[2016] UKFTT 530 (TC)

TC05279

Appeal number: TC/2014/04003

VAT - input tax - s36 VATA - regulations 165 and 171 Vat Regulations 1995 - whether Appellant liable to repay to HMRC previously refunded VAT bad debt relief - whether HMRC correct to conclude that undertakings in letters of comfort, given by holders of loan notes to Appellant's parent company promising non enforcement of interest provisions constituted a payment of consideration against a contract debt on a supply arising between the Appellant and another subsidiary of the parent company - no - appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

D JACOBSON & SONS LTD **Appellant**

- and -

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

TRIBUNAL: JUDGE MICHAEL CONNELL
MEMBER GAY WEBB

Sitting in public at Alexandra House, Parsonage Square, Manchester on 8 February 2016

Ms Zizhan Yang for the Appellant

Mr William Brooks, Officer of HM Revenue and Customs, for the Respondents

DECISION

1. This is an appeal by D Jacobson & Sons Limited ("the Appellant") against the decision of The Commissioners for Her Majesty's Revenue and Customs ("HMRC") to assess the Appellant in accordance with S 73 (1) of the Value Added Tax Act 1994 ("VATA") for the vat quarterly period 09/13, in respect of a refusal of the Appellant's claim to bad debt relief.

2. The issue is whether HMRC are correct to conclude that undertakings in letters of comfort, constitute payment as stipulated by regulation 165 of the Value Added Tax Regulations 1995 ("the VAT Regs"), in which event the Appellant is liable to repay to HMRC £570,824 VAT previously refunded by way of bad debt relief.

3. HMRC consider that interest written off by the holders of loan notes issued by Jacobson Group Limited ("JGL"), the Appellant's holding company, represents a payment of consideration against a contract debt on a supply arising between the Appellant and another subsidiary of the holding company, Famous Footwear Limited ("FFL"). FFL went into administration and the contract debt became irrecoverable.

Background

4. D Jacobson & Sons Ltd, the Appellant Company, describes its main business activity as importers and distributors of footwear. The Appellant is, and was throughout the relevant period, the representative member of a VAT group which also included an associated company Lotus Limited ("LL").

5. JGL was set up in 2006 to acquire the shares of the Appellant Company, which in turn holds the shares of LL. The consideration for the purchase by JGL was partly satisfied by loan notes issued by JGL to the shareholders of the Appellant and partly by shares in JGL. The loan notes were constituted under a deed dated 18 August 2006.

6. It was anticipated by JGL at the time of issuing the loan notes that it would be able to satisfy the interest and capital due under the schedule of repayments; the first repayment of capital being due on 30 November 2009.

7. In 2008, FFL which shared some common ownership with JGL and also had close family ties, acquired the trade and assets of a division of Stead and Simpson which was in the business of retailing footwear and bags. The acquisition was funded in part by a loan of £7,141,370 provided by Melvyn Jacobson and secured by a debenture.

8. Despite expectations, the trading position of JGL was not as good as had been anticipated. In consequence JGL failed to meet its obligation to make the first repayment of capital due in November 2009 and after that date, did not make any payments of either capital or interest due to the loan note holders.

9. In the period, between February 2011 and June 2012, the Appellant and LL supplied footwear to FFL to the value of £1,780,649.84 for onward sale in FFL's retail business. The transactions, including the terms as to payment, were negotiated on an arm's length basis. The supplies were treated under s 43(1)(b) VATA 1994 as having been made by the Appellant as the representative member.

10. During the course of the financial year to 30 September 2012, the directors of JGL became concerned that because FFL was suffering severe financial difficulties, there was a material risk that the outstanding contract debts owed by FFL to the Appellant Company and LL of £1,759,942 and £1,675,358 would not be paid and that FFL would become insolvent. That would result in JGL and other group companies defaulting on their own debt obligations and, in turn, lead to a breach of JGL's banking covenants, and its principal lender, Mr Melvyn Jacobson, exercising his rights against the assets of FFL under the debenture.

11. In August 2012, JGL approached the holders of its loan notes, some of whom had also loaned monies to the Appellant and Brands Global Ltd, another subsidiary of the parent company, to seek some form of comfort that sums falling due to those lenders could be deferred until a later date so as to remove the risk of default.

12. By letters dated 21 August 2012, the loan note holders and lenders wrote to KPMG, the group auditors saying:

> *"In connection with your audit of the financial statements of Jacobson Group Limited for the period ended 30 September 2011, to provide details of the balance outstanding on various loans and their repayment terms:*
>
> *I confirm that I will not recall any of those loans (including the accrued interest) for a period of at least 18 months from the date of this letter, unless agreed in writing between Jacobson Group Ltd and Barclays Bank Plc.*
>
> *Further, in my capacity as a loan note holder I confirm that any shortfall created by any amount due from Famous Footwear Limited will be satisfied (proportionally with other loan note holders) by accrued loan note interest being written off."*

13. The letters were provided to JGL's auditors "to satisfy them that the balance sheet position could be made good, and to give comfort that bank covenants would not be breached".

