all payments received from policyholders must be treated as VAT.

[25] Nevertheless, the critical question is whether the VAT legislation justifies treating the whole of the amount contained in a VAT-only invoice as unpaid VAT and hence refundable. That depends ultimately on the proper construction of section 36 of the Value Added Act 1994, read along with section 19(2) of the same Act. In *Mawer*, *Caernarfonshire Fatstock Group* and *Engineering Services (Bridgend)*, the VAT Tribunal construed the corresponding legislation literally; in *Palmer*, by contrast, the Tribunal expressly adopted a purposive approach to the legislation. On a literal construction, it is possible to justify treating all bad debts as comprising (net) value plus VAT, with the result that the refund must be confined to the VAT proportion. Section 36(2) provides that the refund is to be "of the amount of VAT chargeable by reference to the outstanding amount"; section 36(3) provides that the "outstanding amount" is an amount equal to the amount of the consideration written off; and section 19(2) can be read as stating that consideration is equal to the (net) value of a supply plus the VAT chargeable (although strictly speaking to what that subsection does is to define value, rather than consideration, and to provide that (net) value is equal to consideration less VAT). On that basis, the "outstanding amount" of the consideration written off must, in terms of section 19(2), be treated as both (net) value and VAT.

[26] Tax statutes must generally be construed strictly, and a strict construction will frequently, perhaps normally, be a literal construction. Nevertheless, a strict construction is not the same as a literal construction, and if a literal construction is at odds with the clear and obvious purpose of the legislation I am of opinion that the literal construction must if possible give way to a purposive construction. If, for example, the literal construction produces a result that is perverse, or contrary to

elementary standards of fairness, or which ignores the basic structure of the tax regime in question, it may be appropriate to try to achieve the underlying purposes of the legislation rather than accepting the manifestly unsatisfactory result produced by a literal approach. The construction adopted in such a case can still be regarded as strict, but it is a construction informed by the objectives of the legislation. To do anything else cannot be regarded as intellectually acceptable.

[27] In my opinion this is such a case. The appellants issued VAT-only invoices, on the instructions of Customs and Excise, and when one of these was unpaid it is obvious that the amount that was not recovered all represented VAT. Consequently elementary fairness demands that it should be refunded as if it were all VAT. This point was recognized in *Mawer*, where the VAT Tribunal described the result of their decision as "a material extension of the burden on taxpayers of acting as unpaid tax collectors". The purpose of section 36 is to permit the refunding of VAT in respect of bad debts, to ensure that the taxpayer who collects the VAT on behalf of HMRC is not left out of pocket by a failure to obtain payment from his customer. That purpose requires that the whole of the VAT that has not been recovered from the customer should be refunded; otherwise the taxpayer is out of pocket. Section 36, reading the first three subsections together, permits "a refund of the amount of VAT chargeable by reference to [an amount equal to the amount of the consideration so written off]". The amount written off is, demonstrably, all VAT. The compound preposition "by reference to" indicates that in determining the amount of the refund reference must be had to the consideration that is written off. If that amount is only VAT, that fact must in my opinion be taken into account in determining how reference is to be made to the consideration written off. If that is done, it is clear that the consideration so written off is all VAT, and the refund should be calculated accordingly. When regard is had to the purpose of section 36, I am of opinion that that is a more probable construction than the alternative, that only a percentage should be refundable.

[28] Such a construction is greatly strengthened when regard is had to the impact of the European Directives that form the basis of the system of VAT in the United Kingdom and throughout the European Union. I will now turn to that aspect of the case.

The underlying value added tax system: the significance of European Directives

[29] The VAT legislation in the United Kingdom is ultimately based on European Council Directives. Consequently the Value Added Tax Act 1994 must be construed in a manner that accords with the law of the European Union; that is the result of the United Kingdom's accession to what is now the European Union, and in particular the provisions of Article 93 of the Treaty establishing the European Community, which provides for the harmonization of legislation concerning turnover taxes. The relevant provisions of the European Directives that are relevant to value added tax are found in Article 11C(1) of Directive 77/380/EEC and Article 90 of Directives 2006/1 and 2/EEC (which replaced the former provision on 1 January 2007). Article 11C(1) (which is in substantially identical terms to Article 90) provides as follows:

"In the case of cancellation, refusal or total or partial non-payment, or where the price is reduced after the supply takes place, the taxable amount shall be reduced accordingly under conditions which shall be determined by the Member States.

