TC02611

Appeal number: TC/2012/08549

VAT– PENALTY – ***Failure to notify liability for VAT – Non deliberate – Penalty at 10 per cent of VAT liability – Special reduction – Penalty reduced to nil – Appeal allowed***

FIRST-TIER TRIBUNAL
TAX CHAMBER

JAMES HILLIS **Appellant**

- and -

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

TRIBUNAL: JUDGE MICHAEL TILDESLEY OBE
JOHN ADRAIN FCA

Sitting in public at Tribunals Unit, 3rd Floor Bedford House, 16-22 Bedford Street, Belfast BT2 7DS on 12 December 2012

The Appellant appeared in person

Mrs Sharon Spence of the Appeals and Review Unit for HMRC

DECISION

The Appeal

1. The Appellant appealed against a penalty assessment in the sum of £5,055 dated 11 July 2012 for a failure to notify liability to register for VAT pursuant to schedule 41, Finance Act 2008. The penalty was subsequently reduced to £2,502.

2. Having heard from the Appellant in person and Mrs Sharon Spence of the Appeals and Review Unit for HMRC the Tribunal announced its decision which was that

(1) The strict application of schedule 41 of the Finance Act 2008 to the circumstances of this Appeal produced a result that was contrary to the clear compliance intention of schedule 41.

(2) Given its finding in paragraph 1 above the Tribunal decided that special circumstances applied which justify a special reduction of the penalty to nil in accordance with paragraph 14 of schedule 41.

(3) The Tribunal substituted the penalty of £2,502 with a penalty of nil amount, and allowed the Appeal.

3. On 13 December 2012 HMRC applied for a fully reasoned judgment detailing the decision of the Tribunal.

The Facts

4. The Appellant was a solicitor operating as sole practitioner specialising as a criminal legal aid advocate. The Appellant had set up his practice in October 2009 after being made redundant by his previous employers in September 2009. The Appellant had decided to set up on his own because at that time there were no legal jobs to be found following the collapse of the property market.

5. The Appellant's redundancy payment was put into his new venture which took six weeks to set up and involved the conversion of a disused barber shop into a modest solicitor's office comprising one interview room, one waiting room and a reception area. He employed two part-time members of staff to handle the administration. The Appellant had no working capital for the business and was dependent upon an agreed overdraft of £30,000 with his bank.

6. The Appellant registered with the Legal Services Commission in order to take legal aid work. He also took advice from a recognised accountant about the financial records for the business. The Appellant was advised by various persons that he was unlikely to break even for the first year, and that the likelihood of his business passing the VAT registration threshold was remote. The Appellant did not charge VAT on his invoices for services.

7. The Appellant worked all hours to make his business a success. By the end of his first financial year as at 31 July 2010 the business had become established. He

received no indication from his accountant at that time of the need to consider registering for VAT. The Appellant had assumed that the VAT registration threshold was calculated on a financial year basis, and had monitored the VAT position on that understanding.

8. Around May/June 2011 the Appellant's business was subjected to a routine audit by the Law Society. Following which the Appellant was advised that he should have been monitoring the VAT on a rolling year not a financial year basis. Further he had breached the VAT threshold in September 2010 which gave an effective date of registration of 1 November 2010.

9. The Appellant immediately instructed his accountants to calculate the VAT liability which was in the region of £25,000. The Appellant was advised that he should have the funds ready to pay the outstanding VAT when he informed HMRC of his error. The Appellant was not a person of means. His parents were working class people who did not have the wherewithal to lend their son that sum of money. The Appellant's bank would not extend the overdraft limit. The Appellant's only course was to approach the Legal Services Commission to enquire whether it would meet the output tax liability on the Appellant's invoices. The Appellant understood that the Commission would entertain retrospective claims of this type if it was satisfied that the claim was occasioned by genuine error. Unfortunately the Legal Services Commission took a protracted length of time to meet the claim, despite the Appellant's efforts to speed up the decision making process.

10. As soon as the Appellant received the lump sum payment of £18,000 from the Legal Services Commission, he registered for VAT and paid over the £18,000 to HMRC. The Appellant had to find a further £7,000 from his own resources to meet the VAT liability arising from his failure to register on time. The Appellant's application for registration was made online on 1 December 2011 in which he declared that his taxable supplies had exceeded the registration limit during September 2010.

11. On 12 March 2012 HMRC advised the Appellant of his liability to a penalty and requested that he complete a questionnaire. The Appellant's business premises was burgled and in a separate incident a member of his staff was dismissed which resulted in a delay with the return of the questionnaire. On 2 August 2012 the Appellant declared a net amount of tax due of £25,025.