14. Whilst each of the holders of the loan notes provided letters of comfort, they retained all their other rights under the Loan Note Deed dated 18 August 2006.

15. In the financial year to 30 September 2012, the lenders wrote off interest totalling £3,665,213.03 across the group, of which £2,518,394.41 was in respect of loan notes issued by JGL, £999,934 was in respect of loans made to the Appellant, and £146,884.62 was in respect of loans made to Brands Global Ltd.

16. FFL entered into administration on 8 November 2012. The Appellant and LL had claimed for the amounts due to them as unsecured creditors in the administration

and wrote these amounts off as bad debts in the accounts for the financial year to 30 September 2012.

17. The Appellant, as representative member of the VAT group, made a claim for bad debt relief in its VAT return for the prescribed accounting period ending 31 December 2012, in relation to the consideration due from but not paid by FFL. HMRC agreed that (subject to an adjustment for timing in respect of invoices which were under six months old, which the Appellant was advised could be claimed in its VAT return for the period ending 03/13) all the conditions for bad debt relief were met and allowed the claim for £570,824.

18. However, following further consideration of matters, the HMRC Officer dealing with the VAT reclaim changed his view and decided that the Appellant's claim to VAT bad debt relief could not be accepted. On 4 February 2014 he assessed the Appellant in the sum of £570,824 for the VAT quarterly period 09/13. His reason for arriving at his decision was that after considering further internal guidance and opinion, he considered that the loan note holders and lenders had entered into a contract to guarantee the debts of FFL to the Appellant Company and LL. In reaching his conclusion he relied on the case of *AEG (UK) Ltd* (1993/VATTR 379) ("AEG"), in which it was accepted by the Tribunal that an agreement by a creditor to take shares in lieu of monetary payment against a debt represented non-monetary consideration (irrespective of the fact that the shares ultimately turned out to be valueless).

19. The decision was appealed by the Appellant, but upheld on statutory review on 27 June 2014. The reviewing officer said:

> "The Jacobson Group Ltd Consolidated financial statements for the year ending 30 September 2012, states "During the year the group sold £1,251,000 (2011 £2,528,000) of trading stock to Famous Footwear Ltd, of which H Jacobson, D Green and R Sisson are also directors, and the balance due at the year-end was £3,184,000 (2011 £3,456,000). During the year Famous Footwear Ltd entered into administration and so the group have provided against the full balance due to the Group of £3,184,000. The Directors consider JGL to be the parent company of the group. The ultimate controlling party is Mr H Jacobson by virtue of his majority shareholding in the ordinary share capital.
>
> ….these financial statements included the write off of the interest on the loan notes that Jacobson Group Ltd issued in 2006. They also confirmed that no action had been taken to repay the bad debt claim made on the VAT return for the period ending 12/12.
>
> The above ……is a form of guarantee to satisfy any shortfall that may arise, and the annual account for the year ending 2011 show an intention to satisfy any shortfall that may arise. Guaranteeing a debt is a commitment made by a person to be answerable for the debts or liabilities of another.
>
> Payments are defined in Regulation 165 SI 1995/2518 as:
>
> > "Any payment or part-payment which is made by any person by way of consideration for a supply regardless of whether such payment extinguishes the purchaser's debt to the claimant or not."

Public Notice 700/18 paragraph 3.10 states:

> "If you receive payment, in full or in part, from a guarantor or other person (for example a director of the debtor company), entitlement to relief is reduced by the amount paid. If full payment is made by the guarantor or third party there is no entitlement to bad debt relief."

> … *AEG (UK) Ltd* (LON/93/201A) is relevant. [In that case] following financial difficulties, at a meeting of the client's creditors, an arrangement that shares would be provided in settlement of the outstanding debt was accepted. The Tribunal found that this arrangement constituted 'full consideration' for the debts, and thus no debts remained outstanding and no bad debt relief could be claimed.

> The write-off of the accrued interest made by Mr Harvey Jacobson is a commitment and although your representatives are of the opinion that the gesture was at the loan note holders' discretion and there was no obligation to provide such a guarantee; they equally confirm this was necessary to ensure there would be no breach in respect of bank covenants. The write-off when it came into effect should have been treated as payment for the supply made to Famous Footwear Ltd. It is considered a full payment was made and the bad debt relief should have been repaid at this point."

