

EFFECTIVE PROTECTION OF RIGHTS: THE ‘THREE YEAR CAP’ FIASCO

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Introduction

For nearly ten years the United Kingdom courts and tribunals have grappled with the legality of measures reducing to three years the time limit for reclaiming overpaid or underclaimed VAT (the three year cap). Despite the landmark decision of the Court of Justice in *Marks & Spencer*² given in July 2002, doubts and difficulties remain. A further reference to the Court is pending in *Marks & Spencer (No 2)*.³ The *Fleming*⁴ case will soon be heard by the House of Lords and may itself involve a reference. How has all this come about? Did the government foresee difficulties at the outset? If so, to what extent? Is the Member State's conduct a relevant factor in applying Community law general principles such as effectiveness and the protection of legitimate expectations?

It is helpful to look at matters in the historical context. VAT was introduced in the UK in 1973 and modified in 1978 to implement the Sixth Directive⁵. The Directive contains no rules for a taxpayer to recover overpaid VAT. Articles 17 to 20 provide the framework for deduction of VAT incurred by a taxpayer which relates to his taxable transactions (input VAT). Article 18(3) requires Member States to lay down the conditions and procedures for making claims which have not been made in accordance with Article 18(1) and (2). As the case law of the ECJ makes clear, however, the right to obtain a refund of taxes overpaid in breach

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² *Marks & Spencer plc v CCE* (Case C-62/00) ECJ [2002] STC 1036.

³ *Marks & Spencer plc v CCE* UKHL 53 [2005] STC 1254.

⁴ *Fleming (trading as Bodycraft) v HMRC* EWCA Civ 70, [2006] STC 864.

⁵ Council Directive No 77/388/EEC, OJ L 145, 13.6.1977, p.1.

of Community law is the consequence and complement of the rights conferred on the taxpayer by Community law.⁶ The right to recover input VAT is directly effective notwithstanding the discretion left to Member States regarding its exercise.⁷ In the absence of Community rules governing repayment and time limits, it is for the domestic legal system of each Member State to designate the courts and tribunals having jurisdiction and to lay down the detailed procedures.⁸

Until 1989, domestic law contained no statutory right to reclaim overpaid VAT.⁹ From that date taxpayers could claim regardless of how the overpayment arose and whether or not Community law rights were involved. These new rules were subsequently consolidated into section 80 of the Value Added Tax Act 1994 (VATA). The time limit was set at six years from the date of the overpayment.¹⁰ In cases of mistake, this was extended to six years from the date on which the mistake was discovered or could with reasonable diligence have been discovered.¹¹ In addition to time bar, a further defence was introduced: that repayment would unjustly enrich the claimant.¹² For input VAT no time limit or unjust enrichment defence applied. In practice the tax authorities exercised a discretion to allow late claims under regulation 29(1)¹³.

The three year cap

As the UK VAT system matured and became more complex, litigation increased dramatically. The eighties and nineties saw numerous successful challenges on VAT liability or valuation. Many of these involved ECJ rulings that the UK had incorrectly transposed provisions of the Sixth Directive. Examples are in the finance, insurance, real property and retail sectors, the cultural and sporting

⁶ See case law cited in *Marks & Spencer*, ECJ paragraph 30.

⁷ *Garage Molenheide BVBA v Belgium* (Joined Cases C-286/94, C-340/95, and C-47/96) [1998] STC 126, Advocate General, paragraphs 31 to 32.

⁸ *Marks & Spencer*, ECJ paragraph 34.

⁹ Introduced by section 24 Finance Act 1989. Before that an action for restitution could be brought against the Crown but the defence of mistake of law was sometimes raised.

¹⁰ VATA, section 80(4).

¹¹ VATA, section 80(5). The statutory formulation closely follows section 32(1)(c), Limitation Act 1980.

¹² VATA, section 80(3).

