[2012] UKFTT 169 (TC)

TC01865

Appeal number: MAN/2008/1244

VAT – retail schemes – Regulations 67-75 Value Added Tax Regulations 1995 – appellant incorrectly used Apportionment Scheme 1 – appellant ineligible to use Apportionment Scheme 1 – assessment of output tax on basis of Apportionment Scheme 1 – appeal allowed in principle

FIRST-TIER TRIBUNAL
TAX CHAMBER

MUNAF PATEL **Appellant**
T/A
CLEGGS LANE SERVICE STATION

- and -

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

TRIBUNAL: JUDGE JONATHAN CANNAN
PETER WHITEHEAD

Sitting in public at Manchester on 18 January 2012

Mr Makbul Patel for the Appellant

Mr Bernard Haley, advocate of HM Revenue and Customs for the Respondents

DECISION

Background

1. The appellant is the sole proprietor of a business known as Cleggs Lane Service Station in Little Hulton, Manchester. It is a retail petrol station with a general grocery store attached also selling cigarettes, groceries and other sundry items. This appeal concerns the appropriate method of calculating the appellant's output tax in periods 07/05 to 01/08.

2. Mr Makbul Patel ("Mr Patel") who is the appellant's brother appeared on behalf of the appellant. He has an accountancy degree and on a part time basis acted as the appellant's bookkeeper. He also gave evidence on behalf of the appellant.

3. The respondents' advocate Mr Bernard Haley opened the appeal with the agreement of Mr Patel and called one witness, Mr James Buckley a VAT assurance officer.

4. We are grateful to both parties for the measured way in which they made their submissions. In the event, there was no real factual dispute between the parties.

Retail Schemes

5. The operation of VAT can pose practical problems for retailers, in particular ascertaining the output tax due when a retailer has sales at different rates of VAT. Value Added Tax Act 1994 paragraph 2(6) Schedule 11 recognises these practical problems and provides for regulations to:

> " *make special provision for such taxable supplies by retailers of any goods or of any description of goods or of services or any description of services as may be determined by or under the regulations and, in particular:*
>
> > *(a) for permitting the value which is to be taken as the value of the supplies in any prescribed accounting period or part thereof to be determined, subject to any limitations or restrictions, by such method or one of such methods as may have been described in any notice published by the Commissioners in pursuance of the regulations and not withdrawn by a further notice or as may be agreed with the Commissioners;*
> >
> > …"

6. Pursuant to that provision, the Value Added Tax Regulations 1995 contain regulations 67-75 which provide as follows in so far as relevant:

> "*67(1) The Commissioners may permit the value which is to be taken as the value, in any prescribed accounting period or part thereof, of supplies by a*

retailer which are taxable at other than the zero rate to be determined by a method agreed with that retailer or by any method described in a notice published by the Commissioners for that purpose; and they may publish any notice accordingly.

(2) The Commissioners may vary the terms of any method by—

(a) publishing a fresh notice,
(b) publishing a notice which amends an existing notice, or
(c) adapting any method by agreement with any retailer.

…

69 No retailer may at any time use more than one scheme except as provided for in any notice or as the Commissioners may otherwise allow.

…

71(1) Save as the Commissioners may otherwise allow a retailer who accounts for VAT on the basis of taxable supplies valued in accordance with any scheme shall … continue to do so for a period of not less than one year … and any change by a retailer from one scheme to another shall be made at the end of any complete year reckoned from the beginning of the prescribed accounting period in which he first adopted the scheme.

…

72(1) A retailer shall notify the Commissioners before ceasing to account for VAT on the basis of taxable supplies valued in accordance with these regulations."

7. Under regulation 67(1) HMRC has published various notices including Notice 727 which describes the retail schemes available. More particularly Notice 727/4 describes how to work the Apportionment Schemes 1 and 2 and Notice 727/5 describes how to work the Direct Calculation Schemes 1 and 2. The Notices identify those parts of the schemes which have the force of law under the regulations. They do so by means of boxed text which is expressed to have the force of law.