12. On 14 August 2012 HMRC issued a penalty of £4,754 (19 per cent of the potential lost revenue) which was upheld on review. On 12 November 2012 HMRC reduced the penalty to £2,502 which constituted 10 per cent of the potential lost revenue and the minimum penalty as permitted by the legislation for late notifications of more than 12 months.

13. HMRC also considered whether there was any reason to apply a further reduction under paragraph 14(1), schedule 41 of the Finance Act 2008. HMRC restricted its consideration to the delay experienced by the Appellant in recouping the outstanding VAT from the Legal Services Commission. HMRC concluded that the

circumstances surrounding the Appellant's dealings with the Legal Services Commission and the immediate payment of £18,000 to HMRC did not justify a special reduction because they were not relevant to why the penalty was imposed.

The Law

14. Schedule 41 of the Finance Act 2008 introduced a new penalty regime for failures to comply with obligations to notify liability under various Taxes Acts, which included notification of liability to register for VAT.

15. Paragraph 5 of schedule 41 defines degrees of culpability for failures to comply with obligations, and refers to "deliberate and concealed", and "deliberate but not concealed". Paragraph 6 sets outs the penalties for failures to notify which depends upon the degree of culpability. In respect of a failure to notify liability for VAT registration the penalties are as follows:

(1) 100 per cent of the potential lost revenue for a deliberate and concealed act or failure.

(2) 70 per cent of the potential lost revenue for a deliberate but not concealed act or failure.

(3) 30 per cent of the potential lost revenue for any other case.

16. Paragraphs 12 and 13 of schedule 41 provide for reduction of the penalties where the tax payer discloses a relevant act or failure. Paragraph 12 distinguishes between unprompted and prompted disclosures. Paragraphs 13(3)(a) and 13(3)(b) are of relevance to this Appeal. They give discretion to reduce the 30 per cent penalty for any other case to a specified minimum for disclosures. Thus where HMRC becomes aware of the failure to notify VAT registration less than 12 months after when the tax first becomes unpaid by reason of the failure, the specified minimum is ten per cent for prompted disclosure and nil per cent for unprompted disclosure. Where HMRC becomes aware of the failure 12 months or after when the tax first becomes unpaid the specified minimum is increased to 20 per cent for prompted disclosure and 10 per cent for unprompted disclosure.

17. Paragraph 14 of schedule 41 enables HMRC to reduce a penalty generally if HMRC thinks it right because of special circumstances. Paragraph 14(2) states that special circumstances do not include ability to pay or the fact that a potential loss of revenue from one tax payer is balanced by a potential over payment by another.

18. Paragraph 20 of schedule 41 provides that liability to a penalty in the case of a non-deliberate failure does not arise if there is a reasonable excuse for the act or failure. Paragraph 20(2) sets out circumstances, such as insufficiency of funds not attributable to events outside the taxpayers control, which cannot constitute a reasonable excuse.

19. Paragraphs 17 -19 of schedule 41 deal with the rights of Appeal and the Tribunal's powers. Under paragraph 19(2) the Tribunal may on an appeal against the amount of a penalty affirm HMRC's decision or substitute for HMRC's decision

another decision that HMRC had power to make. In respect of the substitution the Tribunal may rely on special circumstances but only if the Tribunal thinks that HMRC's decision on the application of special circumstances is flawed. Paragraph 19(4) defines flawed as flawed when considered in the light of the principles applicable in proceedings for judicial review.

Reasons

20. HMRC accepted that the Appellant's failure to register for VAT was non-deliberate and that he had made an unprompted disclosure of his default. The penalty for a non-deliberate failure is fixed at 30 per cent of the potential lost revenue which can be reduced by the quality of the disclosure to no less than 10 per cent for failures where HMRC only become aware of the unpaid tax after 12 months or more.

21. In this Appeal HMRC had eventually reduced the penalty to 10 per cent, the minimum possible for unprompted disclosures where the failure to notify was 12 months or more late. The issues, therefore, were whether there was a reasonable excuse for the failure or special circumstances justifying a further reduction in the penalty.

22. The Appellant did not advance a reasonable excuse for his failure. In any event the Tribunal considers that his reason for not complying with the obligation to register arose from an honest misunderstanding of the statutory requirements. In the Tribunal's view an honest mistake on the law is not sufficient to constitute a reasonable excuse. The Appellant argued that there were special circumstances which merited a lowering of the 10 per cent threshold.