¹³ Value Added Tax Regulations 1995 (SI 1995/2518)

exemptions and the distinction between business and non-business activities. Taxpayers were able to treat the Court's decision as "discovery" of a mistaken overpayment and bring claims going back many years for VAT overpaid, plus interest.¹⁴

On 18th July 1996 HM Paymaster-General announced the immediate imposition of a three year cap on claims for overpaid VAT and other indirect taxes.¹⁵ This was expressed to have effect, pending legislation, to all claims, including those relating to overpayments made before the date of the announcement. A series of challenges was mounted. The government's defence that claims were not refused but merely deferred until Parliament could legislate was roundly rejected. In *ex parte Kay*,¹⁶ Keene J relied on the Bill of Rights 1689 and held that the attempt to legislate by administrative circular was an unlawful usurpation of the functions of Parliament.

On 4 December 1996 the House of Commons passed a Budget Resolution¹⁷ giving provisional statutory effect to the cap. This was later enacted in the Finance Act 1997, which substituted a time limit of three years in section 80 VATA and reinforced the defence of unjust enrichment. By section 47(2) the three year cap was:

"... deemed to have come into force on 18 July 1996 as a provision applying, for the purposes of the making of any repayment on or after that date, to all claims under section 80 [VATA] including claims made before that date and claims relating to payments made before that date"

The intended effect was that if a claim had not been made and paid as at 18th July 1996, the three year cap applied. For claims where payment had been obtained following *ex parte Kay*, separate retrospective clawback provisions were introduced.¹⁸

It is likely that, by an oversight, the capping announcement in July 1996 did not deal with late input VAT claims. This was partly why the tax authorities were driven, in subsequent cases, to characterise an underclaim of input VAT as an overpayment in terms of section 80(1) VATA. This caused considerable confusion

¹⁴ Statutory interest is payable under section 78 VATA in cases of official error.

¹⁵ C&E Business Brief 42/96.

¹⁶ *R v CCE, ex parte Kay & Co Ltd and another* [1996] STC 1500.

¹⁷ Under section 1 of the Provisional Collection of Taxes Act 1968.

¹⁸ VATA, section 80(4A) to (4C).

and did not cover taxpayers whose returns showed a net amount of VAT repayable (repayment traders). Accordingly, regulation 29(1A) was inserted into the VAT Regulations with effect from 1st May 1997:

“The Commissioners shall not allow or direct a person to make any claim for deduction of input tax in terms that such deduction would fall to be claimed more than three years after the date by which the return for the prescribed accounting period in which the VAT became chargeable is required to be made”

Similar capping provisions were introduced for correction of errors and bad debt relief claims.¹⁹ As these changes were made by subordinate legislation, no express retrospection was enacted. The tax authorities, however, sought to interpret the provisions as excluding claims made outside the three year cap regardless of when the input VAT was first claimable.

The early challenges and *Marks & Spencer*

Apart from the success in *ex parte Kay* (the practical benefit of which was limited by the clawback rules), taxpayers in England and Wales were initially unsuccessful in their challenges to the three year cap. In *BICC*²⁰ the tribunal held that a late claim of input VAT was subsumed within section 80 VATA and the three year cap in section 80(4) applied. Arguments on the compatibility of domestic legislation with Community law were stood over. In *Marks & Spencer*,²¹ which concerned VAT overpaid on discount vouchers and chocolate covered tea cakes, the tribunal dismissed the appeal principally on the grounds that the taxpayer could not identify any directly effective rights which had been breached by domestic legislation; and, further, as the taxpayer had ‘slept on’ its rights under domestic law, the cap applied.

In *Royal Bank of Scotland*²² the Edinburgh tribunal declined to follow *BICC* and held that refusal to repay input VAT arising before introduction of the cap breached Community law and was not, in any event, within section 80 VATA. The tax authorities appealed to the Court of Session but after several days

¹⁹ Regulations 34(1A) and 165A.

²⁰ *BICC plc v CCE* [1998] VATDR 224.

²¹ *Marks & Spencer plc v CCE* [1997] VATDR 85.