However, in the case of total or partial non-payment, Member States may derogate from this rule".

The general requirement is accordingly that in the event that the price of goods or services is not paid the taxable amount is to be reduced accordingly. That is subject to the possibility of derogation by Member States. The question of derogation was considered in *Goldsmiths (Jewellers) Ltd* v *Commissioners of Customs and Excise*, Case C-330/95), [1997] 3 CMLR 978, where the European Court of Justice held (at paragraphs [15]-[18]) that one of the fundamental principles of the Directive was that the basis of assessment should be the consideration actually received. While a power to derogate existed, it was based on the notion that in certain circumstances and under certain legal regimes non-payment of consideration might be difficult to establish or might be only temporary. Consequently the exercise of the power of derogation had to be justified, in such a way that the principle of fiscal harmonization was not prejudiced. The *Goldsmiths* decision is significant for its emphasis on the principle that VAT should be assessed on the basis of consideration actually received. Apart from that it is unnecessary to consider the case, because counsel for HMRC indicated that derogation was not relied on in the present case.

[30] The underlying basis of the VAT system was considered by the European Court of Justice in *Elida Gibbs Ltd* v *Commissioners of Customs and Excise*, [1996] ECR 1-5339 (Case C-317/94), at paragraphs 19-22:

"19 The basic principle of the VAT system is that it is intended to tax only the final consumer. Consequently, the taxable amount serving as a basis for the VAT to be collected by the tax authorities cannot exceed the consideration actually paid by the final consumer which is the basis for calculating the VAT ultimately borne by him.
20... [O]ne of the principles of which the VAT system [is] based [is] neutrality, in the sense that within each country similar goods should bear the same tax burden whatever the length of the production and distribution chain.
21 That basic principle clarifies the role and obligations of taxable persons within the machinery established for the collection of VAT.
22 It is not, in fact, the taxable persons who themselves bear the burden of VAT. The sole requirement imposed on them, when they take part in the production and distribution process prior to the stage of final taxation, regardless of the number of transactions involved, is that, at each stage of the process, they collect the tax on behalf of the tax authorities and account for it to them.
...
24 It follows that, having regard in each case to the machinery of the VAT system, its operation and the role of the intermediaries, the tax authorities may not in any circumstances charge an amount exceeding the tax paid by the final consumer".

The critical principle that is recognizes in this decision is that the maximum amount of tax that may be collected by the tax authorities is the amount paid by the final consumer; the emphasis is on actual payment rather than a liability to pay. In the present case the final consumers were the various policyholders who were involved in litigation in which the appellant acted. Those policyholders have not paid the VAT that has been reclaimed by the appellants, and accordingly those amounts of VAT are "an amount exceeding the tax paid by the final consumer".

[31] In *Elida Gibbs Ltd* the Court of Justice further referred, at paragraph 30, to Article 11(C)(1) of the Sixth Directive (cited above at paragraph [29]) which, in order to ensure the neutrality of the taxable person's position, provides that in cases of cancellation, refusal or total or partial non-payment, or a reduction in price subsequent to supply, the taxable amount is to be reduced accordingly under conditions to be determined by Member States. At paragraph 31 the Court stated that Article 11(C)(1) was an expression of the principle that the position of taxable persons must be neutral. It continued

"It follows therefore from that provision that, in order to ensure observance of the principle of neutrality, account should be taken, when calculating the taxable amount for VAT, of situations where a taxable person who, having no contractual relationship with the final consumer but being the first link in a chain of transactions which ends with the final consumer, grants the consumer a reduction through retailers or by direct repayment of the value of the coupons. Otherwise, the tax authorities would receive by way of VAT a sum greater than that actually paid by the final consumer, at the expense of the taxable person".

In that case the Court was concerned with money-off coupons which were redeemable against sales, thus reducing the price. The effect of the judgment was that, in calculating VAT, full credit must be given for the value of such coupons. The wider principle that is recognised, however, is that the amount of VAT that is paid on any transaction should not exceed the amount that is actually paid by the ultimate consumer. If the position were otherwise, an extra burden would fall on one of the taxable persons engaged in the chain of supply, and that is contrary to the fundamental principle of the VAT system that the tax actually recovered should be the tax paid by the final consumer; so far as all persons who are involved in the chain supplying the final consumer are concerned, the taxes they pay should not exceed what they can recover from those further down that chain, ending with the final consumer.

