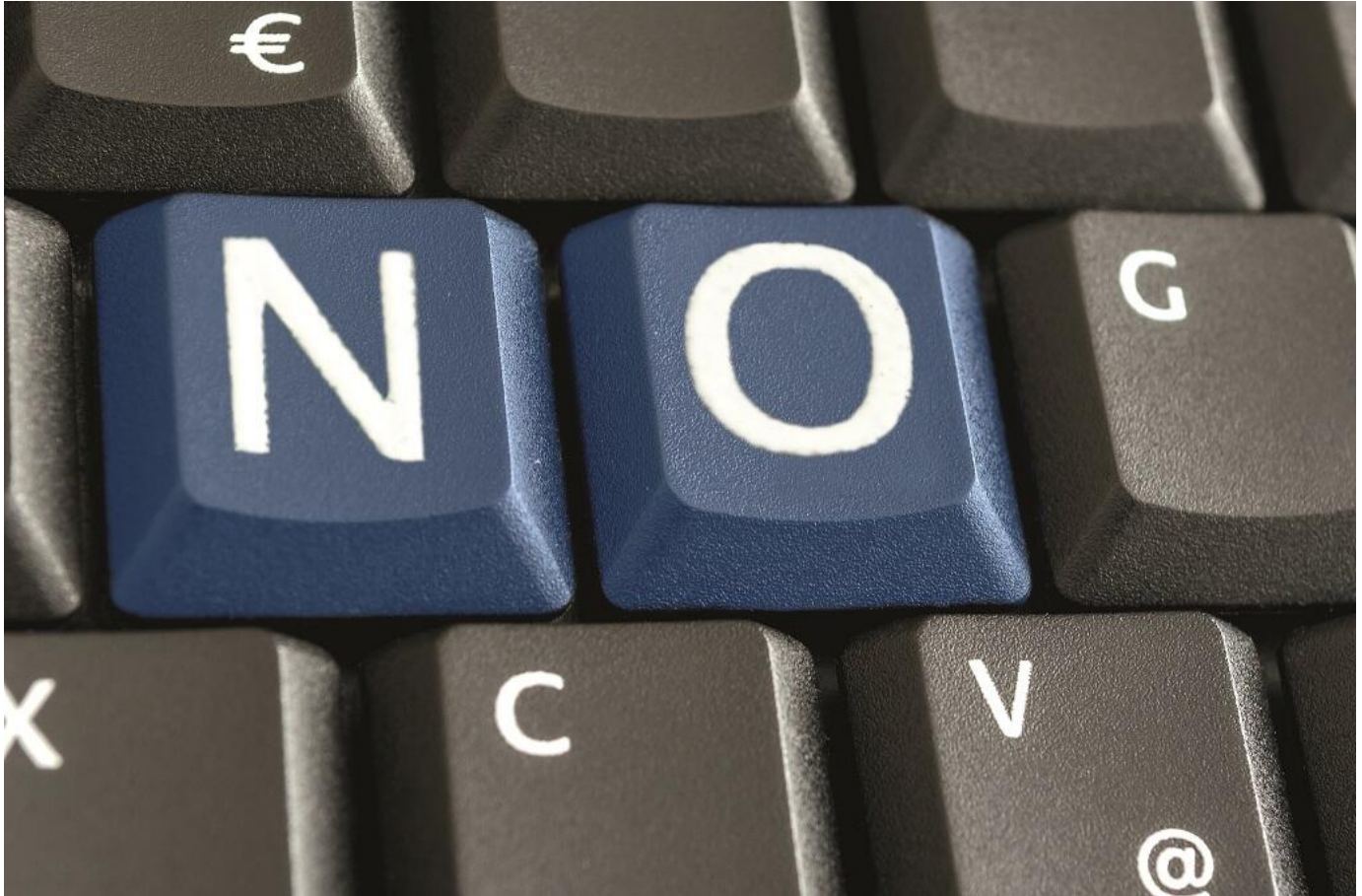


Inhibited thinking?

Indirect Tax



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Douglas Gordon explains the use and misuse of VAT inhibits by HMRC

Key Points

What is the issue?

Use, or misuse, by HMRC of administrative powers to withhold, or inhibit, VAT repayments. These powers may be needed to combat fraud, but are a blunt instrument not subject to the high level of scrutiny and review that applies when officers make assessments

What does it mean for me?

This may severely and unfairly affect a client's cash flow in the context of a dispute

What can I take away?

Awareness of this issue may help to anticipate problems. Early discussion might find better alternative actions by HMRC

An inhibit is a flag set on the HMRC VAT computer at Southend to suspend payments shown as due to a taxpayer that would otherwise be repaid automatically in the normal way. Typically, it will be used to prevent a repayment return being repaid, but it will apply to any credit balance on the taxpayer's account for so long as the inhibit remains in place. It is an internal administrative procedure, usually initiated

by a local officer. There is no requirement on the HMRC officer to notify the taxpayer of the fact that an inhibit has been set up, nor the reasons for doing so, so the taxpayer will usually remain unaware of it until they notice they have not received their money. There is no appeal or any statutory right of review; neither is there a requirement on the officer to use best judgment, nor is there a time limit or requirement for periodic review.

The use of an inhibit is thus a blunt but powerful weapon. In extreme cases, as we have seen in the context of MTIC fraud, starving a business of its VAT refunds for an indefinite period can cause severe difficulties, and even failure of the business. We must remember that VAT is unique in offering criminals the theoretical opportunity to stage raids on the Revenue, and so it is right that HMRC should have the weapons they need, which should include the use of inhibits. Indeed, such use has been approved by the courts (see *R (on the application of UK Tradecorp Ltd) v CCE* [2004] EWHC 2515 (Admin)). But what happens where they are not necessary or appropriate? And who decides?