23. Schedule 41 of the 2008 Act provides no definition of special circumstances. The Act, however, states that ability to pay and the fact that a potential loss of revenue from one person is balanced by a potential overpayment to another cannot amount to special circumstances. HMRC's policy defines special circumstances as either uncommon or exceptional or where the strict application of the penalty law produces a result that is contrary to the clear compliance intention of the law. The FT Tribunal in *Collis v HMRC* [2011] UKFTT 588 (TC) ruled that the circumstance in question must operate on the particular individual, and not be a mere general circumstance that applies to many taxpayers by virtue of the scheme of the provisions themselves.

24. The Tribunal is satisfied that HMRC's decision on special circumstances in this Appeal was flawed in that HMRC did not consider whether the penalty met the clear compliance intention of the law having regard to the Appellant's individual circumstances.

25. The Tribunal considers the penalty regime under schedule 41 is primarily directed at tax payers who deliberately avoid their responsibilities to notify HMRC of their obligation to pay tax. The penalty regime is not intended for tax payers who make a genuine mistake on their liability and disclose their mistake to HMRC. This intention can be discerned from the wording of the legislation which enables a reduction of the penalty to a nil amount where the notification of liability is made

within 12 months and the availability of a reasonable excuse for non-deliberate failures.

26. The report on proceedings of the HC Committee stage of the Finance Bill 2008[1] emphasised that tax payers who have made genuine mistakes should not be deterred by fear of penalties from coming forward and regularising their affairs. Further the 12 month threshold for unprompted disclosures whilst introducing certainty was not set in stone. The HC Committee envisaged that there would be a margin of appreciation for those taxpayers outside the 12 month limit who have made an honest mistake, albeit in the form of a reasonable excuse. The Tribunal considers that the HC Committee's reference to a reasonable excuse encompassed special circumstances, particularly as an honest mistake on the law could not as a rule constituted a reasonable excuse.

27. The Tribunal finds the following in relation to the Appellant's default:

(1) The Appellant set up his solicitors' practice on 1 October 2009, which was his first business venture as a sole practitioner.

(2) The Appellant made a genuine mistake in relation to his obligation to register for VAT.

(3) The Appellant made an unprompted disclosure to HMRC of his failure to notify and a full declaration of the outstanding tax liability.

(4) The Appellant's effective date of registration was 1 November 2010.

(5) The disclosure was made on 1 December 2011 which was one month outside the 12 month threshold for consideration of a nil penalty, and within the margin of appreciation.

(6) The Appellant has discharged his outstanding tax liability of £25,025, of which he could only recover about £18,000 from his clients via the Legal Services Commission.

(7) The Appellant has in effect received a penalty of £7,000 for his failure to notify.

Decision

28. Having regard to the legislative intention and the above findings, the Tribunal is satisfied that the imposition of a penalty for the Appellant's failure produced a result that was contrary to the clear compliance intention of the penalty regime. The Tribunal, therefore, finds that special circumstances applied which justified a special reduction of the penalty to nil.

29. The Tribunal allows the Appeal and substitutes a penalty of £2,502 with a penalty of nil amount.

[1] See Appendix 1.

30. 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 TILDESLEY OBE
TRIBUNAL JUDGE

RELEASE DATE: 26 March 2013

APPENDIX ONE: THURSDAY 12 June 2008 PUBLIC BILL COMMITTEE

Schedule 41

PENALTIES: FAILURE TO NOTIFY AND CERTAIN VAT AND EXCISE WRONGDOING

Mr. Gauke: I beg to move amendment No. 303, in schedule 41, page 404, line 32, after 'failure,', insert

'or (if later) within one month after the time when the person first becomes aware of the failure,'.

The Chairman: With this it will be convenient to discuss amendment No. 304, in schedule 41, page 406, line 11, at end insert—

'Suspension

16A (1) HMRC may suspend all or part of a penalty under paragraph 1 for an act or failure that is neither deliberate nor concealed by notice in writing to P.

(2) A notice must specify—

(a) what part of the penalty is to be suspended;

(b) a period of suspension not exceeding two years; and

(c) conditions of suspension to be complied with by P.

(3) HMRC may suspend all or part of a penalty only if compliance with a condition of suspension would help P to avoid becoming liable to further penalties under—

(a) paragraph 1 for any act or failure that is neither deliberate nor concealed; or

(b) paragraph 1 of Schedule 24 to the Finance Act 2007 for careless inaccuracy.

(4) A condition of suspension may specify—

(a) action to be taken, and

(b) a period within which it must be taken.