20. The Appellant disagreed with the decision and lodged a Notice of Appeal with the Tribunal on 24 July 2014.

21. The Appellant's stated grounds of appeal are that:

i. The facts do not support HMRC's assertion that the loan note holders entered into a contract of guarantee with respect to the debts of FFL to the two companies (the Appellant Company and LL).

ii. As such and in any event, no part of the consideration due from FFL and forming part of the Appellant's accepted bad debt claim has subsequently been received by the Appellant or LL, for the purpose of s 36(5)(e) VATA and regulation 171(1)(b) of the VAT regulations 1995.

The legislation

22. The Relevant legislation is contained in:

Article 2(1)(a) of *Council Directive 2006/112/EC* of 28 November 2006 on the Common System of Value Added Tax ("the PVD"), which provides that "the supply of goods for consideration within the territory of a Member State by a taxable person acting as such" shall be subject to VAT.

Article 73 of the PVD provides that "in respect of the supply of goods or services, other than as referred to in Articles 74 to 77 [not relevant], the taxable amount shall include everything which constitutes consideration obtained or to be obtained by the supplier, in return for the supply, from the customer or a third party, including subsidies directly linked to the price of the supply."

Article 90(1) of the PVD provides that "in the case of cancellation, refusal or total or partial non-payment [...] the taxable amount shall be reduced accordingly under conditions which shall be determined by the Member States".

Article 90(1) of the PVD is implemented in the UK by section 36 VATA 1994, the relevant parts of which provide as follows:

VATA Section 36 *Bad debts*

"(1) Subsection (2) below applies where -

(a) a person has supplied goods or services [...] and has accounted for and paid VAT on the supply,

(b) the whole or any part of the consideration for the supply has been written off in his accounts as a bad debt, and

(c) a period of 6 months (beginning with the date of the supply) has elapsed.

(2) Subject to the following provisions of this section and to regulations under it the person shall be entitled, on making a claim to the Commissioners, to a refund of the amount of VAT chargeable by reference to the outstanding amount.

[(3) In subsection (2) above "the outstanding amount" means—

(a) if at the time of the claim no part of the consideration written off in the claimant's accounts as a bad debt has been received, an amount equal to the amount of the consideration so written off;

(b) if at that time any part of the consideration so written off has been received, an amount by which that part is exceeded by the amount of the consideration written off;

and in this subsection "received" means received either by the claimant or by a person to whom has been assigned a right to receive the whole or any part of the consideration written off]

[(3A) For the purposes of this section, where the whole or any part of the consideration for the supply does not consist of money, the amount in money that shall be taken to represent any non-monetary part of the consideration shall be so much of the amount made up of—

(a) the value of the supply, and

(b) the VAT charged on the supply,

as is attributable to the non-monetary consideration in question

(4) A person shall not be entitled to a refund under subsection (2) above unless—

(a) the value of the supply is equal to or less than its open market value, ...

(b) ...

(4A) .„

(5) Regulations under this section may—

(a) require a claim to be made at such time and in such form and manner as may be specified by or under the regulations;

(b) require a claim to be evidenced and quantified by reference to such records and other documents as may be so specified;

(c) require the claimant to keep, for such period and in such form and manner as may be so specified, those records and documents and a record of such information relating to the claim and to [anything subsequently received] by way of consideration as may be so specified;

(d) require the repayment of a refund allowed under this section where any requirement of the regulations is not complied with;

(e) require the repayment of the whole or, as the case may be, an appropriate part of a refund allowed under this section [where any part (or further part) of the consideration written off in the claimant's accounts as a bad debt is subsequently received either by the claimant or, except in such circumstances as may be prescribed, by a person to whom has been assigned a right to receive the whole or any part of that consideration,]

(ea) ...

(f) include such supplementary, incidental, consequential or transitional provisions as appear to the Commissioners to be necessary or expedient for the purposes of this section;

(g) make different provision for different circumstances.

(6) The provisions which may be included in regulations by virtue of subsection (5)(f) above may include rules for ascertaining—

(a) whether, when and to what extent consideration is to be taken to have been written off in accounts as a bad debt;

(b) whether [anything received] is to be taken as received by way of consideration for a particular supply;

(c) whether, and to what extent, [anything received] is to be taken as received by way of consideration written off in accounts as a bad debt.

(7) The provisions which may be included in regulations by virtue of subsection (5)(f) above may include rules dealing with particular cases, such as those involving [receipt of part of the considerationJ3 or mutual debts; and in particular such rules may vary the way in which the following amounts are to be calculated—

(a) the outstanding amount mentioned in subsection (2) above, and

(b) the amount of any repayment where a refund has been allowed under this section.

(8) Section 6 shall apply for determining the time when a supply is to be treated as taking place for the purposes of construing this section."