[32] That principle is of direct relevance to the present case. In *Elida Gibbs Ltd* it was applied to discount coupons that were available to the ultimate consumer, but in my opinion exactly the same principle must apply in cases where the consumer fails to make payment to his supplier of sums that would otherwise be due. In both cases, the VAT that can be recovered by the tax authorities is limited to the amount paid by the final consumer. It is significant that the principle in *Elida Gibbs Ltd* is formulated in terms of the amount of VAT that is recoverable by the tax authorities. It is the amount of VAT paid by the ultimate consumer that limits what can be recovered. Even if the net price of the goods or services is paid, if it is clear that VAT has not been paid, that is a limitation on recovery.

[33] On HMRC's contentions, the amount of tax payable by the appellants would substantially exceed the amount of tax recovered from the consumers of their services. That is contrary to Article 11C(1) of the Directive 77/380/EEC and Article 90 of Directives 2006/1 and 2/EEC, as explained in *Elida Gibbs Ltd*. That is in my opinion a very good reason for not construing section 36 of the Value Added Tax Act 1994 in the manner suggested by HMRC, and it lends strong support to the construction suggested above at paragraph [27].

The European Convention on Human Rights

[34] Apart from the need to interpret United Kingdom VAT legislation in accordance with EU Directives regulating turnover taxes, it must also be construed in accordance with the European Convention on Human Rights. That is the result of section 3 of the Human Rights Act 1998. In addition, in implementing EU legislation, it has been held that fundamental rights form an integral part of the general principles of European law, and must be applied whenever possible in applying European legislation or national legislation based on European Directives: *Wachauf* v *Bundesamt fuer Ernaerung und Forstwirtschaft*, [1991] 1 CMLR 328, at paragraphs [17]-[19]; *Hauer* v *Land Rheinland-Pfalz*, [1980] 3 CMLR 42, at paragraphs [15]-[17]. In the latter case the European Court of Justice expressly stated, at paragraph [17], that article 1 of the first Protocol to the European Convention on Human Rights, which protects the right to property, must be recognized in the Community legal order.

[35] Notwithstanding what is said to the last paragraph, I am of opinion that the European Convention on Human Rights is not of assistance to the appellants in the present case. Caution is required in applying the Convention to taxation. The law governing the recovery of taxes is entirely statutory, and both the substance and the form of the legislation represent the outcome of political processes. Indeed, taxation can be regarded as a pre-eminently political matter, although in an ideal world the political process would no doubt be informed by intelligent economic views. Politically, dramatic differences in opinion exist regarding the form and rates of taxation, and the reconciliation of these competing views must be left to democratic processes. It is generally wrong for courts to interfere in this area, except in extreme cases. A further consideration is that taxes are set by Parliament and no one else; that is one of the lasting achievements of the constitutional struggles of the 17th century. Once again, it is important that the courts should respect the outcome of the democratic process.

[36] The application of the Human Rights Convention is fundamentally different from that of the European Directives set out in paragraph [29] above. The United Kingdom's system of VAT is directly based on European Directives that are designed to achieve harmonization of turnover taxes across the European Union. Thus the United Kingdom legislation is intended to implement the underlying European principles, and under the Treaty establishing the European Community, which has force of law under the European Communities Act 1972 and subsequent legislation, those principles must be respected. Moreover, those principles are specifically directed towards a system of turnover taxes. That is quite different from applying the principles found in the European Convention on Human Rights, which are of necessity at a very general level, to a very specific system of taxation.

[37] Nevertheless, the European Court of Human Rights has been prepared to apply Article 1 of the First Protocol to the Convention to taxation: *National & Provincial Building Society* v *United Kingdom*, (1997) 25 EHRR 127, at paragraphs 78-83 (although the Court's finding was that there had been no violation of Article 1 of the First Protocol); *Bulves AD* v *Bulgaria*, [2009] STC 1193, at paragraphs 53-71. Article 1 of the First Protocol is in the following terms:

"Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law. The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties".

In *National & Provincial Building Society* the European Court of Human Rights indicated that Article 1 contains three distinct but connected rules, and that the proper approach to a complaint about taxation was to examine it from the angle of the control of the use of property in the general interest "to secure the payment of tax": paragraphs 78 and 79. The Court continued (at paragraph 80):

"According to the Court's well-established case law, an interference, including one resulting from a measure to secure the payment of taxes, must secure a 'fair balance' between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights. The concern to achieve this balance is reflected in the structure of Article 1 as a whole, including the second paragraph: there must therefore be a reasonable relationship of proportionality between the means employed and the aims pursued.

