TC02368

Appeal number: TC/2010/01285

VAT - input tax - professional fees incurred by holding company - whether there has been a supply of services - whether services used for business purpose

FIRST-TIER TRIBUNAL
TAX CHAMBER

CLOUD ELECTRONICS HOLDINGS LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE W D F COVERDALE
MR R PRESHO

Sitting in public at Leeds on 14th January 2011

Mr S Charles, Accountant, of Hawsons for the Appellant

Mr R Chapman, Counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. Cloud Electronics Holdings Limited (Holdings) appeals two HMRC decisions:

1.) A decision to assess Holdings pursuant to S73 of the Value Added Tax Act 1994 in the sum of £8,487 (plus interest) representing input tax claimed in the period 12/08 but disallowed by HMRC. This decision was notified to Holdings by Notice of Assessments dated 21.12.2009. In fact £1,312.50 is not in dispute so the figure appealed is £7,135.36.

2.) A decision to reject a Voluntary Disclosure, submitted by Holdings' representative on 25.09.2009, claiming input tax incurred in the period 12/08 in the sum of £10,807. This decision was notified to the representative by letter dated 20.10.2009.

2. Holdings trades from premises in Sheffield. It was incorporated on 28.02.08 as the vehicle for a management buy-out of Cloud Electronics Limited (Cloud) and was registered for VAT with effect from 01.03.2008. Holdings acquired the entire share capital of Cloud for £5.4 million. None of the former shareholders of Cloud are shareholders of Holdings and they have no further investment in the company. The former officers of Cloud involved in the acquisition of Holdings are Simon Curtis and Clare Powell (referred to as "the management buy-out team").

3. The input tax in issue related to professional fees for services of due diligence and other services rendered prior to the incorporation of Holdings. Professional advisers included:

- DLA Piper UK LLP Solicitors providing legal advice
- Ford Campbell Freedman Corporate finance advisers
- Hawsons Accountants undertaking the due diligence exercise
- Walker Morris Solicitors advising Royal Bank of Scotland

4. Letters of Engagement have been disclosed together with relevant invoices; the supplies in respect of which input tax was claimed were as follows:

INPUT TAX	**PERIOD 12/08 RETURN**	**VOLUNTARY DISCLOSURE**
DLA Piper	£168 + £1,312.50 Allowed	£6,256.52 Refused
Ford Campbell Freeman		£4,550.00 Refused
Hawsons	£2,800.00 Disallowed	
Walker Morris	£4,375.36 Disallowed	
Brown McLeod	£1,312.50 – Disallowed but not now in dispute	

5. The engagement letters are considered in turn.

6. DLA Piper

There were separate engagement letters for (i) drawing up consultancy agreements and (ii) legal advice in respect of the management buy-out. A very large amount of work was to be done by DLA Piper with extensive documentation covering every aspect of important elements of financing and contractual agreements relating to the business of Cloud in the context of the formation of Holdings. The letter referring to "Consultancy Agreements – Terms of Engagement" was dated 07.04.2008 and related to supplies recognised by HMRC as made to Holdings. The other letter, dated 16.01.2008, was addressed to Mr Curtis and Ms Powell; Holdings had not yet been incorporated and was known as 'Newco'; it was an Engagement Letter headed "Proposed Buy-out of Cloud Electronics Limited" and purported to confirm that DLA Piper would be acting "On behalf of management" and "On behalf of Newco". Signed agreement and acceptance was required of both Mr Curtis and Ms Powell as authorised signatories of Newco.

7. The input tax claimed in Holdings' 12/08 return was allowed because it related to advice on employment and post-competition matters, both of which were commissioned by Holdings and were used by it for its business purposes.

8. HMRC took the view that the input tax claimed in the Voluntary Disclosure related to advice commissioned by Mr Curtis and Ms Powell; DLA Piper were undertaking to "act on behalf of the management buy-out team in relation to the proposed buy-out by a new company to be incorporated for the purpose of Cloud Electronics Limited." It was considered that:

(a) the supply had not been made to Holdings and

(b) the services had been consumed within the acquisition process rather than for the ongoing business of Holdings.

Accordingly input tax was refused.

