TC02086

Appeal number: TC/2011/05795

VAT - Flat Rate Scheme - withdrawal from scheme - HMRC's refusal to allow retrospective withdrawal - section 84(4ZA) VATA 94 - whether HMRC could reasonably have been satisfied that there were grounds to refuse retrospective withdrawal - held yes - appeal dismissed.

FIRST-TIER TRIBUNAL
TAX CHAMBER

NORTHERN RENOVATIONS LIMITED **Appellant**

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

TRIBUNAL: **JUDGE KEVIN POOLE**
JOHN COLES

Sitting in public in Wine Street, Bristol on 6 June 2012

Anthony Sauer, Director, for the Appellant

Lynne Ratnett, HMRC Appeals and Review Unit for the Respondents

DECISION

Introduction

1. This appeal arises from HMRC's refusal to agree to a retrospective withdrawal by the Appellant from the VAT Flat Rate Scheme.

The facts

2. There was no dispute as to the facts of this appeal, which we find as follows after reading the bundle of documents submitted by HMRC and after hearing evidence from Mr Anthony Sauer, director of the Appellant.

3. The Appellant started in business at the end of 2003. Its business was described on its VAT registration form as "Marine Consultancy and Property Letting", though we did not hear of any activity under the latter heading during the course of the evidence.

4. Mr Sauer described briefly how the business had grown out of his previous personal involvement in the shipping industry. Its early activity was mainly described as "consulting and project management overseeing repairs and conversions of large vessels". By way of example, one of its earliest projects was advising on the conversion of a former North Sea ferry into a hospital ship.

5. On 26 August 2004, the Appellant applied to join the VAT Flat Rate Scheme (the "FRS") established under section 26B Value Added Tax Act 1994 ("VATA") and regulated by Regulations 55A to 55V of the Value Added Tax Regulations 1995 ("the VAT Regulations"), requesting 1 August 2004 as its date for joining the FRS. In its application to join the FRS, it described its main activity as "Management Consultancy in the Marine Construction Industry". At that time, the applicable rate for the "Management Consultancy" business was 12.5%, and this was the closest approximation in the published list of business activities to the Appellant's business at the time. Mr Sauer (who signed the application on behalf of the Appellant) confirmed that he had read HMRC's Notice 733 about the FRS as part of the process of applying to join. Having done so, however, he put it to one side and forgot about it.

6. At some time thereafter, the Appellant (acting on professional advice) bought some canal boats and hired them out as an investment activity. It did not operate the hiring business itself, it merely provided the capital for buying the boats and received an income out of the proceeds of hire generated by a separate holiday canal boat hire company which actually operated that business in its own right. The timing of the commencement of this activity was not clear but it was not significant for the purposes of this appeal.

7. At the beginning of 2009, the Appellant started a new line of business, ship surveying. This business was carried out at many locations, in the UK, elsewhere in the EU and outside the EU.

8. When the Appellant submitted its first invoice to a customer for this activity in early 2009, it initially added VAT in the normal way. Its customer however responded by pointing out that the work done for it was zero rated under the normal rules (presumably under Item 9 in Schedule 8 VATA, which zero rates "[a]ny services supplied for or in connection with the surveying of any ship or aircraft or the classification of any ship or aircraft for the purposes of any register").

9. The Appellant therefore issued a new zero rated invoice to the customer. This was correct. However the Appellant did not then include this zero-rated turnover within its turnover calculation in fixing its VAT liability under the FRS. Mr Sauer explained that his understanding was that zero rated turnover was effectively outside VAT and therefore did not need to be included. He had not taken any steps to check the position.

10. This error was repeated a number of times over the following two years or so.

11. To compound matters, the Appellant also failed to keep itself up to date with the changes in the flat rate applicable to its business under the FRS. That rate changed from time to time, as HMRC had warned in Notice 733 that it might.

12. All this came to light after a control visit from HMRC to the Appellant in February 2011.

13. The Appellant then became aware that its continued operation under the FRS from early 2009 had been extremely ill-advised. Instead of securing a simplification of the Appellant's VAT affairs at a broadly neutral VAT cost, the FRS (correctly operated) resulted in the Appellant having to pay VAT at a flat rate of 9.5% (in 2009), 10.5% (in 2010) and 12% (in 2011) on its zero rated ship surveying income. If it had not been in the FRS, it would not have been obliged to pay this VAT and it would also have been able to recover the input VAT incurred by it in connection with that part of its business. To make matters worse, Mr Sauer estimated that some 40% of the Appellant's ship surveying turnover was spent on overheads on which it incurred input VAT (a far higher proportion than had applied to its original business activity).

14. Once the Appellant appreciated this, it applied immediately to HMRC to withdraw from the FRS. It asked for that withdrawal to take effect retrospectively, from the time when it commenced its ship surveying activity.