Furthermore, in determining whether this requirement has been met, it is recognized that a Contracting State, not least when framing and implementing policies in the area of taxation, enjoys a wide margin of appreciation and the Court will respect the legislature's assessment in such matters unless it is devoid of reasonable foundation".

[38] In *Bulves* the Court had to deal specifically with a claim for the deduction of VAT. The taxpayer had purchased goods from a supplier and recorded the purchase in its accounting records for a particular month. It supplier did not record the sale in its accounting records until a later period. The tax authorities decided that no supply had taken place during the period reported by the taxpayer, and consequently the taxpayer could not deduct the amount that it paid to its supplier as VAT. It was held that the taxpayer, because it had complied fully and timeously with the relevant VAT legislation, and could not force its supplier to report the sale properly, could justifiably expect to be allowed to benefit from one of the principal rules of the VAT system by deducting the input tax that it had paid to the supplier: paragraphs 54, 57. On that basis the Court concluded that "the applicant company's right to claim a deduction of the input VAT amounted to at least a 'legitimate expectation' of obtaining effective enjoyment of a property right amounting to a ‘possession’ within the meaning of the first sentence of art 1 of the First Protocol". Thus the ability to deduct input VAT may be protected by Article 1 of the First Protocol. The Court went on to consider whether the interference with the taxpayer's right to claim a deduction was justified. It stated that "an instance of interference, including one resulting from a measure to secure payment of taxes, must strike a 'fair balance' between the demands of the general interests of the community and the requirements of the protection of the individual's fundamental rights": paragraph 62. It was emphasized that the taxpayer had fully complied with its VAT reporting obligations, and that the VAT due on the chain of supplies in question had eventually been paid to the state: paragraph 67. Moreover, the taxpayer had no power to control compliance

by a supplier with its VAT reporting obligations: paragraph 69. Against that background, the Court concluded that the refusal of the right to deduct input VAT amounted to "an excessive individual burden on the applicant company which upset the fair balance that must be maintained between the demands of the general interest of the community and the requirements of the protection of the right of property": paragraph 71.

[39] I was also referred to another case on Article 1 of the First Protocol, *Broniowski* v *Poland*, (2005) 40 EHRR 21, where that article was applied to the rights enjoyed by Polish citizens who had been repatriated from the eastern territories of the country, east of the Bug River, following the Second World War. In that case the Court emphasized that the essential object of Article 1 "is to protect a person against unjustified interference by the State with the peaceful enjoyment of his or her possessions": paragraph 143. The case is notable for its emphasis on the principle of a "fair balance". On this matter, the Court stated (at paragraph 150):

"In particular, there must be a reasonable relationship of proportionality between the means employed and the aim sought to be realized by any measures applied by the State, including measures depriving a person of his or her possessions. In each case involving the alleged violation of that Article the Court must, therefore, ascertain whether by reason of the State's action or inaction the person concerned had to bear a disproportionate and excessive burden".

[40] *Bulves* was relied on by counsel for the appellants. That case involved fairly extreme facts, in that the taxpayer was deprived of a right that was fundamental to the operation of the VAT system as a result of factors entirely outwith its control. In the present case counsel for the appellants submitted that the appellants had been required to render a VAT-only invoice to a person, the policyholder, other than the person with whom they contracted, the insurer, and that as a result they had incurred a bad debt consisting only of an amount of VAT. HMRC, however, had refused to allow bad debt relief against the whole of the amount of VAT that was not paid; the result was that the appellants were substantially out of pocket. They had paid the full amount of VAT charged to the tax authorities, but they had only been given relief for 7/47 of that amount. Counsel accepted that, in applying the Convention to taxation, it was necessary to look for something like a discrepancy between taxpayers, in a manner that was disproportionate. In this case the normal taxpayer was entitled to deduct the full amount of VAT that had proved to be a bad debt, but the appellants, because of the effect of the instruction given to them by the tax authorities, had only been permitted to recover a small part of such an amount. That was a discrepancy, and it was disproportionate.