9. Ford Campbell Freeman

This firm rendered Corporate Finance advice to the management buy-out team and to Holdings. There was an incidental benefit to Royal Bank of Scotland (which was providing loan finance). The engagement letter dated 11.01.2007 (incorrectly typed as 2008) was addressed to Simon Curtis but stated explicitly that "When Newco has been formed, we shall issue an engagement letter addressed to it seeking its formal endorsement of the terms of our engagement". HMRC concluded from all the circumstances that the supply in question was not made to Holdings and was in any event consumed within the acquisition process. Accordingly this element of the voluntary disclosure was refused.

10. Hawsons

The engagement letter was for due diligence work in connection with the proposed acquisition of Cloud Electronics Limited by a new company ('Newco') and was

addressed to Simon Curtis and Royal Bank of Scotland. The management buy-out team invested substantial sums in the buy-out and were rightly anxious to have the benefit of professional advice as to the suitability of their investment. Assurances as to the viability of the business were essential for the management buy-out team and Holdings. If the due diligence exercise had been negative then the buy-out would not have proceeded and Holdings would not have carried out any active steps.

11. HMRC considered that it was clear that the service was commissioned by Mr Curtis or Royal Bank of Scotland to inform their decision whether to invest; the service was not commissioned by Holdings which had not been incorporated at the commissioning stage and was not supplied to it. It was further considered that, as the service was used to inform the investment decision of Mr Curtis and Royal Bank of Scotland, rather than in carrying out the ongoing business of Holdings, the input tax could not be recovered by Holdings.

12. Walker Morris

These solicitors primarily represented the interests of Royal Bank of Scotland but their services were also of benefit to the management buy-out team and Holdings. Holdings was unable to produce a copy of the engagement letter but contended that, as it was ultimately the beneficiary of the service supplied, it was liable for the costs which it paid in full. Input tax was claimed on the 12/08 return on the apparent basis that it was sufficient that it had obtained something of value for the purposes of its business in return for the payment of the fees. HMRC considered that the service was commissioned by and supplied to Royal Bank of Scotland and as Holdings was not the commissioning body and the services were not used for its ongoing business purposes the input tax would be disallowed.

13. Brown McLeod

An engagement letter was not disclosed. Brown McLeod had acted as accountants for Cloud for many years. In the absence of evidence that the supply was made to Holdings for the purposes of its ongoing business the input tax was disallowed. This is evidently no longer in dispute.

14. In his evidence to the Tribunal Mr Curtis says that he does not believe that the letters of engagement were ever ratified by Holdings.

15. Holding's case, in summary and as outlined in the Notice of Appeal dated 15.01.2010, is that the benefit of the services was received by Holdings who paid for them and therefore should be able to recover the input VAT on the basis that it received the services. Reference was made to a number of cases namely:

Mono Global (18559)
Redrow Group PLC
Airtours Holiday Transport Limited (TC00201)

16. The Notice of appeal went on to say that "The fact that the company was not incorporated is not relevant as pre-incorporation expenses can be claimed under SI 1995/2518". It was confirmed that £1,312 in the Brown McLeod invoice was now

accepted but with the Voluntary Disclosure of £10,807 being refused there remained a total of £17,982 VAT in issue.

17. The relevant legislation is S24(1) of the Value Added Tax Act 1994:

"Subject to the following provisions of this Section, "input tax" in relation to a taxable person, means the following tax, that is to say-
(a) VAT on the supply to him of any goods or services ...
being (in each case) goods or services used or to be used for the purposes of any business carried on by him.

18. HMRC's position, therefore, is that no element of the input tax which was disallowed or refused was supplied to Holdings for the purposes of its ongoing business; in each instance the supplies were made to another entity for the benefit of that entity or were consumed within the acquisition process or both; Holdings cannot then establish any entitlement to deduction of the disputed input tax.

19. The Tribunal accepts that in order for an input tax claim to be valid, the claim must be made by the person to whom the supply was made. This fundamental principle overrides the question of who may have paid for the supply in question or who may have possession of the relevant invoice or other evidence. In certain circumstances it is common practice for a third party to pay for goods or services which are, in fact, supplied to someone else; in such cases the person making the payment does not have the right to deduct input tax; this applies whether the payment was made due to a legal requirement or is simply a normal commercial practice; only the recipient of the supplies is entitled to recover input tax

20. HMRC has, therefore, correctly observed in correspondence that for VAT to be a person's input tax there are two questions to be satisfied: the first is the "to whom" question – who received the supply? If the supply is indeed to the person concerned then the second question is whether that supply is used by that person for a business purpose – the "purpose" question.