8. In broad terms, Apportionment Scheme 1 is a simple scheme designed for smaller businesses. It involves calculating the value of purchases for resale at different rates of VAT and applying the proportion of those values to the total sales in order to calculate the output tax. Apportionment Scheme 2 involves calculating expected selling prices of standard and lower rated goods, working out the ratio of these to the expected selling prices of all goods received and applying this ratio to the gross takings.

9. Direct Calculation Scheme 1 involves calculating the expected selling price of goods at one or more rates of VAT and calculating the proportion of takings on which

VAT is due. Direct Calculation Scheme 2 is the same as Scheme 1 but involves an annual stock adjustment.

10. Regulation 67 also makes provision for a retailer to use "*a method agreed with that retailer*" which HMRC describe as "bespoke retail schemes". If a trader does not apply a retail scheme set out in a notice, or a bespoke retail scheme agreed with HMRC, he must account for VAT at the appropriate rate on a transaction by transaction basis.

11. The schemes described above were introduced in 1997. Immediately prior to being introduced there were a series of schemes known as Retail Schemes A, B, C and D. The pre-1997 terminology has been retained by many traders and indeed officers of HMRC. Hence, Apportionment Scheme 1 is similar to and sometimes known as Retail Scheme D. Direct Calculation Scheme 1 is similar to and sometimes known as Retail Scheme B.

12. There are various Tribunal decisions in which it has been accepted that by virtue of Regulation 71(1) the Commissioners have a discretion to permit a trader to change the retail scheme in use with retrospective effect. See for example *Gyte & Gyte v HMCE (VAT Tribunal Decision 16031)*. The Commissioners allow such retrospective changes only in exceptional circumstances and the Tribunal has a supervisory jurisdiction in relation to such decisions. In other words, it is only if the Commissioners unreasonably refuse to permit a retrospective change of scheme that the Tribunal can interfere.

13. Having set out the nature of the retail schemes and the legislative framework it is useful to step back and consider what the retail schemes are designed to provide. The answer is a practical means by which retailers can identify and account for output tax where they have sales at different rates of tax. That point was made by Dyson J and subsequently endorsed by the Court of Appeal in *United Norwest v C & E Comrs [1998] STC 1065 at 1070*:

> "*The purpose [of scheme B] is clear and the aim is to produce a figure which is as accurate as possible consistent with the simplicity of the method employed by the scheme.*"

14. It is clear that where a retail scheme is operated incorrectly, HMRC is entitled to make an assessment to reflect the correct operation of the scheme. See for example *Midlands Co-operative Society Ltd v Customs & Excise Comrs [2002] STC 198* where the taxpayer adopted Scheme B but failed to make an adjustment required by the Notice in relation to sales where the expected selling price was not achieved. An appeal against the resulting assessment was dismissed.

15. The notices issued by HMRC for each scheme describe the calculation required to implement that scheme. Those calculations are in boxed text indicating that they have the force of law. Notice 727 describes the retail schemes generally. In paragraph 3.7 there is boxed text in relation to Apportionment Scheme 1 which indicates that the following has the force of law:

"*You can only use the scheme if your total tax exclusive turnover from retail sales does not exceed* ***£1 million***"

16. The Notice does not expressly say so, but we construe that to mean an annual turnover of £1 million. That gives rise to something of a conundrum because the tax inclusive turnover is the only figure that is known. In order to find the tax exclusive turnover it is necessary to use one of the retail schemes. The effect of paragraph 3.7 must mean, therefore, that if using Apportionment Scheme 1 gives a tax exclusive turnover exceeding £1 million the trader is not entitled to use that scheme.

17. Similarly, in paragraph 3.12 there is boxed text in relation to Direct Calculation Scheme 1 which indicates that the following has the force of law:

"*You cannot use Direct Calculation scheme (1) if your annual tax exclusive retail turnover exceeds* ***£1 million***."