Value Added Tax Regulations 1995

As far as is relevant:

Reg. 165 Interpretation of Part XIX. In this Part -

"claim" means a claim in accordance with regulations 166 and 167 for a refund of VAT to which a person is entitled by virtue of section 36 of the Act and "claimant" shall be construed accordingly;

"payment" means any payment or part-payment which is made by any person by way of consideration for a supply regardless of whether such payment extinguishes the purchaser's debt to the claimant or not;

"purchaser" means a person to whom the claimant made a relevant supply; "refunds for bad debts account" has the meaning given in regulation 168; "relevant supply" means any taxable supply upon which a claim is based;

"return" means the return which the claimant is required to make in accordance with regulation 25;

"security" means—

(a) in relation to England, Wales and Northern Ireland, any mortgage, charge lien or other security and

(b) in relation to Scotland, any security (whether heritable or moveable), any floating charge and any right of lien or preference and right of retention (other than a right of compensation or set-off).

Reg 171 Repayment of a refund

(1) Where a claimant -

(a) has received a refund upon a claim, and

(b) either -

(i) a payment for the relevant supply is subsequently received, or

(ii) a payment is, by virtue of regulation 170 or 170A, treated as attributed to the relevant supply, or

(iii) the consideration for any relevant supply upon which the claim to refund is based is reduced after the claim is made,

he shall repay to the Commissioners such an amount as equals the amount of the refund, or the balance thereof, multiplied by a fraction of which the numerator is the amount so received or attributed, and the denominator is the amount of the outstanding consideration, or such an amount as is equal to the negative entry made in the VAT allowable portion of his VAT account as provided for in regulation 38.14.

(2) The claimant shall repay to the Commissioners the amount referred to in paragraph (1) above by including that amount in the box opposite the legend "VAT due in this period on sales and other outputs" on his return for the prescribed accounting period in which the payment is received.

(3) Save as the Commissioners may otherwise allow, where the claimant fails to comply with the requirements of regulation 167, 168, 169, 170 or 170A he shall repay to the Commissioners the amount of the refund obtained by the claim to which the failure to comply relates; and he shall repay the amount by including that amount in the box opposite the legend "VAT due in this period on sales and other outputs" on his return for the prescribed accounting period which the Commissioners shall designate for that purpose.

(4) If at the time the claimant is required to repay any amount, he is no longer required to make returns to the Commissioners, he shall repay such amount to the Commissioners at such time and in such form and manner as they may direct.

(5) For the purposes of this regulation [but subject to paragraph (6) below,] a reference to payment shall not include a reference to a payment received by a person to whom a right to receive it has been assigned.

(6) Paragraph (5) above does not apply where any person to whom the right to receive a payment has been assigned (whether by the claimant or any other person) is connected to the claimant.

(7) Any question for the purposes of paragraph (6) above whether any person is connected to the claimant shall be determined in accordance with section 839 of the Taxes Act.

(8) Paragraphs (6) and (7) above apply where the right to receive a payment is assigned on or after 11th December 2003.

The Appellant's contentions

23. Ms Zizhan for the Appellant submits that the Appellant is only required to repay to HMRC the bad debt relief VAT refund if it has subsequently received a payment "by way of consideration for" the supplies of shoes made to FFL, (see definition of "payment" in regulation 165).

24. In order for a payment to be "consideration for" a supply, there must be a direct link between the supply and the payment. This principle is well established in the case law of both the European Court and the UK domestic court (see *Apple and Pear Development Council v Customs and Excise Commissioners* (Case 102/86) [1988] STC 221 at [11] and [12]; *Tolsma v Inspecteur der Onizetbelasting Leeuwarden* (Case C-16/93) [1994] STC 509 ("*Tolsma*") at [13]; *Customs and Excise Commissioners v*

Church Schools Foundation Ltd [2011] EWCA Civ 1745, [2001] STC 1661 ("*Church Schools*") at [41]).

25. A direct link between a supply and a payment requires reciprocal performance by the supplier and the payer (*Tolsma* at [14], as interpreted in *Church Schools* at [31] to [33]). In other words, a direct link between supply and payment exists only where there is reciprocity in the relationship between the supplier and the payer (*Church Schools* at [35]): where the payment is made "in return for" or as "remuneration for" the supply (*Church Schools* at [94]) "There has to be an exchange of promises or a supply against agreement for remuneration." (*Church Schools* at [95]).

26. The legislation and case law embody the fundamental VAT principle of fiscal neutrality, which provides that "the basis of assessment is the consideration actually received", and which "requires the member states to reduce the taxable amount and, consequently, the amount of VAT payable by the taxable person whenever, after a transaction has been concluded, part or all of the consideration has not been received by the taxable person." (*Goldsmiths (Jewellers) Ltd v Customs and Excise Commissioners* (Case C-330/95) [1997] STC 1073 at [14] to [16]).