21. A taxpayer has to succeed on both parts of S24(1). If he falls on the first part ("to whom") the second part ("purpose") does not arise. It is these factors which need to be considered when making a claim for recovery of input tax.

22. It is not in dispute that Holdings paid for the services rendered by the various suppliers. The Tribunal has to consider whether they received anything for their payments.

23. The Tribunal has noted the case of *Customs and Excise Commissioners v Redrow* [1999] STC 161 in which it is stated that in these circumstances exact contractual relationships are not of primary importance. In *The Commissioners for Her Majesty's Revenue and Customs v Airtours Holidays Transport Limited* NCN [2010] UKUT 404 (TCC) the Upper Tribunal, agreeing with Lord Hope in *Redrow*, stated at Paragraph 16 of its decision that:

> "The principle is that where the person contracted for a service primarily for the benefit of a third party and paid for it, the question to be asked was "Was something being done for him for which, in the course or furtherance of a business carried on by him, he has had to pay a consideration which has attracted VAT?" (Lord Hope); or "did he obtain anything – anything at all – used or to be used for the purposes of his business in return for that payment?" (Lord Millett), which is also expressed as "something of value" in his conclusion. These questions are aimed at deciding whether the payer received something to be used for the purpose of its own business even though the main service was supplied for the benefit of a third party".

24. The engagement letters refer, of course, to the management buy-out team as well as Newco. HMRC take the view that the parties securing benefit from the services being rendered were the management buy-out team but not Newco (Holdings).

25. It is clear that Holdings had not yet been incorporated at the dates of the Engagement letters: those letters were sent by the professional advisers in January 2008; the date of incorporation was 29.02.2008. The Tribunal is invited to consider whether services can be obtained by an entity that does not yet exist.

26. The services of the professional advisers were rendered over a period of time which certainly ran into the period after the incorporation of Holdings. In fact, if the acquisition of Cloud by Holdings had not proceeded there would still have been a liability for those professional fees but at a much reduced level. It must be right to say that most of the work will have been done after the incorporation date 29.02.2008. Furthermore, and importantly, the tax points of the professional advisers' accounts were all in March and April 2008 i.e. after the date of Holdings' incorporation. Therefore the services were largely obtained by an entity that did indeed exist.

27. The exercise being carried out by some of the professional advisers was a Due Diligence exercise. This was carried out not only on the initial instructions of the management buy-out team but also at the request of Royal Bank of Scotland which was providing funding to Holdings to assist with the acquisition. The principal purpose of the Due Diligence report for that Bank was "to assist the Interested Parties to make a decision as to whether or not to provide the funding for the acquisition of [Cloud]" (undated instruction letter from Royal Bank of Scotland received by Hawsons on 21.01.2008).

28. It is important to note that the Due Diligence exercise was being carried out, certainly as far as the management buy-out team were concerned, as a mechanism to enable them to confirm a decision to acquire Cloud – a decision that had been made during the previous year. Mr Curtis, who has given oral evidence to the Tribunal, had begun working for Cloud in 2007 with the intention of managing a management buy-out. He was following professional advice in using Holdings as a vehicle for the acquisition. The use of this vehicle was therefore planned and all the professional advisers were aware of its use when sending their initial letters of engagement.

29. Furthermore the Tribunal determines that the advice, from which the management buy-out team benefitted, was not advice whether to invest in Holdings – a decision that had been made some six months previously – but rather advice on whether Holdings should invest in Cloud i.e. the advice being addressed to Holdings.

30. The professional advisers were therefore aware (and stated explicitly in their engagement letters) that they were to be acting for Holdings who would be their client and with whom they would deal. It is noted that DLA Piper's first Engagement Letter was addressed to "Simon Curtis and Clare Powell" but after the incorporation of Holdings they sent a further letter on 07.04.08 concerning "Consultancy Agreements – Terms of Engagement", to "Mr S Curtis, Cloud Electronics Holdings Limited" and in that letter they confirmed that "our client in this matter will be "Cloud Electronics Holdings Limited". Therefore by that time Mr Curtis had the authority of his directorship of Holdings to instruct these professional advisers who were to do work and supply services for Holdings thereafter.