²² *The Royal Bank of Scotland Group plc v CCE* [1999] VATDR 122.

argument²³ abandoned their appeal. Meanwhile, Marks & Spencer's appeal to the High Court²⁴ had been dismissed. Also dismissed was an appeal to the tribunal regarding late input VAT claims in *University of Sussex*.²⁵

The Court of Appeal heard *Marks & Spencer* in December 1999. The claim for VAT overpaid on discount vouchers fell into two parts (the early vouchers claim and the late vouchers claim). The early vouchers claim arose in respect of periods when domestic law did not correctly transpose Article 11A of the Sixth Directive. The late vouchers claim arose for periods when domestic law had correctly transposed the Directive but in practice was applied by the authorities in a way which was inconsistent with the Directive. The tea cakes claim arose because, under transitional arrangements in Article 28(2)(a) of the Directive, Member States are permitted to retain zero-rates on certain food items; VAT had been overpaid because the tea cakes should have been zero-rated on a true construction of domestic law. All three types of claim related to VAT allegedly overpaid before 18 July 1996. The Court dismissed the appeal in relation to the late vouchers and tea cakes claims, principally on the ground that the taxpayer could not rely on any directly effective Community law right to override the domestic capping rules. The appeals on the grounds of discrimination between payment and repayment traders and on unjust enrichment were also dismissed. On the early vouchers claim, however, the Court accepted that domestic legislation had infringed directly effective rights, but was uncertain whether Community law permitted the amendment of a domestic law time limit with immediate effect. Thus, on that very limited basis, a question was referred to the ECJ.²⁶

While *Marks & Spencer* was proceeding to Luxembourg, the High Court allowed the taxpayer's appeal in *University of Sussex*.²⁷ This established that a late claim for input tax VAT falls within regulation 29 rather than section 80 VATA. As regulation 29(1A) cannot be retrospective, the refusal of the taxpayer's claim was held to be unlawful.

Decision of the Court of Justice

The ECJ decision in *Marks & Spencer* extends beyond the referred question and

²³ Unreported.

²⁴ [1999] STC 205.

²⁵ *University of Sussex v CCE* (2000) VAT Decision 16656.

²⁶ [2000] STC 16.

²⁷ [2001] STC 1495.

considers both types of voucher claim.²⁸ The issue before the Court was whether national legislation retrospectively curtailing the time limit for reclaiming sums levied in breach of Community law is compatible with the general principles of Community law. The ECJ clearly stated that Article 11A of the Directive confers directly effective rights and VAT overpaid in breach of such rights is in principle recoverable. The effects of a Directive continue even after it has been transposed into domestic law and are breached by an incorrect application of domestic law. The remedies and procedures for claiming repayment are for domestic law. It is not incompatible with Community law to set reasonable time limits, and even to shorten existing time limits, provided that the legislation complies with the principles of equivalence and effectiveness. These are, first, that the rules safeguarding Community law rights must not be less favourable than those governing similar domestic actions and, second, that they do not render virtually impossible or excessively difficult the exercise of those rights. The principle of the protection of legitimate expectations must also be respected. The above principles are infringed by national legislation retrospectively curtailing the period within which repayment may be sought of sums collected in breach of directly effective Community law rights.

Following their defeat in Luxembourg, the tax authorities did not enact legislation repealing or amending section 47(2) Finance Act 1997. Instead, they sought by administrative circular²⁹ to create retrospectively (a) a transitional period (making VAT overpaid before 4 December 1996 eligible for repayment) and (b) an extended claim period (in which such claims could be made or, if already made and rejected, reasserted).

The Court of Justice, however, handed down judgment in *Grundig*³⁰ in September 2002. This concerned Italian legislation reducing limitation periods, of five years and ten years, to three years. The issue was whether the new limitation period could apply retrospectively and whether (as the Advocate General thought) a 90 day transitional period was adequate. The Court held that in such a case a transitional period of 90 days was too short and the minimum period could be assessed at six months:

²⁸ Under Article 234 EC the Court must provide the referring court with an answer which will enable it to determine the case before it. This may require reformulation of the referred question: *Krüger GmbH & Co KG v Hauptzollamt Hamburg-Jonas* (Case C-334/95) [1997] ECR I-4517.

²⁹ C&E Business Brief 22/02 issued on 5 August 2002.

³⁰ *Grundig Italiana SpA v Ministero delle Finanze* (Case C-255/00) [2002] ECR I-8003.

“... to ensure that rights conferred by Community law can be effectively exercised and that normally diligent taxpayers can familiarise themselves with the new regime and prepare and commence proceedings in circumstances which do not compromise their chances of success ...”³¹

Subject to this, a reduced time limit can be applied retrospectively.