15. HMRC permitted the Appellant to withdraw from the FRS with effect from 23 February 2011, the date of its letter to them requesting such withdrawal. They refused however to agree to the withdrawal taking effect retrospectively. They raised an assessment for the net shortfall of VAT which they considered to have been paid. That assessment was notified to the Appellant by letter dated 8 February 2011 and was subsequently confirmed (subject to some adjustment) on review.

16. In due course the Appellant appealed against HMRC's refusal to agree to its retrospective withdrawal from the FRS, and that was the appeal before us at the hearing.

17. During the hearing, Mr Sauer also raised another point which had not been mentioned in the notice of appeal, namely that some of the services supplied by the Appellant might have fallen outside the scope of VAT altogether by reason of the nature of the work and the location it was carried out. If this was correct, the fees for that work would properly fall outside the turnover calculation for the purposes of the FRS. That was not an issue that had been raised before in the appeal, so Mrs Ratnett very fairly and correctly agreed that the point could be left open and re-examined properly after the hearing, with the possibility of coming back to the Tribunal on that point if necessary.

18. We therefore treated this hearing as relating solely to the issue of whether the Appellant should be permitted to withdraw retrospectively from the FRS. We address this as effectively a preliminary point and expressly give permission to either party to apply for a further hearing to determine the other issue if it should prove impossible to resolve it by agreement.

The Law

19. It is not necessary to set out all the legislative provisions governing the FRS, about which there is no dispute for the purposes of the preliminary issue. The crucial provisions for the purposes of this appeal are as follows.

20. Paragraph 55M(1) of the VAT Regulations provides, so far as relevant, as follows:

> "(1) Subject to paragraph (2) below, a flat-rate trader ceases to be eligible to be authorised to account for VAT in accordance with the scheme where -
>
> ....
>
> (g) he opts to withdraw from the scheme..."

21. Paragraph 55Q(1) of the VAT Regulations provides, so far as relevant, as follows:

> (1) The date on which a flat-rate trader ceases to be authorised to account for VAT in accordance with the scheme shall be -
>
> ....
>
> (e) where regulation 55M(1)(g) applies, the date on which the Commissioners are notified in writing of his decision to cease using the scheme, or such earlier or later date as may be agreed between them and him..."

22. Rights of appeal are set out in section 83(1) VATA, which provides, so far as relevant, as follows:

"(1) Subject to sections 83G and 84, an appeal shall lie to the tribunal with respect to any of the following matters -

....

(fza) a decision by the Commissioners -

(i) refusing or withdrawing authorisation for a person's liability to pay VAT (or entitlement to credit for VAT) to be determined as mentioned in subsection (1) of section 26B..."

23. The right of appeal is somewhat qualified by section 84(4ZA) VATA, which provides, so far as relevant, as follows:

"(4ZA) Where an appeal is brought -

(a) against such a decision as is mentioned in section 83(1)(fza), or

(b) to the extent that it is based on such a decision, against an assessment,

the tribunal shall not allow the appeal unless it considers that HMRC could not reasonably have been satisfied that there were grounds for the decision."

Appellant's submissions

24. Mr Sauer argued that there was no attempt to avoid tax here. The rules were not being artificially manipulated to achieve a tax advantage. Quite the opposite, in fact, the operation of these somewhat complex and confusing rules was creating an entirely inappropriate and artificial tax liability which he would have certainly avoided by the simple expedient of immediately withdrawing from the FRS if he had spotted the problem. It was not appropriate for a simplification measure to be allowed to take effect so as to inflate significantly the amount of the Appellant's tax liability. The remedy was for HMRC to permit the Appellant to withdraw from the FRS retrospectively back to the time it started carrying out the marine survey work.

HMRC's submissions

25. Mrs Ratnett accepted that the rules did seem to have operated to the detriment of the Appellant in this case, but it was in the nature of a scheme such as the FRS that there would be some winners and some losers in terms of the actual amount of VAT falling due. The purpose of the scheme however was to give taxpayers a free choice as to whether they wished to avail themselves of the opportunity for some simplification, at the possible cost of some extra VAT liability. The terms of the scheme (in particular, what had to be included as turnover in the flat rate calculation) were clear from Notice 733, which also made it clear that participants could be worse

off under it and needed to keep its application to their case continually under review, especially if their business activities changed.

26. Mrs Ratnett pointed out that HMRC's published guidance made it clear (at FRS4100) that "the fact that a business would have paid less VAT is not sufficient reason to agree an earlier date of withdrawal from the scheme", and that:

> "You should normally refuse an earlier date where the business has already calculated its VAT liability for the period(s) using the FRS accounting method. This is because FRS exists to simplify VAT accounting and record keeping, so allowing a business to spend less time on VAT. Allowing a business to withdraw from a retrospective date in these circumstances would undermine the purpose of the scheme."

27. The same guidance goes on to say that in "exceptional circumstances" it may be appropriate to permit retrospective withdrawal, for example where "compassionate circumstances, or the survival of the business" were involved. Mr Sauer did not seek to bring this case within either of those two categories.