31. It was always the intention of the management buy-out team to create a Holding Company for the purpose of acquiring and managing Cloud. All of the professional advisers knew that. By the time the letters of engagement were sent out the way forward was clear and was acknowledged by the professional advisers. In so far as Walker Morris was reporting direct to the Royal Bank of Scotland it was nevertheless acknowledged that Holdings was to be responsible for their fees so, again, the true intentions of all parties was known and reflected in the subsequent progress of the transaction of acquisition.

32. Mr Chapman draws the attention of the Tribunal to *BAA Limited v The Commissioners for her Majesty's Revenue and Customs* [2010] UKFTT 43(TC) and the observations of the First-tier Tribunal in that case concerning the requirement to be carrying out economic activity as core to the concept of an ability to recover input tax. The matter was considered in *Wellcome Trust Ltd v Customs and Excise Commissioners* [1996] STC 945, another First-tier Tribunal case, at paragraph 101: a passage was recited from *Polysar Investments Netherlands BV v Inspecteur der Invoerrechten en Accijnzen* [1993] STC 222, paragraph 239 of which reads:

> "The mere acquisition of financial holdings in other undertakings does not amount to the exploitation of property for the purposes of obtaining income therefrom on a continuing basis because any dividend yielded by that holding is merely the result of ownership of the property. It is otherwise where the holding is accompanied by direct or indirect involvement in the management of the companies in which the holding has been acquired, without prejudice to the rights held by the holding company as shareholder.
>
> ... art 4 of the Sixth Directive [EC Council Directive 77/388] is to be interpreted as meaning that a holding company whose sole purpose is to acquire holdings in other undertakings, without involving itself directly or indirectly in the management of those undertakings, without prejudice to its rights as a shareholder, does not have the status of a taxable person for the purpose of VAT and therefore has no right to deduct tax under Art 17 of the Sixth Directive."

33. Mr Chapman submits that the only management services carried out by Holdings related to the management of the debt that arose on acquisition of the shares in Cloud and that Cloud has simply carried on trading as before irrespective of the change of ownership.

34. The management services carried by Holdings went further than managing debt. It is noted from the Witness Statement of Mr Curtis that Holdings submitted a VAT return on 08.01.2009 for the long period 01.03.2008 to 31.12.2008 and this showed

output VAT due on management services to Cloud Electronics of £91,400 (and input VAT relating to advisers' fees of £9,968.36). VAT was due and paid in the sum of £81,431.64. Management charges had therefore been in excess of £450,000 which is a substantial sum and it is therefore concluded that Holdings was supplying substantial management services to Cloud and this was genuine economic activity. The management charges were not based upon the salaries of the directors (the two companies sharing the same directors); Cloud itself paid the directors' salaries.

35. The Tribunal therefore accepts that the management charges reflected the costs incurred by Holdings in managing the group and that this was genuine economic activity.

36. Addressing a further point taken by Mr Chapman, the Tribunal has considered whether there is a direct and immediate link between Holdings' input tax and its ongoing output tax. Since it has been carrying out an economic activity, as stated above, it is not difficult to conclude that there is such a link. Mr Chapman speculates whether Holdings has, in reality, paid for the various services and whether there may possibly have been some recharge to Holdings, with Holdings in fact acting as agent for Cloud. It will suffice to say that there is no evidence to support such an assertion.

37. The Tribunal concludes, therefore, that services were indeed supplied to Holdings which was carrying out economic activity at the material times and was certainly incorporated by 29.02.2008 and registered for VAT with effect from 01.03.2008. As stated above much, and indeed most, of the professional advisers' work was done, and services supplied, after the dates of the letters of engagement in January 2008 and after the dates of incorporation and registration for VAT. By that time Holdings was carrying out the very activity for which it was formed, namely to facilitate the acquisition and conduct of the business of Cloud.

38. The two tests in S24(1) were therefore satisfied at the time the professional advisers sent out their engagement letters, those letters reflecting the intentions of the parties at the time they entered into legal relations.

39. Accordingly this appeal is allowed in respect of each of the relevant invoices issued by DLA Piper, Ford Campbell Freeman, Hawsons and Walker Morris.

40. 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.

W D F COVERDALE
TRIBUNAL JUDGE

RELEASE DATE: 14 November 2012