(5) On the expiry of the period of suspension—

(a) if P satisfies HMRC that the conditions of suspension have been complied with, the suspended penalty or part is cancelled, and

(b) otherwise, the suspended penalty or part becomes payable.

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(6) If, during the period of suspension of all or part of a penalty under paragraph 1, P becomes liable for any other penalty, the suspended penalty or part becomes payable.'.

The Chairman: I call David Gauke again.

Mr. Gauke: Thank you, Sir Nicholas, again. *[Laughter.]* May I say how pleased I am to learn that Government Back Benchers are paying such close attention and I shall see what I can do about it.

Amendment Nos. 303 and 304 relate to penalties for non-deliberate failure to notify. It might be worth making a general point about the policy because in their approach to enforcement and penalties the Government will want people to come back into the system. When people have erred and particularly where they have not deliberately erred but found that through some mistake they are in breach of the tax law and regulations, the Government will rightly want to ensure that they comply in future. The system has its deterrents and its punishments but the desire rightly must be to ensure that those taxpayers comply in future and that they regularise their arrangements. With regard to both of these amendments we must bear in mind

whether the Government has quite got the balance right. That is the point that we are testing.

On amendment No. 303, in the proposals for late notification penalties, the penalty chargeable to a person whose failure to notify is not deliberate will normally be 30 per cent. of the potential lost revenue but can be reduced for an unprompted disclosure. The reduction will normally be to 10 per cent. of the potential lost revenue but can be greater, even to nil per cent. if HMRC is told about the failure within 12 months. This point is made by the Low Incomes Tax Reform Group—there are many unrepresented taxpayers who simply do not know that they need to notify HMRC of something and their non-culpable failure can go undetected for many years. When eventually they find out and notify HMRC, compliance officers have hitherto been empowered to agree a nil penalty. The LITRG says, however, that that will no longer be the case under these proposals. Consequently, the purpose of amendment No. 303 is to enable a reduced or nil penalty to be charged where HMRC is first told of the failure within 12 months of it occurring or within 12 months of the taxpayer first becoming aware of it, whichever is later.

There is a precedent for that within the tax credits system where a claimant is obliged to notify HMRC of a change of circumstances within one month of the change or one month of the claimant first becoming aware of it. Under the penalties proposals in schedule 41, there is scope for a nil penalty in special circumstances where the taxpayer has a reasonable excuse for not informing HMRC. However, the view of the LITRG—an organisation that has considerable experience in the sector—is that trying to persuade HMRC that the unrepresented taxpayer has a reasonable excuse is often a hopeless task. The amendment would therefore give greater certainty to the taxpayer and preserve the status quo.

Amendment No. 304 introduces a suspension regime in the context of these non-deliberate failures to notify. A key feature of the new penalty regime as a whole is the provision of penalties for failure to notify as a result of carelessness. We suggest that such penalties could be suspended for up to two years, because if a

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taxpayer has merely been careless, they should be encouraged to comply with the rules in future. The schedule 24 position can be distinguished from what we are talking about because HMRC argues that suspension is about curing systemic failures, to which schedule 24 relates, and it could be argued that a failure to notify is a one-off failure rather than a systemic problem, so suspension is not appropriate. To some extent, I am anticipating the argument that the Financial Secretary might make, but we point out that if the Government's aim is to get people to comply and to keep complying, it would fit well into the framework to have a two-year suspension of penalties for careless failure to notify, on the condition that accurate tax returns were submitted on time in that period.

Such a requirement would be as measurable as any other criterion used for suspension and would give exactly the incentive that HMRC seeks to get taxpayers to operate properly. Without it, the incentive is for taxpayers to stay outside the system in the black economy. That is the thinking behind both of our amendments. The Low Incomes Tax Reform Group and the Chartered Institute of Taxation have made sensible representations to us on the issue, and we would be grateful if the Government closely considered the proposals.

Jane Kennedy: To prevent penalties from becoming a barrier to people coming forward when things have gone wrong, there are substantial reductions in penalties for disclosure by taxpayers. Paragraph 13(5) of schedule 41 says that if a person comes forward unprompted within 12 months of tax becoming unpaid as a result of a failure to notify, the penalty may be reduced to nil. That involves a date that is identifiable to the taxpayer, their advisers and HMRC, and it provides clarity on how long the additional reduction will apply. That is important to encourage people to come forward to HMRC early, and was amended in line with suggestions that were made during consultation. It means that someone who starts a business in one year and delays going to an accountant to sort out their tax until just before the following 31 January deadline—I can imagine that all the work of setting up in business could, on occasion, lead to that happening—would still be able to escape a penalty.