The *Grundig* case resulted in the UK tax authorities revising their administrative circular.³² This was subsequently described by the Court of Appeal³³ as of labyrinthine complexity suggesting an anxiety not to give further opportunities for late claims than was required by *Grundig*. In summary, the transitional period was extended to 30 June 1997 and the claim period to 30th June 2003. By concession, claims arising otherwise than under directly effective Community law rights were included but, in all cases, the VAT had to have been overpaid before 4th December 1996.

Following the ECJ decision, *Marks & Spencer* came before a differently constituted Court of Appeal in March 2003. It was joined with the tax authorities’ appeal from the High Court decision in *University of Sussex*.³⁴ The Court was able to give judgment for Marks & Spencer on the vouchers claims. Issues on tea cakes and unjust enrichment have gone further. In *University of Sussex* the Court upheld the High Court’s view on the input tax claim which, in any event, was also covered by the principles established by the ECJ in *Marks & Spencer*.

The Aftermath

The Court of Appeal decision in *Marks & Spencer: University of Sussex* is applicable to a great many cases where protective claims were made either before, or immediately after, introduction of the three year cap. No doubt most of these have by now been settled. There are a number of cases still being litigated on historic claims under the rules for correction of errors and bad debt relief. In the motor industry multiple and complex claims, arising from two landmark ECJ cases,³⁵ are subject to certain special arrangements.

³¹ *Grundig* ECJ, paragraph 40.

³² C&E Business Brief 27/02 issued on 7 October 2002.

³³ In *Fleming*, [2006] STC 864, per Arden LJ at [10].

³⁴ [2004] STC 1.

³⁵ *Elida Gibbs Limited v CCE* (Case C-317/94) ECJ [1996] STC 1386; *EC Commission v Italy* (Case C-5/95 [1997] STC 1062.

There are three categories of case, however, where there is an ongoing dispute with the tax authorities. These may be summarised as:

- (1) Late claims for input VAT made after 1st May 1997 relating to input VAT incurred before that date.
- (2) Claims for VAT overpaid before 4th December 1996 which, the tax authorities argue, do not fall within the retrospective transitional arrangements in C&E Business Brief 27/02.
- (3) Claims for overpaid VAT and late input VAT claims, where the overpayment or underclaim relates to periods after capping was introduced and where the claim is *prima facie* capped.

The category (1) cases

The two recent and important cases are *Fleming*,³⁶ already referred to, and *Condé Nast*.³⁷ In *Fleming* the taxpayer sold quality cars. Input VAT on three out of a total of thirteen cars purchased in 1989 and 1990 was not claimed because VAT invoices were not available. A claim was finally made in October 2000, which the authorities refused, relying on regulation 29(1A). The tribunal and the High Court dismissed the appeal.³⁸ They decided that although regulation 29(1A) had been enacted without any transitional period and, in appropriate cases, could be disapplied in favour of a taxpayer with directly effective Community law rights, such protection was not indefinite. If a claim was not brought within a reasonable time, the principle of legal certainty entitled the court to refuse to disapply the cap. *Condé Nast* also concerned input VAT. This was incurred between 1973 and April 1997. Although the tribunal found that the underclaim was discovered by 30th June 1997 at the latest, a claim was not made until 27th June 2003. The High Court noted that regulation 29(1A) included no proper transitional period. Whilst accepting that strictly it did not apply, the Court addressed the rationale of Business Brief 27/02. It should be borne in mind that by this time the tax authorities were interpreting Business Brief 27/02 to require not only that a taxpayer *could* have made a claim by 30th June 1997 but also that the taxpayer *would* have made such a claim had a transitional period been in operation.

³⁶ *Fleming (trading as Bodycraft v HMRC* EWCA Civ 70, [2006] STC 864.

³⁷ *The Condé Nast Publications Limited v CCE* [2005] STC 1327; [2006] EWCA Civ 976. [2006] STI 1881.

³⁸ [2004] V&DR 172; [2005] STC 707.