27. Ms Zizhan argues that for the reasons given below, no consideration for the supplies to FFL has been received. As such, the Appellant remains entitled to the full amount of the bad debt relief refund and there is no basis for any repayment.

No Guarantee

28. The only basis on which HMRC say the Appellant ought to repay the VAT refund is that the write-offs of interest extended to JGL (and, presumably, also to the Appellant and Brands Global Ltd) by their lenders were made under a "guarantee to settle any amounts owed by FF to the Appellant", and as such "constitute a payment as described by regulation 165 of the VAT Regs". This position is untenable for the following reasons.

29. First of all, there was no guarantee. A guarantee is a contractual promise for which consideration must be provided (*Moschi v Lep Air Services Ltd & ors* [1973] AC 331 ("*Moschi*") at 346F-347A and 349B-D; Chitty on Contracts (32nd edn) at paras 45-001, 45-002, and 45-022, and in this case no consideration has been given by the Appellant or LL (or, for that matter, FFL) for the lenders' undertaking to write off the interest. The write-offs were nothing more than gratuitous acts by the lenders to support the businesses of the debtor companies and the group at large (as stated in the relevant financial statements).

30. The absence of consideration is sufficient to dispose of HMRC's only argument in this appeal. Indeed, HMRC agrees that "there was no enforceable guarantee" [HMRC's decision letter of 4 February 2014]. But, in any event and without prejudice to the above, there are other reasons why, plainly, there was no guarantee.

31. It is well established that there are two possible types of obligations on a guarantor:

(1) a "see to it" obligation, by which the guarantor undertakes to ensure the principal debtor meets its obligations to the creditor, in breach of which the remedy lies in damages; and

(2) a "conditional payment" obligation, by which the guarantor undertakes to pay if the principal debtor fails to do so (*Moschi* at 344G-345C; Chitty at 45-001).

32. In this case, there was clearly no "see to it" guarantee. Nor was there a "conditional payment" guarantee for the following reasons:

(1) A payment by a guarantor discharges the principal debtor by that amount (see Chitty at 45-084), yet the interest write-offs did not discharge FFL's debts to the Appellant and LL.

(2) Related to this is the principle of co-extensiveness, which is a fundamental feature of guarantees. This provides that in the event of a failure to perform by the principal debtor "the creditor can recover from the guarantor [...] whatever sum the creditor could have recovered from the debtor himself as a consequence of that failure. The debtor's liability to the creditor is also the measure of the guarantor's." (*Moschi* at 349A-B). This feature does not exist in the present case since the benefit of the interest write-offs did not accrue to the creditors - the Appellant and LL - save for the £999,934 written off in favour of the Appellant which in any event does not correlate to the £1,762,289.80 owed by FFL to the Appellant.

(3) In respect of all supplies made to FFL in relation to which payment was due, FFL had already defaulted before the lenders undertook the interest write-offs. Accordingly the lenders could not have taken on any "conditional payment" obligation since there was no conditionality.

33. Since HMRC's only argument in this case for why the Appellant should repay the vat refund is that there had been payments under a "guarantee to settle any amounts owed by FF to the Appellant" and, for the reasons given above, HMRC's case must fail.

No direct link between the supplies to FFL and the interest write-offs

34. Furthermore, and in any event, there was no direct link, or reciprocal performance, between the supplies of shoes to FFL and the interest write-offs, for the following reasons:

(1) The shoes were supplied long before the lenders undertook to write off any interest. They were supplied "in return for" due payment by FFL, not against any promise on the lenders' part to write off interest.

(2) There was no agreement between the Appellant and LL as suppliers on the one hand and the lenders on the other hand. The latter's promise to write off

the interest was voluntary and (because no consideration was given for it) not binding (see *Tolsma* at [17] and *Church Schools* at [103]).

(3) The lenders had not requested the supplies to FFL. Nor can it be said that they had given the interest write-offs "in return for", or as "remuneration for", the supplies to FFL.

35. The interest write-offs were nothing more than voluntary acts of support by the lenders for the businesses of the debtor companies and the group as a whole. They were not "consideration for" the supplies of shoes to FFL. Accordingly, there is no basis for any repayment under para 171 of the 1995 Regs.

Other flaws in HMRC's case

36. HMRC contend that FFL has the same common directors as JGL. To the extent that this is a statement of the fact that certain individuals are directors of both FFL and JGL, the Appellant does not dispute it, but submits that it is irrelevant to the determination of this appeal.

37. However, to the extent that this is an attempt by HMRC to pierce the corporate veil, there is clear authority from the Supreme Court that such an approach cannot be allowed (*Prest v Petrodel Resources Ltd & ors* [2013] UKSC 34; [2013] 2 AC 415 at [35], [81], [102], and [103]).