18. Paragraph 4.2 of Notice 727, again with the force of law, states in relation to all the schemes:

"… *You must use the scheme for 12 months, unless:*

- *You become ineligible for the scheme you are using or*
- *We allow or require an earlier change.*

If you become ineligible you must cease to use the scheme from the end of the next complete accounting period. *"* [emphasis added]

19. An example is given in the Notice of a trader finding that his turnover makes him ineligible for the scheme.

The Facts

20. On the basis of the evidence, which as we say was not in dispute, we make the following findings of fact.

21. The appellant commenced business in 1991 and at the same time became registered for VAT. At that time all the bookkeeping was carried out by a professional accountancy firm. That firm also prepared annual accounts, operated a PAYE scheme and prepared VAT returns for the appellant. After a few years the appellant lost confidence in his accountants and also felt that they were charging too much. Mr Patel felt that the job was relatively straightforward and with his experience agreed to do the job himself. The nature of the business has changed over the years, in particular the general retail side of the business has expanded.

22. Mr Patel did not investigate which retail scheme the business had been using, but felt that it was Retail Scheme B prior to the 1997 changes. When he took over from the accountants he effectively started from scratch. He looked at the retail schemes and his recollection is that he was advised by someone in the industry who

had adopted a retail scheme. When the provisions changed in 1997 he was aware of that fact and read notifications including Customs & Excise Notices issued at the time.

23. Mr Buckley carried out a routine audit visit in May 2008. He told us in evidence that the accounting records were in good order, well maintained and easy to follow. The audit report records that Mr Patel told Mr Buckley that he had been using the same accounting method since the business started and called it "Scheme B". Mr Buckley however identified that no zero rated mark up had ever been calculated. Mr Patel had told Mr Buckley that the same scheme had been checked on the last audit visit some 16 years previously and no problems had been found.

24. There were a number of documents included in the hearing bundle to which we were not referred during the course of the hearing. However it is clear that to some extent they bear on the evidence we heard. The bundle contains a visit report from April 1992. The visit report identifies Mr Patel as the bookkeeper but that VAT returns were completed by an accountant. It also records that Retail Scheme B had been "adopted/approved" on 1 March 1992 and further:

> "*Calculated zero rated mark up being used for groceries at 20%. This percentage being used by accountant to calculate output tax.*"

25. In March 1997 there was a letter from the appellant to Customs & Excise which was also not referred to during the hearing. It records that the appellant was at that time using retail Scheme B. The bundle also contains details of a telephone call to HMRC by Mr Patel on 3 September 2001. We take this to be the appellant's brother. The purpose of the call was to request the various Notices dealing with each of the retail schemes. We find as a fact that Mr Patel consulted these Notices in September 2001.

26. From the evidence we have heard and seen we find that the original accountants had indeed used Scheme B and that Scheme B had been used or intended to be used by the appellant until at least 1997. At some time between 1997 and 2001 Mr Patel changed the method of calculation. He continued with the new method of calculation until the visit by Mr Buckley in May 2008. During the period from at least 2001 to 2008 Mr Patel was well aware from the published notices how each of the various retail schemes worked. It is significant that in calculating output tax for the VAT returns Mr Patel told us that he thought he was using one of the authorised schemes.

27. The basis upon which Mr Patel calculated the output tax in the periods up to 2008 was by reference to the following formula:

$$\frac{\text{Net Standard Rated Goods for Resale}}{\text{Net total of all goods for resale}} \times \text{Daily Gross Takings} \times 7/47 = \text{Output Tax}$$

28. Mr Buckley considered that this was an incorrect application of Apportionment Scheme 1 (Retail Scheme D). Instead of using the gross standard rated goods for resale and the gross total of all goods for resale Mr Patel had used the net figures, that is the figures exclusive of VAT. In addition no annual adjustment had been made as required by the notice. Mr Buckley then made a calculation of output tax using Apportionment Scheme 1 with the gross figures available to him. The result was under-declared output tax of £10,417 for the 11 periods 07/05 to 01/08. Mr Buckley notified his findings to the appellant and invited observations.

29. Mr Patel responded by letter dated 17 June 2008. He disagreed with Mr Buckley's conclusions and maintained that he had been using Retail Scheme B (Direct Calculation Scheme 1). He rejected Mr Buckley's calculation based on Apportionment Scheme 1. He also included his own calculations which he said "*correctly applied*" Retail Scheme B. For that purpose he enclosed a schedule which included a calculation of the mark-up on zero-rated goods for resale, said to be 25%. It is common ground that the schedule then applied Direct Calculation Scheme 1 in a way which was mathematically correct. The result of Mr Patel's calculation was an apparent over-declaration of output tax amounting to £9,161.49 over the same 11 periods.