In *Condé Nast*, the High Court was clearly influenced by the tribunal's findings of fact. It decided that, as a reasonable transitional period had long since passed, legal certainty prevailed and the decision of Evans-Lombe J in *Fleming* should be followed. The Edinburgh tribunal has taken a stricter view of regulation 29(1A) and held, in *Abercromby*,³⁹ that transitional periods should be clearly stated in the legislation and fixed in advance. This derives from a principle of Community law that incompatible legislation can be finally remedied only by legislative provisions of equal force.⁴⁰

Fleming was recently heard by the Court of Appeal which allowed the taxpayer's appeal.⁴¹ Ward and Hallett LJ considered that regulation 29(1A) was silent as to a transitional period and the court could not construe one out of nothing. Accordingly, the regulation fell to be disapplied in relation to input VAT incurred before 1st May 1997. The late claim for input VAT succeeded. Ward LJ observed *obiter* that any transitional period could run only from when a taxpayer was aware of his Community law right to make a belated claim, that is following the ECJ decision in *Marks & Spencer*. Arden LJ considered the court had power to imply a transitional period which respected the principle of effectiveness; indeed she considered Community law required such a course on a proper reading of *Grundig* and in the interests of legal certainty. On the facts as found, however, Arden LJ agreed with the result because Mr Fleming's claim was made in 2000, long before 5th August 2002 when, following the *Marks & Spencer* decision, Business Brief 22/02 was issued. In view of the constitutional implications of the case, the Court gave leave (on terms) for an appeal to the House of Lords.

Condé Nast was heard by a differently constituted Court of Appeal and judgment given on 11th July 2006.⁴² The case concerned a claim for input tax on staff entertaining incurred between 1973 and 2003 which was the subject of a belated claim made on 27th June 2003. The Court felt obliged to follow the majority decision in *Fleming* and refused to pre-empt the House of Lords by seeking an ECJ reference. Chadwick LJ expressed sympathy *obiter* for the view that some reasonable transitional period should be implied into regulation 29(1A). He could see no valid distinction between claims under section 80 and input tax claims. Given that until October 2003 the Commissioners treated input tax claims as arising under section 80, it was held that any reasonable transitional period should at least mirror the arrangements in Business Briefs 22/02 and 27/02 in order to

³⁹ *Abercromby Motor Group Limited, Linn Motor Group Limited v CCE* [2005] V&DR 190.

⁴⁰ *EC Commission v United Kingdom* (Case C-33/03) [2005] STC 582.

⁴¹ [2006] STC 864.

⁴² [2006] EWCA Civ 976; [2006] STI 1881.

ensure the protection of legitimate expectations. Accordingly, on the facts, the taxpayer succeeded in relation to periods arising before 1st May 1997.

The category (2) cases

Several cases have concerned claims for overpaid VAT apparently within the terms of Business Brief 27/02 but where the tax authorities seek to impose some additional requirement. The most common such case is a requirement not only that a claim *could* have been made but that it *would* have been made.

In *Condé Nast* the High Court stated *obiter* that this requirement was a breach of the principle of effectiveness and this view was shared by the Court of Appeal.⁴³ Other cases in this category involve claims either discovered later than 30th June 1997 or else presented after the 30th June 2003 deadline. In cases such as *John Martin Group*,⁴⁴ the Edinburgh tribunal has been quite creative in finding that an initial intimation of claim falling within the time limits was left open, thereby allowing detailed calculations or recalculations to be added outside the extended time limit. In *Scottish Equitable plc*⁴⁵ the Edinburgh tribunal went a stage further and held that as the three year capping was enacted without a transitional period fixed in advance by the legislation, it breached Community law and must be disapplied: see *EC v United Kingdom*. Following *dicta* in *University of Sussex*⁴⁶, the previous six year limit was applicable and the claims were in time. The tax authorities have appealed to the Court of Session. Very recently, a similar issue has arisen in *EMI*.⁴⁷ This concerned a claim made in 2003 backdated to 1987. The tribunal has referred a number of questions to the ECJ, including whether the United Kingdom complied adequately with the ECJ judgment in *Marks & Spencer* and whether the retrospective introduction of transitional arrangements by administrative circular was compatible with Community law.

The category (3) cases

These are cases where the overpayments or underclaims arose after introduction of the capping rules but the claim was not made within a three year period. In

⁴³ Per Chadwick LJ [48] to [50].