38. HMRC rely on the decision in *AEG* for the proposition that "settlement of a debt does not have to be monetary in nature, payments can be in some other form of security to settle the amount owed". That may be so, but AEG does not assist HMRC in this appeal.

39. The issue in *AEG* was whether the Appellant Company, which had received shares stated to be "in full consideration" for the debt outstanding on certain supplies, was correct to argue that, because the shares were effectively worthless, the debt remained a bad one and therefore the company was entitled to bad debt relief. The Tribunal held that, because the Appellant had received the shares (whatever their actual value) "in full consideration" for its debt, there was no "outstanding amount" for the purpose of s 11(3) of the Finance Act 1990 (now s 36(3) VATA 1994) and, as such, the Commissioners had correctly rejected the claim for bad debt relief.

40. The Tribunal in *AEG* did not concern itself with whether or not (1) the shares were "consideration for" the relevant supplies, or (2) they had been received by the Appellant Company. As such, that decision is irrelevant to the determination of the present appeal.

41. Indeed, by seeking to impose on the Appellant an amount of VAT by reference to consideration that has not been received, HMRC's position breaches the fundamental principle of fiscal neutrality. The fact is that no consideration "for" the supplies relevant to the bad debt relief refund was received; accordingly, there is no basis for assessing the Appellant to any repayment of that refund.

HMRC's case

42. Mr Brookes for HMRC contends that the legislation at s 36 VATA and regulations 165 and 171 of the VAT Regs are pertinent to determining this appeal.

43. The legislation sets down certain time limits and criteria that must be met to bring a valid claim. Section 36(1)(a) is not in dispute. It is accepted that the two companies, by way of a series of transactions, supplied FFL with goods to the value of £3,435,300.

44. Similarly s 36(1)(b) is not in dispute; and save for £16,888.40 which was restricted (as that proportion of the claim which failed to comply with the six month rule) s 36(1)(c) is also not in dispute.

45. It is also not in dispute that s 36(5)(a) was met. At the relevant time the limit specified was four years following the time specified by s 36(1)(c).

46. However, Mr Brookes argues that the effect of the undertakings in the letters of comfort being actioned constituted payment as defined by regulation 165:

> "payment" means any payment or part-payment which is made by any person by way of consideration for a supply regardless of whether such payment extinguishes the purchaser's debt to the claimant or not;

47. "Payment" relates 'any payment'. That payment can be made by 'any person'. It is not required that the payment extinguishes the debt.

48. Whilst consideration is not defined in legislation, it is generally taken to mean anything by way of payment for a supply of goods.

49. HMRC maintain that the letters of comfort provided by the loan note holders effectively undertake to satisfy any debt owed by FFL to the Appellant.

50. Whilst acknowledging that paragraph 3.10 of Notice 700/18, does not have the force of law, it represents the publicly available guidance on the issue.

> "3.10 What if I receive payment from a guarantor or other person?
>
> If you receive payment, in full or in part, from a guarantor or other person (for example a director of the debtor company), entitlement to relief is reduced by the amount paid. If full payment is made by the guarantor or third party there is no entitlement to bad debt relief."

51. The payment can take any form, it does not have to be a payment in monetary terms. HMRC contends that the write off of loan note interest constitutes payment.

52. It is not in dispute that the write off of interest owed to the loan note holders actually took place.

53. That being so, HMRC contends that the whole of the bad debt VAT claim of £570,824 is repayable by the Appellant in accordance with regulation 171 of the VAT Regs.

54. HMRC contends that they are further supported by their own internal guidance VBDR2100:

"Payments: What constitutes a payment?

> The typical form of payment would be a monetary payment by the customer. The regulation, however, is widely drawn and includes a number of other forms of payment:
>
> - any non-monetary payments, for example, goods or services provided in exchange;
> - third party payments received;
> - payments received from a guarantor of the customer;
> - mutual debts are treated as a payment with relief available on any amount remaining after offsetting amounts owed to the customer;
> - the value of any enforceable security is treated as a payment;
> - payments made by the customer's insurers (for example where part or all of a repair bill at a garage is paid by the customer's insurer).
>
> If a business takes out an insurance or similar policy to pay out in the event of their customer's debt going bad, this does not constitute a payment for the purposes of establishing whether it can claim bad debt relief.
>
> In AEG (UK) Limited 1993 (VTD 11428) the Tribunal found that shares provided in settlement of an outstanding amount constituted full payment and thus no bad debt relief could be claimed. The share certificates were issued following a meeting of the customer's creditors and a majority of the customer's creditors had accepted this in settlement. The supplier, who had voted against the terms of the settlement, had sought to claim that the share certificates received were worthless."