30. In the final paragraph of his letter Mr Patel sought a repayment of £9,161.49. It is common ground that this request for a repayment was made in time. However both parties agreed that it would be necessary for Mr Buckley to have access to the underlying records before the amount of any repayment could be finalised if the appellant is entitled to use Direct Calculation Scheme 1. In particular Mr Buckley would need to verify the calculation of the mark up on zero rated goods. It was also common ground that the different outcome between the two schemes reflected the fact that the business achieved a higher mark up on zero rated goods than it did on standard rated goods, of which by far the most significant was fuel sales.

31. Mr Buckley maintained his position and issued an assessment in the sum of £10,417. He stated in correspondence that Mr Patel could not have been using Scheme B, or a variant of it, correctly or otherwise, because there was no calculation of the zero-rated mark up. He further considered that this would amount to retrospective use of another retail scheme which was not permissible.

32. In response, Mr Patel stated that his original calculations had not been correct either under Scheme B or Scheme D. However the appellant had previously told Customs & Excise (as they then were) that Scheme B was in operation. As such there was no retrospective change.

33. Mr Patel requested a reconsideration of the assessment. On review, HMRC maintained that the scheme actually used was based on Apportionment Scheme 1, albeit the incorrect application of that scheme. During the course of the review process, the reviewing officer accepted that Mr Patel's original calculation "*was not according to published rules*". Mr Patel relied on this in his submissions to us as being a concession which helped the case he was putting forward on the appeal. We deal with this point below.

34. We note that Apportionment Scheme 1 is the most straightforward retail scheme. The attraction to a trader is the simplicity of the scheme reflected in the nature of the records required to use the scheme and the simplicity of the calculations. Having said that, Mr Patel in the present case plainly did not find the scheme simple to use notwithstanding that he had an accountancy degree. Mr Patel's evidence was that he had made a basic error. We find that rather surprising, but we have no reason to doubt Mr Patel's evidence and indeed HMRC did not suggest anything other than a simple basic error on the part of Mr Patel.

The Appellant's Submissions

35. Mr Patel, on behalf of the appellant made the following submissions:

(1) The actual calculation which he used during the period of assessment was not according to the published rules. In particular it was not Apportionment Scheme 1 because:

(a) It used net purchases in the fraction described above rather than gross purchases.

(b) The turnover of the business was more than £1 million.

(2) The appellant is not seeking to retrospectively change the retail scheme being used because he was never using a valid scheme in the first place.

(3) HMRC cannot, as a matter of discretion or otherwise, choose which published scheme is most suitable for the appellant's business.

(4) The appellant is therefore at liberty to use the most appropriate published scheme, which he contends is Direct Calculation Scheme 1.

(5) If the appellant does require a retrospective change to the scheme then it should be allowed.

The Respondents' Submissions

36. Mr Haley on behalf of the respondents submitted that when one looks at the original calculations carried out by the appellant, he intended to use Apportionment Scheme 1. The calculation bore all the traits of that scheme, albeit that the calculation was carried out in error. The calculation bore none of the traits of Direct Calculation Scheme 1.

37. The turnover restriction of £1 million did not, he submitted, have the force of law. In those circumstances Mr Haley contended that it is open to HMRC to

recalculate the output tax according to the correct application of Apportionment Scheme 1

Decision

38. It has been necessary for the purposes of our decision to go beyond the submissions which were made to us both in setting out the law above and in setting out the reasons for our decision. In particular, HMRC only appreciated during the course of the hearing that the turnover limit of £1 million for Apportionment Scheme 1 and Direct Calculation Scheme 1 was exceeded in the relevant periods.

39. We have found as a fact that Mr Patel was intending to use one of the published retail schemes. The form of the calculation used is consistent only with Apportionment Scheme 1. We further find therefore that Mr Patel had been intending to use Apportionment Scheme 1 since at least 2001. In fact however he put the wrong figures into the calculation.

