

## COMPOUND INTEREST IN VAT CASES

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As the only person in my family who is not a chartered accountant, I am frequently reminded that a point to do with numbers is really obvious when even a lawyer understands it. By that test, the injustice of courts only giving simple interest is really obvious. It is very hard to understand why claimants should be restricted to simple interest.

It's not really the fault of lawyers that the courts are unjust: it's the politicians' fault. For some inexplicable reason, the forerunners to the Supreme Court Act gave the High Court power to award only simple interest. In some very special circumstances the Chancery Division retains a medieval power to award compound interest. (The power is literally medieval – it is not as though compound interest is a cutting edge development in economic theory.) Judges have been criticising their lack of power to award compound interest in other cases for literally centuries. In 1893 in *London Chatham & Dover Railway*, the House of Lords complained that Parliament had dallied for far too long about remedying the injustice.

The closest anyone has come to a defence of the status quo (in a non-tax context) was Lord Lloyd in *Westdeutsche v Islington BC* [1996] AC 699. All Lord Lloyd said was that he could see that there *might* be reasons why Parliament might have preferred simple interest – principally simplicity of calculation. This is not very convincing. It would be even simpler to give no interest at all – but even more unjust. Compounding is not very difficult. The “complexity” of five minutes with a calculator can make tens of millions of pounds of difference: it's not that much of an imposition on a Court. The other four judges in *Westdeutsche* all said that it was obviously unjust to give only simple interest. Two of them thought the Courts should take matters into their own hands, and two agreed with Lord Lloyd that it was for Parliament to change the law.

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Parliament has of course done nothing, although the Law Commission has recommended a change in the general law and, to get over concerns about lawyers not being very good at doing the sums for compounding, has suggested a website where lawyers can get over their problems with numbers by plugging in the principal, the date, and get an instant calculation.

The law is supposed to follow commercial sense. It is plainly failing to do so if it cannot give compound interest. It makes no sense to a commercial person, who is paid compound interest or pays compound interest to a bank, that he should only pay or be paid simple interest.

Policy is supposed to encourage speedy litigation. The restriction to simple interest encourages whoever has the money to drag out litigation. The more dilatory the Defendant, the greater the reward thanks to the miracle of compounding. This is a perverse incentive.

It is blatantly unjust. In one case I was involved in HMRC's expert agreed that wrongly forcing my client to pay it "tax" which had been repaid with simple interest had halved the interest bill that the Government would have paid on the gilts market.

Customs have stepped in where law lords fear to tread: they have suggested that the rationale of s.78 is to achieve "commercial restitution – without encouraging taxpayers to use Customs as a bank". This is bizarre. Has anyone ever met a client who wanted to lend money to Customs at 1% under base rates but didn't want to use the gilts market and so tried overpaying VAT instead? This tells us more about Customs' grip of commercial reality than it tells us about the rationale for simple interest. Moreover, this doesn't explain why compound interest is available for other indirect taxes (with monthly compounding).

## **Tax Cases**

The taxpayer might be thought to be in an even stronger position than the victim of a breach of contract. In *Woolwich v IRC* [1993] AC 70, the House of Lords explicitly created a remedy on the basis that:

*“the nature of a demand for tax or similar impost on the citizen by the state, with the perceived economic and social consequences of non-payment stemming from the inequality of the parties' respective positions, and the unjust enrichment falling on the state where the citizen paid an unlawful demand to avoid those consequences, warranted a reformulation of the law of restitution so as to recognise a*

*prima facie right of recovery based solely on payment of money pursuant to an ultra vires demand by a public authority.”*

The VAT Act contains two interest provisions which have been used to try to get compound interest.

The first, which everyone is very familiar with, is s.78 – “Interest in certain cases of Official Error”. This allows taxpayers to recover simple interest (with the clarity which only the finest legal minds can produce, in accordance with the Air Passenger Duty Regulations).

In one early case, *Margrie Holdings*, compound interest was awarded by a Tribunal. Conspiracy theorists may speculate as to why the only *Margrie Holdings* decision available online is not the decision on compound interest. There are some grainy, late generation photocopies of the decision which are traded around the VAT bar.