55. In *AEG*, Judge Heim quoted from the decision in *A-Z Electrical v Commissioners of Customs & Excise* (LON/93/95A) ("*A-Z*"):

> "In my view the solution is to be found by considering whether in July 1991 there was the receipt of payment. I form the view that by accepting the new preference shares in full and final satisfaction of debt, the Appellant, like the other shareholders, agreed that the debts should be satisfied by an equivalent sum of money being subscribed for the preference shares. No cash changed hands. I cannot accept the contention that the shares were then valueless."

56. In *A-Z* the Appellant did not vote at the creditors' meeting to accept the offer of preferential shares by way of payment. The Appellant considered the shares to be worthless.

57. The Judge went on to state:

> "As it turned out the creditors got a bad bargain. But in law each of them received payment in full of his debt, paying the right sum for his new shares. That can be fairly stated, as it was expressed to me during the hearing, as "taking the shares in full and final satisfaction of the debt". A debt so satisfied in my view is a debt paid."

58. In his penultimate paragraph, Judge Heim accepted that the arguments in *A-Z* applied, finding that the issue of shares replaced the debt due such that there was no amount outstanding which could be subject to bad debt relief.

59. In the case of *Berck Ltd* (VTD20051), Lady Mitting also considered what can be considered as "payment". She concurred with Judge Heim in concluding this does not have to be monetary. She states at paragraph 16:

> "The Appellant clearly gained benefit from the management buyout because it retained its customer and retained a chance of repayment of a major part of the indebtedness. This benefit to the Appellant on its own, cannot amount to a satisfaction of the debt or a consideration for the writing off such that bad debt relief could be denied. But once one adds in the additional element of the agreement, namely that in return for the writing off of the debt, Flex entered into an exclusive supply agreement, the situation changes and immediately there is consideration for the writing off. In return for writing off the debt, the Appellant has received the benefit of an exclusive supply agreement. In this way, the debt has been satisfied and as such cannot give rise to a claim for bad debt relief."

60. In the instant appeal, the loan note holders had received no repayments of capital. They had received no payments of interest since November 2009. They had to consider the financial predicament of JGL. If JGL had failed, the whole value of the loan notes could be lost to them. They voluntarily agreed to settle what was owed by FFL to the Appellant.

61. HMRC contends that the undertakings when referring to "any shortfall" refer to the debtor FFL in the Appellant's accounts; and that "any amount due from Famous Footwear Limited" is the £3,435,300 owed by FFL to the Appellant.

62. HMRC also assert that "will be satisfied" should be given its dictionary definition:

i. Meet a financial obligation.
ii. To discharge fully (a debt, obligation)
iii. To pay a creditor.

63. It is of significant importance that the Appellant, LL and FFL are owned by JGL. Two of the loan note holders, D Green and R Sisson were directors of FFL, they provided letters of comfort in their own right. Another director of FFL, H Jacobson, provided seven letters of comfort in his capacity as a trustee of seven separate trusts.

64. This appeal bears similarity to the case of *Garforth (HM Inspector of Taxes) v Tankard Carpets Ltd*. [1980] STC 251. In line with the instant appeal it involved the fortunes of three companies. In that case one company had given security by way of a

guarantee to an associated company. In the High Court Walton J (commencing at the end of page 349) states:

> "It must in the nature of things, be extremely difficult for any directors of two associated companies in the position of Carpets and JLT to be certain in whose best interests - or, rather, in whose exclusive interests - any step which they take is being taken. Obviously, there is nobody but themselves to say what was in their own minds; and obviously, again, it must require a superhuman effort of mind (of which extremely few persons, if any, are capable) to rule out entirely from consideration the possibility of benefit to one's other company when concentrating on the exclusive requirements of just one of them. In my judgment, Commissioners should be extremely slow in coming to any conclusion that the act was done solely for the benefit of the trade of one of the companies concerned and should in general do so only where there are wholly separate findings of primary fact not depending on the say-so of the directors concerned. I cannot resist the impression that in 99 cases out of 100 the correct primary fact to find will be that which was in fact found in this case; namely, that in such a situation as the present, the interests of all the companies were considered together."

HMRC contend that in the instant case FFL owed the Appellant in excess of £3.5m. There was little prospect of FFL meeting its obligation to the Appellant. There was a significant material risk of FFL's principal lender, Mr M Jacobson, exercising his rights under the debenture.

65. It is not in dispute that JGL owed the loan note holders significant amounts of money: £12,700,783 in capital, plus accrued interest that had gone unpaid since November 2009. The situation left JGL at significant risk of failing to meet the terms of its banking covenant and paying its own creditors.