40. When a trader incorrectly applies a retail scheme it may be because he misunderstands the formula. Alternatively he may understand the formula perfectly well, but simply extracts the wrong figures from his records to put into the formula. Whatever the reason might be, the trader is still seeking to account for VAT on the basis of taxable supplies valued in accordance with the particular scheme. It seems to us that the taxpayer's intention is relevant in determining which, if any, retail scheme he is applying. Prior to 1997 that intention could usually be ascertained from the VAT return itself where the trader was required to identify the retail scheme being used. Since 1997 there has been no requirement to indicate on the VAT return which retail scheme is being used. However the intention of the trader can be ascertained from the evidence. Mr Patel had read the various notices dealing with each scheme and we are satisfied that he will have understood them. He had an accountancy background. Mr Patel himself stated that he was intending to apply one of the published retail schemes. That could only have been Apportionment Scheme 1. There is no suggestion that he was concerned with expected selling prices of goods or the mark up on goods which would be required for the other relevant schemes.

41. In support of his first submission, Mr Patel relied upon a "concession" by the review officer that the scheme being operated was not according to the published rules. We do not accept that we are bound by the view of the review officer in these circumstances. It is for this Tribunal to apply the law to the facts as found. In any event the real question as we see it is not whether Mr Patel's original calculation was according to the published rules, but whether or not the appellant was using or intending to use one or other of the permitted retail schemes.

42. Mr Patel has produced annual turnover figures exclusive of VAT for the 12 months to 30 April 2006 and 30 April 2007 which are £1,122,818 and £1,074,151 respectively. The figures he has calculated however are on the basis of Direct Calculation Scheme 1. On the basis of those figures which we accept, and on the basis of the level of turnover generally, we find that the appellant was not entitled to use Direct Calculation Scheme 1 during the periods assessed. We have carried out our

own exercise using Mr Buckley's figures for Apportionment Scheme 1. For the same periods the annual turnover figures exclusive of VAT are £1,115,005 and £1,066,642. On the basis of those figures and on the basis of the level of turnover generally we find that the appellant was not entitled to use Apportionment Scheme 1 during the periods assessed. Indeed it was accepted at the hearing that the turnover threshold had been breached for both schemes.

43. In the circumstances the appellant was "ineligible" (in the terminology employed by Notice 727) to use Apportionment Scheme 1, at least during the periods assessed. An issue then arises as to the effect of a trader purporting to use a retail scheme which he was not eligible to use and further incorrectly implementing the scheme in any event. In those circumstances, HMRC would be entitled to make an assessment to make good any tax loss if they considered that the returns were incorrect. Similarly, a trader could make a voluntary disclosure if he considered that the returns were incorrect and that he had overpaid tax. In the present case that is what has happened. However we have to consider whether the assessments and the voluntary disclosure have been made on an appropriate basis.

44. HMRC have sought to assess the tax by reference to Apportionment Scheme 1. The question which arises is whether they should recalculate the tax due by reference to the retail scheme the trader was intending to use, even if the trader was ineligible to use that scheme? Alternatively whether they should ignore the scheme that the trader was intending to use and make a best judgement assessment based on all the evidence available. In the present case HMRC have done the former. We do not consider that in circumstances such as this HMRC would have a choice, effectively depending on which gave the better outcome. That would be inconsistent with the principle of legal certainty. Nor, to be fair, do HMRC argue that they have such a choice. They say that where a trader is intending to use a particular retail scheme they are entitled to ensure the correct application of that scheme. In our view that would not be controversial in circumstances where the trader was eligible to use the particular retail scheme. However as a matter of law if a trader is ineligible to use a particular scheme he must cease to use that scheme (*Paragraph 4.2 Notice 727*). In the light of that provision we consider that HMRC are not entitled to assess by reference to a scheme used or intended to be used where the trader is not eligible to use that scheme. In those circumstances the assessment ought to be made by reference to best judgement generally, in other words what approach gives the best estimate of the output tax due.