28. Mrs Ratnett also referred us to the comments of Henderson J in the High Court on the policy referred to at [26] above, in the case of *HMRC v Burke* [2009] EWHC 2587 (Ch) at [25]. It is worth saying that the case (and Henderson J's comments) were concerned with an application for retrospective admission to the FRS rather than a retrospective withdrawal, but we see no difference in principle between the two in terms of the application of the policy. Henderson J said this:

> "I comment that this appears to me to be an entirely rational policy, which reflects the simplification policy of the Flat-Rate Scheme itself. If a taxpayer has already accounted for VAT in the past on the normal basis, and in accordance with the general law then in force, there is no way in which retrospective admission to the scheme can simplify the accounting exercise that he has already carried out. In such cases, the only likely motive for seeking retrospective entry is that the taxpayer would, in fact, have ended up paying less tax had he been a member of the scheme, and that is indeed the position so far as Mr Burke is concerned."

29. Mrs Hartnett also referred us to the comments of Judge Nicholas Aleksander in *Brian Reynolds v HMRC* [2010] UKFTT 40 (TC), a First-tier Tribunal case involving an appeal against refusal to permit retrospective withdrawal from the FRS. In that case, Judge Aleksander said this:

> "HMRC's policy is generally not to allow retrospective application or withdrawal from the flat rate scheme - and that retrospective applications should only be allowed in exceptional circumstances. The mere fact that a taxpayer will pay more tax under the flat rate scheme is not considered exceptional for these purposes. In our view this is a rational policy. The flat rate scheme is intended to provide a measure of simplification for small businesses, and is intended to be revenue

> neutral. The objective of the scheme is not to provide a mechanism for small businesses to pay less VAT - and this is clear from the provisions of the VAT Directive which allow member states to implement simplified VAT accounting arrangements for small businesses. The flat rate scheme is based on average rates of input recovery for business sectors - and as it is based on averages, it is inevitable that some taxpayers will pay more (or less) than average. If taxpayers were allowed to join or withdraw from the scheme retrospectively, then this would defeat the simplification objectives of the scheme. Taxpayers could "game" the system - and join the scheme on a "punt", and after three years review their input VAT and apply to withdraw from the scheme with retrospective effect if they found they would pay less VAT as a result."

30. This is only a decision of the First-tier Tribunal and is not therefore binding on us. It also involved an appellant who was a plumber, who simply established that his own VAT situation would be better off outside the FRS than within it. It had none of the special features of the current case, in which significant amounts of zero rated turnover had to be brought into the turnover calculation without the Appellant becoming aware of that fact until two years later. We would observe however that simplification has two aspects. Not only does it simplify matters for the taxpayer, it also simplifies matters for HMRC and it seems to us entirely appropriate that it should only be in "exceptional circumstances" that they should be asked to allow the taxpayer to re-open past VAT returns by permitting retrospective withdrawal.

Discussion and decision

31. The hurdle that the Appellant must leap in order to succeed in this appeal is a high one. We must only allow the appeal if we "[consider] that HMRC could not reasonably have been satisfied that there were grounds for the decision" to refuse retrospective withdrawal from the FRS. In this context, "grounds" must connote good, valid or reasonable grounds.

32. We are satisfied that there are good policy reasons for HMRC in general to restrict the exercise of their discretion to "exceptional circumstances". These policy reasons are summarised by the comments of both Henderson J and Judge Aleksander set out above.

33. We are also satisfied that the simple fact that a higher tax liability will ensue if HMRC refuse to exercise their discretion will not, of itself, require them to do so.

34. What we must decide in this case is whether HMRC could reasonably have been satisfied that there were grounds to refuse retrospective withdrawal and not whether we would have reached the same conclusion.

35. We do not accept that "compassionate circumstances, or the survival of the business" are the only things that might justify retrospective withdrawal - we take these to be examples rather than an intentionally exhaustive list in HMRC's guidance.

36. We do not however consider that a failure on the part of a participant in the FRS to understand and appreciate the full implications for it of such participation (as set out in the relevant Notice) can amount to exceptional circumstances, except where there is some other circumstance (such as, perhaps, misleading advice from HMRC) that has led to that failure.

37. In all the circumstances of this case, we consider HMRC could reasonably have been satisfied that there were grounds for refusing to permit retrospective withdrawal and therefore we cannot override their decision. The appeal on this issue is therefore dismissed.

38. If the parties are unable to agree the amount of the assessment which arises as a result of this decision, then either party may apply to the Tribunal for final determination of that amount. It would greatly assist the Tribunal if HMRC could at that stage provide a supplementary statement of case, 14 days in advance of the hearing, to clarify the outstanding issues between the parties.

39. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

KEVIN POOLE
TRIBUNAL JUDGE

RELEASE DATE: 18 June 2012