⁴⁴ *The John Martin Group v HMRC* (2005) VAT Decision 19257.

⁴⁵ *Scottish Equitable plc v HMRC* (2006) VAT Decision 19418.

⁴⁶ [2004] STC 1, at 59 [181] to [185].

⁴⁷ *EMI Group plc v HMRC* (2006) VAT Decision 19417.

*LAMIT*⁴⁸ the High Court upheld the tribunal and observed that *Marks & Spencer* did not render a three year time limit unlawful and regulation 29(1A) was to be disapplied only so far as necessary to comply with the principle of effectiveness.

As *Scottish Equitable* and *EMI* both concerned claims for periods spanning introduction of the three year cap, they also fall within category (3). As noted above, in the former the appeal was allowed and the three year cap disapplied altogether; in the latter, the case is referred to the ECJ. One of the grounds on which *Scottish Equitable* sought to strike down the three year cap was the conduct of the tax authorities. This was a combination of failures correctly to transpose and implement the insurance exemption, misleading guidance and seeking to frustrate a court decision by persisting in the three year cap. The tribunal considered that the *Emmott*⁴⁹ principle was of very narrow application and did not apply on the facts. The issue of the Member States' conduct and the extent to which it may be precluded from taking advantage of its own wrong are factors which now need to be addressed by the ECJ in the context of capping.

Back to Luxembourg?

Currently there are two references to the ECJ pending: *Marks & Spencer (No 2)* and *EMI*. In the first, the House of Lords accepted that passages in the Advocate General's Opinion and the EC Commission's written observations in *Marks & Spencer* appear to conflict with the Court of Appeal's final conclusion on the tea cakes claim.⁵⁰ There remains real doubt as to the relevant principles of Community law. Accordingly, the House of Lords (as the national court of last resort) had no alternative but to make another reference. If the ECJ upholds the taxpayer's arguments this could extend the ambit of claims for tax overpaid before 4th December 1996. *EMI* falls within categories (2) and (3). If the ECJ rules that a retrospective imposition of a transitional period by administrative circular does not secure adequate protection of rights then many claims in these categories should now succeed. It is to be hoped that, in considering the principle of effectiveness, the ECJ will offer some guidance to the national courts on the relevance of conduct. Is a taxpayer to be deprived of his right to present claims where the public pronouncements and strategy of the tax authorities has been aimed to discourage and obstruct claims? Even if transitional periods can be fixed

⁴⁸ *Local Authorities Mutual Investment Trust v CCE* [2004] STC 246.

⁴⁹ *Emmott v Minister for Social Welfare and the Attorney-General* (Case C-208/90) ECR I-4296; see also *Fantask AS v Industrieministeriet* [1997] ECR I-6783; *Metallgesellschaft Limited v IRC* [2001] STC 452 at 479.

⁵⁰ [2005] STC 1266, *per* Lord Walker at [40] to [44].

administratively (and more than five years after the cap was introduced), is a six month period (from 4 December 1996 to 30 June 1997) sufficient to replace the previous six year limit, which could be further extended in cases of mistake? The *Grundig* ruling was based on wholly different facts.

In category (1) claims it may be that the House of Lords will find no difficulty in upholding *Fleming* on its facts. However, if the Court takes the bold step of reading into regulation 29(1A) a transitional period compatible with Community law, there remains a real question as to when such period should start to run, especially in cases where the conduct of the Member State has caused or contributed to the late claim. The facts of *Condé Nast*⁵¹ bring this into sharp focus. HMRC are likely to seek permission to appeal. As the House of Lords is the national court of last resort a further reference to the ECJ may be necessary.

Conclusion

There are many reasons for describing the introduction and application of the three year cap as a fiasco. The tax authorities should now seek a graceful exit. If proper remedial legislation is enacted some further claims will arise. It is unlikely that, after nearly ten years, these would be numerous. No criticism could be made if the tax authorities decided to audit them rigorously and, where appropriate, raise the defence of unjust enrichment. But further attempts by the authorities to stuff the genie back into the bottle will cause only further resentment and provoke more costly litigation.

⁵¹ [2006] EWCA Civ 976; [2006] STI 19881.