A few years ago a member of the CIOT reported the following case. The client was a landed estate comprising a number of entities, some registered, some not. The client made standard-rated, zero-rated and exempt supplies. The client also employed a number of people in its estate office, and also as farm workers of various kinds including building maintenance men. The client operated a paymaster arrangement for these individuals, who were jointly employed. However, a visiting HMRC officer decided that VAT was due on the staff recharges. No more need be said here of that dispute other than the fact that, after two-and-a-half years, the commissioners decided that VAT was not due on the recharges.

The salient point here is that on the day after visiting the client, the officer set an inhibit because it so happened that the client had a couple of minor repayment returns outstanding. And there the inhibit remained throughout the dispute.

Not all of the client's VAT returns were for repayments. The mix of taxable and exempt supplies varied from period to period for obvious reasons, and for a couple of quarters in each year they were usually in a repayment situation. The liability of client's supplies had nothing to do with the question of the liability of the staff recharges. Nor did the alleged tax due on the recharges represent potentially lost revenue to HMRC, since most of the charges were made to registered entities that could have deducted the VAT had it been charged. Moreover, although the estate's

normal supplies varied from period to period, the level of staff recharges remained fairly constant. Thus, the amount of tax at risk from HMRC's point of view was the same whether the client had submitted a payment or a repayment return, whereas the inhibit affected only the repayment returns.

Use of an inhibit in these circumstances was therefore arbitrary. It bore no relation to the tax at risk and was inappropriate for a case of this kind. The taxpayer was not a dubious cross-border dealer in phones or electronic chips, but a landed estate; the taxpayer's family had owned the estate for generations. They weren't about to leave the country.

There is a feeling in situations of this kind that use of an inhibit can be seen as coercive rather than protective. If the officer was intending solely to protect the revenue, the correct and most effective way would have been to issue an assessment in relation to the specific supplies with which he was concerned to the best of his judgment, even if that would have entailed more work.

The officer was asked to withdraw the inhibit. The officer replied: 'Until an amount is established as a VAT credit, HMRC have no powers to make a repayment of VAT and so [I] cannot do so,' under VATA 1994 s 25(3) and refused to withdraw it or to discuss it further. Another letter sent to his superior also fell on stony ground. HMRC thus pulled up the drawbridge and defied the taxpayer, in effect, to seek judicial review, which is the only judicial remedy available. However, most clients are unwilling to do this because of the huge cost.

The inhibit remained in place over the next two-and-a-half years with more repayment returns adding to the logjam. None of those returns, of course, could have been foreseen or taken into account by the officer in making his original decision to set the inhibit, and nor did the submission of any or all of them seem to have the effect of calling into question the continuing need or relevance of the inhibit. The effect of the inhibit became more severe with the passing of time without the original facts having changed.

Enquiries through the CIOT's VAT and indirect taxes committee since that case have revealed that other members had similar stories to tell with similar concerns. It seemed to the committee that the same care and standards should be applied to the use of inhibits as are applied to the issue of assessments and that current procedures and safeguards fell short of them. It seemed that, without published

guidance, any taxpayer would struggle and fail to persuade an officer not to use an inhibit where an assessment should be used, or to keep the inhibit under review as circumstances changed.

We wrote to HMRC in February 2012 asking whether there was any internal guidance issued to officers and whether this could be published. We pointed out the dangers and the apparently arbitrary and inappropriate use of inhibits in the examples that had been provided to us. We suggested that appropriate time limits and review procedures were necessary and that taxpayers should have safeguards and a right of review and appeal.

The HMRC response in March 2012 defended the use of inhibits while acknowledging that they applied in a 'broad spectrum' of cases and therefore that each case had to be decided on the facts and risks. Compensation, it was said, was available in the form of repayment supplement. It appeared that in each case use of an inhibit was in fact reviewed by a senior officer, but only after the event; there was no indication that any such review had ever produced a voluntary admission of misuse, or had produced any offer of redress. We were told that HMRC were proposing to review the use of inhibits in 2012/13 and that we would be informed of the outcome. There was no acknowledgement that there were legitimate concerns. There was no offer to consult or make changes.

We followed up our original letter in August 2012 with more detailed suggestions for a published code of practice on the use of inhibits. In the meantime, the European Court of Justice delivered its judgment in the case of *Enel Maritsa Iztok 3 AD v Direktor 'Obzhalvane i upravlenie na izpalnenieto' NAP* (Case C-107/10). This dealt with the provisions of article 183 of the Principal VAT Directive which deal with the repayment of credits for input tax, but the reasoning in the case makes it clear that it would apply to inhibits, which constitute the withholding of the excess of input tax over output tax. In its conclusions, the court held:

'Article 183 of Directive 2006/112...is to be interpreted as precluding national legislation under which the normal period for refunding excess valued added tax, at the expiry of which default interest is payable on the sum to be refunded, is extended where a tax investigation is instigated, the effect of the extension being that such interest is payable only from the date on which the investigation is completed...'

We considered that the combined effect of the above judgment and that of *Garage Molenheide BVBA* (Case C-286/94) is that interest is due rather than repayment supplement.

We are still waiting for the results of the review that was mentioned in 2012/13 and do not know whether it was undertaken. We have written again recently to HMRC, and a reply had yet to be received as *Tax Adviser* went to press. We intend to continue raising concerns about this issue in the hope that the eventual result will be a more transparent use of this power by HMRC, and better safeguards for taxpayers against misuse.

In the meantime, if members have any comments on this issue, or can provide further examples of official misuse of inhibits, email the CIOT indirect taxes committee at indirecttax@ciot.org.uk