The hon. Gentleman says that he has heard representations that it is a "hopeless task"—that phrase was used—trying to persuade HMRC of a reasonable excuse. HMRC has made it clear that a person who had reasonable grounds for believing that an obligation to notify did not arise will have a reasonable excuse. That and other matters of interpretation will be published in HMRC guidance. If there are clear examples of HMRC not applying that, I will be happy to consider the examples. Let me give a few examples of what might constitute a reasonable excuse, but this is not an exclusive list: compassionate circumstances, such as serious illness, at the time when notification was required; doubt about whether an activity is taxable; and uncertainty about employment status when there is genuine doubt as to whether a person is self-employed.

A fundamental problem with the alternative proposed in amendment No. 303 is that it will be difficult to ascertain, in any verifiable way, when the taxpayer became aware of the failure. Where a taxpayer has a

reasonable belief that an obligation to notify did not arise, they will not be charged a penalty. That will be so even if HMRC, or a tribunal, subsequently determines that the activity is taxable—an important safeguard for taxpayers.

10.15 am

An example is a case in which where there is genuine uncertainty about whether there is an obligation to provide notification. Someone may consider all the facts, take advice and conclude that their activity is not taxable. I think of my dad, who is an avid collector of small die-cast models of diesel trucks. He goes to events called swap meets, which other avid collectors of diesel trucks attend, and they swap trucks. The value of those items depends on the condition of the box as much as the model being swapped. Small amounts of money are exchanged, and we would not want to catch people engaged in that kind of hobby, which may, or may not, be a trade. That is not quite an interest to declare, but my dad came to mind when I was thinking about the details of the measure.

The concept of reasonable excuse will address that type of situation, and HMRC will publish guidance to make that clear. That mirrors the principle that is applied to incorrect returns: if a mistake is made, despite reasonable care being taken, it should not be penalised. If the amendment were accepted it might be perceived as unfair to the compliant majority who come forward to register and pay tax that is due on time.

With no clear downside for those who fail to do so, compliant taxpayers may lose confidence in the fairness of the system.

Mr. Mark Field (Cities of London and Westminster) (Con): I listened with interest to what the Minister said, particularly the example that she gave. The Opposition are concerned that that the bar is set too high. The reality, as far as I can see, is that for anybody with any previous business experience—through incorporation, or trading as a sole trader and thus having dealings with tax officers—and for anybody who has ever taken professional advice from an accountant and so on, will almost certainly be unable to claim under these provisions. We are trying to capture, as it were, such individuals, who have made a genuine mistake, in our amendment.

Jane Kennedy: I accept the point that the hon. Gentleman has made, and I undertake to keep that particular provision under close review to make sure that it works as intended, in the event that we resist the amendment.

Amendment No. 304 seeks to provide the facility to suspend penalties for failures to notify that are "neither deliberate nor concealed". Conditions for suspension would be that a further failure to notify did not occur, and that a carelessly incorrect return should not be made for a period of up to two years. The suspension of penalties is an innovative aspect of the new penalties introduced for incorrect returns in the Finance Act 2007, which did a lot of good work. That is appropriate in the case of errors due to poor accounting or record-keeping systems. Conditions are set so that someone spends money to improve systems to prevent further inaccuracies, but the amendment seeks to apply similar

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provisions to the failure to notify penalties. However, there is an important difference, as HMRC believes that it would be unworkable. The obligation to notify a new taxable activity is a one-off, unlike submitting accurate returns, which is an ongoing requirement for most taxes.

It is hard to see what conditions could be set to help the taxpayer avoid a further penalty for failing to notify. The provision would be applicable only if they started another taxable activity requiring notification and, again, it is difficult to see how specific conditions could be set to help prevent them making an error in subsequent returns. It was suggested in the consultation that suspension of a failure to notify penalty should be made on the condition that routine tax obligations, such as filing returns and paying tax on time, are complied with for a period. That makes more sense, but there are still difficulties with that approach, not least because it could weaken and confuse the message that people must tell HMRC when they start a new taxable activity. Both amendments are unnecessary, particularly amendment No. 303. Amendment No. 304 is unworkable, so I suggest that neither amendment should be pressed further.

Mr. Gauke: I welcome the Financial Secretary's remarks about the concept of reasonable excuse. The term "hopeless task" was not mine, but was used by the low incomes tax reform group, which has a great deal of experience in this area. She made an interesting practical point about how HMRC would ascertain when somebody became aware, but again, I highlight the fact that the tax credit system permits that. She may have her own views about how that aspect of the tax credit system operates, but it does allow for that.