"Traders could sting HMRC for lost profits"
by Greg Lacey

In its recent attempts to stamp out fraud in the mobile phone/CPU trading sector, HMRC's actions could end up costing the Treasury more than the revenue it hopes to save should one route for remedy prove successful. Greg Lacey of FAR Consulting explains how this potential irony may occur…

Recent articles have claimed that VAT Carousel Fraud cost the UK Exchequer over £1.9 billion in 2005, and the problem is now so severe that it is distorting the UK's trade figures. As part of an attempt to combat the scale of the fraud, HMRC has recently withheld VAT repayments to undertake "extended verification" of deals entered into.

However, suspicions must be that HMRC is simply seeking to slow the amount of trading by reducing demand in the market so less VAT will be lost to fraud this fiscal year. Put another way; stop trading for six months and HMRC will be able to report to parliament that they have saved one half of the estimated £1.9 billion lost annually. With this goal in mind, HMRC's objective in carrying out its "extended verification" might simply be to delay the repayment of VAT as long as possible.

Effect of HMRC's actions

Whilst good intentions lay behind the approach, HMRC's actions have also penalised legitimate traders. A lack of information from HMRC has exacerbated the problem as many traders who have had VAT withheld since May or June 2006, still do not know how long the "extended verification" will last, and when, if at all, any repayments will be forthcoming.

VAT repayments are essential to many, if not all, companies within this sector who rely on regular repayments to fund ongoing business. This is particularly the case for traders involved in exporting. Consequently many companies have been starved of their funding and as a result have "temporarily" ceased trading. Many have been forced to reduce costs, including making staff redundant, have had subsidiary businesses affected and ultimately have had to consider exiting the sector.

With seemingly no end in sight, many companies may have to cease trading permanently and administration/insolvency is now a very real concern. All of this is relevant when considering potential remedies.

Potential remedies and recovery of damages

Rather than sit and wait for the inevitable, some traders are actively seeking to get their VAT repaid. Through applications made under the Freedom of Information Act some have sought to expose information that will embarrass HMRC into making concessions. Another route is to apply for a Judicial Review of HMRC's actions.

One of the benefits of the Judicial Review approach is that it enables traders to seek to claim the lost profits which they might have made had HMRC not withheld VAT.

Making a successful claim for damages under Judicial Review

When assessing the level of damages the Courts have found that it is often invaluable to have an independent accountant's report to help demonstrate what, if any, losses have been suffered by the party seeking Judicial Review.

In the case of traders, to establish a claim it will first be necessary to have accounting input in examining a company's "working capital" (or funding), in order to demonstrate that it was the withholding of VAT that prevented further trading. As most traders utilise all available cash to fund the VAT paid up front to suppliers, it should not be too difficult for a specialist forensic accountant to demonstrate this to be the case.

To then assess the losses suffered by traders, it is necessary to consider how the company would have traded had it continued to receive regular VAT repayments alongside its current actual position having had VAT withheld.

Typically, companies that have not traded for four or five months, because VAT was withheld, can look to claim for the loss of profit to date. Such losses can be assessed on the basis of past trading. Providing that there is adequate supporting documentation it may also be possible to claim any additional costs that have been incurred, including the professional fees involved in dealing with the problem.

However, by far and away the largest element of these claims is likely to be the future losses a company will suffer should it be forced to cease trading or even to exit the sector. In our experience, such claims can far exceed the value of profits lost to date as the future losses reflect the profits that the company would have generated for the foreseeable future. This can include profits that any dependent subsidiary companies may have expected to earn. If a company ceases trading or exits the sector, the consequential loss of profits could be ten times the annual profits generated.

Therefore, with so many companies affected by HMRC's recent actions, it is easy to see that if these claims are successful the Treasury will have to find the funding to meet these payments, which, across the sector as a whole, could reach billions.

Conclusion

With these claims lies a potential future embarrassment for the Treasury. If traders are successful in bringing claims against HMRC, the Treasury could end up having to pay out compensation to legitimate traders which could be on the same scale as the VAT that HMRC might claim to have saved (i.e. the half of £1.9 billion referred to earlier). For the Treasury therefore, it could be that a short term gain will come at considerable cost over the longer term.

This is of little concern to the traders affected who just want to continue going about their legitimate business. With that in mind, if nothing else, serving notice on HMRC of an assessment of the potential losses that will be suffered if a company ceases trading should provide some motivation to speed up the release of VAT currently being withheld. Or at the very least should go some way to ensuring a company's file is moved to the front of the queue.