66. Letters of comfort were provided and had the desired effect as far as the Appellant's bankers are concerned. HMRC maintains in line with Walton J's comments "it would take superhuman effort of mind" to say that putting the offers of comfort into effect was merely to ensure the Appellant did not fail to meet its own financial obligations and not as is stated within those letters; in layman's terms, pay what FFL owed to the Appellant. HMRC therefore contend that the write off of the loan note interest constitutes consideration for the supplies in question.

67. It is not disputed that there was no realistic prospect of FFL meeting its obligations to the Appellant. The loan note holders agreed to write off loan note interest that they were entitled to receive. The write off was for a specific purpose - to satisfy the shortfall in the Appellant's accounts created by FFL failing to pay for the supplies made to it. The write off of that interest is consideration for the supplies in question.

68. The terms of the letters of comfort therefore constitute consideration for the supplies made by the Appellant and LL to FFL; as such regulation 171 applies.

Conclusion

69. HMRC's decision is predicated on their submission that the letters of comfort represent a contract of guarantee, and that the effect of the implementation of the undertakings given in those letters of comfort, constituted 'payment' as defined by regulation 165. In support of that submission HMRC asserts that the waiver of interest and deferral of scheduled capital repayments constitutes 'consideration' for 'a supply' as referred to in regulation 165.

70. We do not agree with that submission and concur with Ms Zizhan that for payment to represent consideration, firstly it is necessary for there to be a direct link between the supply and the payment and secondly for there to be reciprocity between the supplier and the payer.

71. A guarantee is a contractual obligation for which consideration must be provided. The letters of comfort were not a guarantee because they were purely gratuitous acts by the lenders to save the JGL group as a whole and thereby preserve the residual value of the loans. The write off of the debt secured the long term interest of the loan note holders as it enabled JGL to continue in business and, ultimately, secure the ability of JGL to generate profits from which it could eventually repay the principal amounts and accrued interest on the loan notes.

72. There was no direct link or reciprocal performance between the supply to FFL and the interest write offs. The lenders agreed to the interest write offs some considerable time after the supply to FFL. It is an established principle of contract law that consideration must be executory or executed, but not '*past*' see Re *McArdle* ALL ER 905. At the time when HMRC allege that the loan note holders entered into the contract of guarantee it was already clear that FFL would be unlikely to be able to pay the Appellant. In commercial terms, HMRC suggest that the lenders entered into an agreement, in return for no apparent consideration.

73. A 'payment', in order to be 'consideration' must discharge a liability arising under a contract. The letters of intent did not do that. There was no contractual relationship between the loan note holders on the one hand and the Appellant and LL on the other. There was also no contractual relationship between the loan note holders and FFL as the debtor. Therefore the declarations of intent by the loan note holders could not represent 'payment' of FFL's debt.

74. It is an established principle of contract law that consideration, as recognised in law, must move from the promisee (or by a promisee's guarantor). A mere causal link between a contract debt and payment is not sufficient. As stated in HMRC's guidance, insurance payments to cover bad debts do not represent consideration for a supply.

75. The letters written by the holders of the loan notes to the auditors of JGL could not be construed as intending to create legal relations. The letters related to the audit of the group company's accounts and financial statement. For that purpose, it was addressed to KPMG in that firm's capacity as auditor and was not expressed as a contract or commitment by the loan note holders to assume the obligations owed by FFL to the Appellant and LL.

76. HMRC rely on the decision in *AEG* where a creditor accepted shares in discharge of a debt. However as the Appellant argues, the Tribunal in that case did not concern itself with whether or not the shares were "consideration for" the relevant supplies. As such, we agree with the Appellant that the decision is irrelevant to the determination of the present appeal, where there was no agreement to accept shares or any other asset in discharge of a debt.

77. HMRC refer to the fact that the Appellant, LL and FFL are owned by JGL and that FFL has the same common directors as JGL, three of them providing letters of comfort. HMRC thereby question the motive of the directors in agreeing to the write offs. However that is irrelevant to the determination of this appeal. As the Appellant argues, to the extent that this is an attempt by HMRC to pierce the corporate veil, it cannot succeed. In any event there was a clear but separate commercial interest in the loan note holders agreeing as they did. Further, not all of the loan note holders who gave letters of intent shared those connections.

78. Finally, we concur with the Appellant that HMRC's position, in seeking to impose an amount of VAT by reference to consideration that has not been received, breaches the fundamental principle of fiscal neutrality. No "consideration for" the supplies relevant to the bad debt relief refund was received; accordingly, there is no basis for assessing the Appellant to any repayment of that refund.

79. For the above reasons the Tribunal allows the appeal.

80. 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.

MICHAEL CONNELL
TRIBUNAL JUDGE

RELEASE DATE: 26 JULY 2016