[41] Counsel for HMRC submitted that, in considering a claim under Article 1 in a case of this kind, it was necessary to consider whether a fair balance had been struck between the general interest and the appellants' rights under that Article. If the appellants were to succeed, they must show a disproportionate and excessive burden. Moreover, under that Article, the state enjoys a wide margin of appreciation. In the circumstances of the present case, no disproportionate and excessive burden had been shown by the taxpayer. The cases referred to by counsel for the appellants were distinguishable; in particular, *Bulves* was one where the tax authorities had required the taxpayer to pay VAT a second time the with the result that the state received VAT

twice. In the present case, by contrast, the issue was relief for bad debts, in a situation where, if the taxpayer was correct, VAT would not be paid at all. Moreover, the particular taxpayer was not singled out for discriminatory treatment; the literal interpretation of the rule in section 36 would apply to all cases where VAT-only invoices were issued. Furthermore, the approach taken by HMRC was necessary to prevent taxpayers from allocating sums received from their debtors first to their fees and only secondarily to VAT; if that were permitted, the tax authorities would lose revenue. Overall, the position taken by HMRC struck a fair balance between the interest of the particular taxpayer and those of the tax authorities.

[42] Clearly Article 1 of the First Protocol can be used to control the imposition of taxation, but as I have already indicated I think that this is only possible in fairly exceptional cases. In general the tax system is a matter for political decision, and the courts should not interfere with the legislation that has been passed by Parliament. The argument for interference may be stronger in cases where a discretion is accorded to the tax authorities, or where the tax authorities take steps that go beyond the terms of the taxing statutes and the general law; in such a case it is obviously important that different taxpayers should be treated consistently with one another, although that is perhaps a principle that can be secured by the Scottish rules governing the judicial control of administrative action, without any need to resort to the Convention. In the present case the appellants' invoicing of policyholders rather than insurers for VAT was directed by the tax authorities, although according to the general law that was a permissible interpretation of the supply that was made by them; as indicated in paragraph [11] above, the appellants' services were supplied both to the insurers who instructed them and to the policyholders on whose behalf they acted in litigation. Consequently I do not think that it can be said that this is a case where the tax authorities can be said to have gone beyond the general law. Moreover, it is significant that the purpose of the direction was to ensure that input VAT on the appellants' services was deductible by policyholders in the normal case where the policyholders pay the VAT. Thus the direction given by Customs and Excise was in large measure designed to benefit taxpayers, although not, obviously, the appellants. Nor can it be said that the position taken by HMRC involved the exercise of a discretionary power; it was rather an application of existing legal principles designed, as I have said, to enable policyholders engaged in litigation to deduct input tax.

[43] One further point is perhaps significant in the context of Article 1. At the level of strict economic analysis, it can be said that the appellants, and other solicitors engaged in insurance work, bear the risk that policyholders fail to pay VAT. This is not fundamentally different from the risk that other debts will not be paid. Indeed the risk of bad debts is a universal feature of commercial life. Various measures can be taken to reduce the risk. An obvious measure, the taking of security, is clearly not practicable in the present case. In that event, however, the solution is to price services in such a way as to absorb the risk of bad debts. If there were a substantial increase in unpaid debts, whether of fees or outlays or VAT, the remedy available to solicitors would be to increase the level of fees. Moreover, the existing level of fees must provide the means to deal with such bad debts as arise in the course of business. In this way the risk that a debtor fails to pay is effectively insured against. Regardless of remedial measures, however, the fundamental point is that bad debts are a problem that all traders and all those in professional practice must deal with. In my view the risk of non-payment of VAT by a policyholder falls into precisely that category.

Requiring the appellants and other solicitors to carry the risk of bad debts cannot accordingly be described as disproportionate, or as failing to strike a fair balance, and this applies to VAT as much as to other debts. The fact that the VAT is collected on behalf of HMRC does not alter this result; it is still a debt due by the policyholder to the appellants, and the appellants' liability to pay VAT is a debt due by them to HMRC. The fact that a trader or professional person incurs bad debts is not a good reason for refusing to pay creditors. Consequently I reject the appellants' arguments based on Article 1 of the First Protocol.

Conclusion

[44] Nevertheless, for the reasons stated earlier, I am of opinion that the appellants' fundamental argument is correct, and that the present appeal should be allowed. I should add, however, that the arguments addressed to me were considerably more developed than those presented to the First Tier Tribunal; in particular the appellants' argument based on the European Directives does not appear to have been presented to them, and that is an argument that I have found persuasive. I was not addressed on the question of expenses and I make no finding in that respect.

LORD DRUMMOND YOUNG
JUDGE OF THE UPPER TRIBUNAL

RELEASE DATE: 20 DECEMBER 2011