45. The whole purpose of the retail schemes is to provide an estimate of the output tax of a retailer selling goods at different rates of tax. HMRC assessed using Apportionment Scheme 1 without apparently appreciating that the turnover limit had been exceeded for the periods in question. In those circumstances HMRC are entitled to reach a judgement as to what is the best estimate of the output tax due. That must involve looking at all the available evidence. In the ordinary course they might be expected to adopt the retail scheme which in their judgement gave the best estimate. Such an approach does not amount to HMRC simply choosing the retail scheme which they think most appropriate as the appellant suggests. Depending on the facts it may be necessary to vary a retail scheme in order to arrive at the best estimate. Indeed it may well be appropriate, depending on the facts, to ignore the turnover limits in the

published scheme. The purpose of the process in these circumstances is to arrive at the best estimate of the tax due, not simply to apply one or other of the retail schemes.

46. For the same reasons we reject Mr Patel's submission that it is open to the appellant in these circumstances to insist upon a particular retail scheme being used for the purposes of assessment and/or a voluntary disclosure. The appellant is in the same position as HMRC. He is entitled to put forward what he considers to be the best method of calculating the output tax due. As indicated above, that may be by reference to a particular retail scheme as published or with variations depending on the facts of the case and the evidence available.

47. It is notable that Notice 727/4 itself recognises that where a trader achieves a higher mark up on zero rated goods Apportionment Scheme 1 gives rise to more output tax than other schemes (*Paragraph 3.1.1*). In principle, Direct Calculation Scheme 1 would appear to give a fairer result to a trader in the position of the appellant. The evidence was, and we accept, that the mark up on standard rated goods, principally fuel sales, was much lower than the mark up on zero rated goods such as sandwiches and groceries. However the appellant could not have used Direct Calculation Scheme 1 because he exceeded the turnover limit. As we have said, however, for the purposes of identifying the correct amount of tax it may be appropriate to ignore that limitation because in challenging the assessment and/or a voluntary disclosure it is not simply a question of applying a retail scheme, rather it is a question of identifying whether the assessment is excessive or whether the return overstates the amount of tax due.

48. This is not a situation where a trader is seeking to retrospectively change the scheme being used. Rather he is seeking to identify the output tax chargeable where he has made incorrect VAT returns. In the circumstances no question arises as to whether the appellant should be entitled to make a retrospective change to the retail scheme which was used. In any event, the appellant is seeking to use Direct Calculation Scheme 1 for which he was ineligible and it is difficult to see how a refusal in those circumstances could ever be unreasonable.

Conclusion

49. The burden is on the appellant to satisfy us that the assessments are excessive and should be reduced. On the basis of the evidence as to the mark up on zero rated and standard rated sales we are satisfied that the assessments are excessive. In principle, therefore, we allow the appeal against the assessments.

50. Both parties accepted during the course of the appeal that Mr Buckley had not had an opportunity to verify the basis of Mr Patel's calculations using Direct Calculation Scheme 1. In particular, the mark ups used for different categories of zero rated goods and the proportion of sales within those categories. Mr Patel himself did not produce evidence to the Tribunal which would enable us to form any view on the reliability of those calculations. In those circumstances we are not in a position to make any decision on the quantum of the assessment or on the appeal against the voluntary disclosure. It seems to us that the question of quantum and the appeal

against the voluntary disclosure are all part and parcel of the same issue, namely what is the correct amount of output tax for which the appellant ought to account.

51. It may be, and we express no view on this, that there is another method which could be used on the basis of the available records to give a fairer result than Apportionment Scheme 1 or Direct Calculation Scheme 1. It will be necessary for the parties to consider in the light of this decision and on the basis of the records and explanations available what calculation gives the best estimate of output tax. If no agreement is possible, the matter can be restored to the Tribunal for a further hearing on the issue of the quantum of the assessments and, if appropriate, the appeal against the voluntary disclosure.

52. We invite the parties to agree directions in relation to the issue of quantum and the voluntary disclosure. In the absence of agreement either party can apply to the Tribunal for directions.

53. 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.

TRIBUNAL JUDGE
RELEASE DATE: 2 March 2012