The Finance Act 1997 inserted a provision which prevents the Tribunal giving interest on interest under s.78. This is a statutory dead end.

The other major provision in the VAT Act concerning interest is s.84(8) – “Further Provisions relating to appeals”. This provides:

“ ... (8) Where on an appeal it is found –

- (a) that the whole or part of any amount paid or deposited ... is not due; or
- (b) that the whole part of any VAT credit due to the appellant has not been paid,

so much of that amount as is found not to be due or not to have been paid shall be repaid (or, as the case may be, paid) with interest at such rate as the tribunal may determine...”

It does not say whether this is simple or compound. Was this overlooked in the FA 1997?

There is at least one tribunal case going on at the moment where it is being argued that the s.80 power is a compound power. But generally people have sought to attack the problem sideways on. There are two such main side approaches.

### *Claim a High Simple rate*

This is the first route. Recently, in *RSPCA Properties* (Decision 19440), the taxpayer conceded that the s.84(8) power was to give simple interest only, but asked for a higher rate under s.84 than the s.78 rate, to reflect the fact that it was not getting compound interest. The Tribunal was sympathetic and explicitly approved awarding a higher rate of interest under s.84(8) to reflect its (alleged) lack of power to compound: see para 82 of the Decision. Expect this to get more popular.

However, especially in cases where the claims go back 30 years or so, Tribunals will need to give simple rates of interest which have a banana republic feel to them: 30% or more. Tribunals may have some reluctance to do this, although there is no reason in principle why they should not. Indeed, as a matter of principle, it is in precisely those cases that compound interest is most required to achieve a just result.

The Tribunal in *RSPCA Properties* was brave. In the High Court, *Elite Mobile* tried the same approach, asking the judgment rate because there was no compound interest power. Commercial practitioners have long been familiar with the Court giving interest at the judgment rate (much higher than commercial rates at the moment, 8%) in a tacit acknowledgment of the injustice of simple interest. Lindsay J was very unsympathetic to this approach: see his judgment at [2005] STC 275. This is out of line with the sentiments expressed by the House of Lords about the injustice of simple interest.

### *EU law*

This is the second route. There are 2 different arguments potentially available.

The first, which was run in *Elite Mobile*, is to say that s.78 interest is sufficiently out of line with commercial terms as to breach the taxpayers' EU right to an effective remedy for the Commissioners' breach of the EU sixth directive rights to reclaim input tax. This is based on the *Molenheide* line of authority. In *Molenheide* the ECJ struck down Belgian restrictions on the payment of interest on VAT. These were significantly more onerous than simple interest under s.78. Normally of course questions of interest are "ancillary" and are a matter for domestic law, at least within a wide margin of discretion. Lindsay J was dismissive of this line.

The second argument is derived from a direct tax case re breach of EU directly effective rights: *Sempra Metals v IRC* [2005] STC 687. The effect of the Advance Corporation Tax regime in the UK was to require companies with foreign parents to pay tax 9 months earlier than companies with UK parents. This was held to be a

breach of EU law by the ECJ. The Court of Appeal, following the judgment of the ECJ in *Metallgesellschaft* [2001] STC 452, agreed that until the repayment of the principal, the Claimant was entitled to compound interest as a matter of EU law. From the date of repayment of the principal, the Claimant was left with a purely domestic claim for damages, and from that date it was entitled to simple interest.

By analogy, provided the taxpayer can show a breach of a directly effective EU right, there should be a claim for compound interest on wrongly paid “tax” until the tax is repaid. This point has just been referred to the ECJ by the Court of Appeal in *BT Plc*. That reference should clear up the scope of *Sempra Metals* in VAT cases.

At the moment it is not clear what, if any, time limits will apply to such claims. It could be that there is no time bar at all. It could be that that time runs from the date of the original payment, and is barred after six years. It could be something in between, such as the date of payment of the simple interest. Taxpayers who may have claims should consider issuing a protective Claim Form.

Finally, every silver lining has a cloud. I venture to predict that sooner or later compound interest will become the norm. When the Commissioners tire of fighting these battles, they will get the law changed so that they can charge compound interest as well as finding themselves forced to pay it increasingly frequently.