HMRC - VATSC99100 - Illegal Supplies: Basic Principles

Illegal supplies do not automatically fall outside the scope of sections 4 and 5 of the VAT Act 1994: see the case of Oliver at VATSC04100. The European Court has stated that such supplies fall outside the scope of VAT only if the concept of fiscal neutrality is not compromised. The leading case is Witzemann v Hauptzollamt [1993] STC 108.

In finding that the supply of counterfeit money fell outside the scope of Article 2(1) of the Sixth VAT Directive (now Article 2(1) of the Principal VAT Directive) the Advocate General stated:

Illegality manifests itself in many forms and there are many products that either cannot be lawfully traded or trade which is subject to certain restrictions: drugs, counterfeit money, weapons, pornography, the pelts of certain animals, stolen goods and so forth. Not every transaction tainted with illegality will be exempt from taxation. A line must be drawn between, on the one hand, transactions that lie so clearly outside the sphere of legitimate economic activity that, instead of being taxed, they can only be the subject of criminal prosecution and, on the other hand, transactions which, though unlawful, must none the less be taxed, if only for the sake of ensuring, in the name of fiscal neutrality, that the criminal is not treated more favourably than the legitimate trader.

This statement indicates that it is only those activities which are illegal throughout the European Community, and which would not result in a distortion of trade, which fall outside the scope of VAT. The sale of stolen vehicles, for example, is seen to be a supply, because otherwise legitimate car dealers would be disadvantaged.

However, the sale of heroin by street dealers falls outside the scope of VAT as there is a universal prohibition on its sale (except for strictly controlled purposes such as medicine). By treating the supply in this manner there would be no distortion of trade.

National courts must therefore follow the principles established by the ECJ in this area of the tax and, in particular, take into account the intra-community dimension.

Polok

The UK High Court judgment in the case of R&J Polok, t/a Supreme Escorts [2002] STC 361, provides useful guidelines.

Mr and Mrs Polok ran an escort agency that supplied clients with the company of both female and male escorts. The question was whether they acted as an agent or principal for VAT purposes. However, the Tribunal widened the issues and looked into the nature of the escorts’ activities - a point neither side had raised. Because evidence indicated that the escorts provided sexual services, the Tribunal held the Poloks supplied procurement services that were illegal under the Sexual Offences Act 1956 - consequently, it concluded that their services were wholly outside the scope of the tax.

The High Court overruled the Tribunal’s decision on this, finding it had erred in its application of European Court precedent. Before holding the Poloks’ procurement services to be outside the scope of VAT, the Tribunal should have established that such services are prohibited in all the Member States and that they are so inherently illegal that they fall outside all normal commercial activity. It had failed on both these points. It also failed to take into account the fact that the provision of escorts is in itself a lawful and autonomous activity. The Poloks’ services therefore properly fell within the VAT net. To treat them otherwise would give a competitive advantage over escort and introductory agencies that did not provide sexual services.

This decision is valuable in emphasising that national courts must be careful about too readily giving “illegal”, non-taxable, status to supplies - it is only in the very rarest of cases that activities can be removed from the normal VAT provisions because of their illegality.

The above are situations where the normal VAT approach to supplies is complicated by issues of illegality or accident.

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