[2020] UKFTT 0098 (TC)

TC07592

VALUE ADDED TAX – default surcharge – whether a reasonable excuse – whether surcharges proportionate – appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

Appeal number: TC/2018/07136

BETWEEN

MILES WATER ENGINEERING LTD **Appellant**

-and-

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

TRIBUNAL: JUDGE GUY BRANNAN
MR JULIAN STAFFORD

Sitting in public at Norwich on 22 November 2019

Mr Giles Orford for the Appellant

Mr John, litigator of HM Revenue and Customs' Solicitor's Office, for the Respondents

DECISION

INTRODUCTION

1. This is an appeal against a VAT default surcharge for two VAT periods: 11/17 and 02/18 in the amounts of £14,337.18 and £10,950.27 respectively.

THE FACTS

2. The primary facts are not in dispute and are set out below.

3. Miles Water Engineering Ltd ("the Appellant") carries on the business of consultancy, design, build and renovation of water related projects. It registered for VAT in February 2013. It submits VAT returns and payments electronically pursuant to Regulation 25A Value Added Tax Regulations 1995.

4. The Appellant has been in the default surcharge regime since VAT period 02/14.

5. VAT period 02/14 had a due date for electronic VAT returns and payments of 7 April 2014. The VAT return was received before the due date on 4 April 2014. However, the Appellant's VAT payment reached HMRC after the due date on 17 June 2014. Accordingly, the Appellant entered the default surcharge regime and received a surcharge liability notice but did not suffer an actual surcharge.

6. Next, in relation to the VAT period 05/14, the VAT return was received on 27 June 2014, before the due date of 7 July 2014. The Appellant's VAT payment, however, was received by HMRC late on 25 September 2014. Consequently, a surcharge liability notice extension was issued at 2%.

7. The VAT period 08/14 had a due date of 7 October 2014 for electronic returns and payments. In this case, however, the VAT return was received late on 17 October 2014. The Appellant paid their VAT liability in three instalments. The first instalment was received on 6 November 2014 and the final payment was received on 7 January 2015. As a result of the late submission of the return and payments, a surcharge liability notice extension was issued at the rate of 5%.

8. Next, as regards VAT period 02/15, this had a due date of 7 April 2015 for submission of an electronic return and payment of VAT. Again, the Appellant paid their VAT by way of instalments. The first payment was received after the due date on 9 June 2015 and the final payment was received on 7 August 2015. This resulted in a surcharge liability notice extension being issued at the rate of 10%.

9. The VAT period 11/15 had a due date of 7 January 2016 for electronic returns and payments. The VAT return was received before the due date on 5 January 2016. The Appellant paid its VAT in four instalments: the first payment was received on 18 April 2016 and the final payment was received on 12 August 2016. Consequently, HMRC issued a surcharge liability notice extension at the rate of 15%.

10. In relation to VAT period 05/16, this had a due date of 7 July 2015 for electronic returns and payments. Both the return and the payment were late and a tax assessment and surcharge assessment were issued on 15 July 2016. The Appellant submitted its VAT return on 17 August 2016. The VAT was paid in three instalments: the first payment was received on 1 September 2016 and the final payment was received on 24 January 2017. On receipt of the VAT return the exact tax liability of the Appellant was established and a surcharge reduction notice was issued at 15% in the amount of £6220.69.

11. The VAT period 11/16 had a due date of 7 January 2017 for electronic returns and payments. The VAT return was received on 6 January 2017. The appellant paid its VAT liability by way of five instalments. The first instalment was received after the due date on 2 February 2017 and the final payment was received on 30 March 2017. Consequently, a surcharge liability notice extension was issued at the rate of 15%.

12. The VAT period 05/17 had a due date of 7 July 2017 for electronic returns and payments. The VAT return was received on the due date of 7 July 2017. Once again, the Appellant paid its VAT by way of two instalments. Both payments were received after the due date on 17 November 2017. As a result, a surcharge liability notice extension was issued at the rate of 15%.

13. In relation to VAT period 08/17, HMRC cancelled the default surcharge for this period by their letter of 6 December 2017. By a letter dated 27 October 2017, the Appellant requested a review of the default surcharge for VAT period 08/17. In their reply dated 6 December 2017, HMRC stressed the importance of "time to pay" arrangements being agreed in advance of the due date. Nonetheless, HMRC agreed to cancel the default surcharge for the period 08/17.

14. The two default surcharges which are the subject matter of this appeal relate to the VAT periods 11/17 and 02/18.

15. As regards the period 11/17, the due date for receipt of electronic returns and payments was 7 January 2018. The return was received one day late on 8 January 2018. The VAT payment was made in five instalments, the first payment being made on 7 February 2018 and the final payment being made on 18 May 2018. A surcharge liability extension notice was issued on 12 January 2018 at the rate of 15%, in the amount of £14,337.18

16. In relation to the VAT period 02/18, the due date for receipt of electronic returns and payments was 7 April 2018. The Appellant's VAT return was received on 5 April 2018. The Appellant's VAT payments were made in two instalments: the first payment was made late on 18 May 2018 and the balance was paid on 4 June 2018. A surcharge liability notice was issued on 13 April 2018 at the rate of 15% in the amount of £10,950.27.

17. It is not disputed that the Appellants did not make any "time to pay" arrangements (under section 108 Finance Act 2009). Furthermore, there was no dispute about the way in which the surcharge liability notices had been calculated or issued.

18. Mr Orford, a director of the Appellant, told us that after the business was set up in March 2013, the first year of trading did not go as expected and the business suffered serious cash flow problems.

19. In particular, the Appellant's first major project was as a subcontractor for a civil engineering firm. This contractor was, however, very difficult to deal with making a number of unreasonable demands and raising a number of issues. Consequently, the project did not return the expected cash flow and resulted in reduced profit margins. In fact, towards the end of the project the consequences became apparent – the Appellant was not paid its "retention money" until three years after completion. In the event, the contract cost the Appellant approximately £200,000. This meant that the Appellant was unable to pay its VAT liability on time, although did eventually pay it.

20. These cash flow difficulties had knock-on consequences in the next few years. Mr Orford did not realise that he could approach HMRC with a request for "time to pay". He felt that HMRC were at fault for not alerting him to this possibility which compounded the problems in the VAT period 08/14. He considered HMRC could have been more proactive in informing

him of options to prevent the escalating default surcharges. He noted, however, that "on the small print at the back of the HMRC letters there is some information about contacting them if in need of help."

21. In addition, in the first few years of the company's business, Mr Orford believed he was poorly advised by the Appellant's accountants who did not inform him of "time to pay" arrangements. He was now aware of the importance of filing the Appellant's VAT return on or ahead of time, thus enabling the option of a "time to pay" arrangement being established. That would have been important in the first critical year of trading, before the damage and spiralling consequences of the increasing rate of default surcharge reached almost unmanageable levels. By the end of 2014, Mr Orford understood the potential to apply for a payment plan, but significant damage had already been done by this point and the Appellant's ability to pay its VAT liability was significantly hampered.

22. Mr Orford considered that he had only two options: he could either wind up the business or continue to work through the problems despite the increased default surcharge burdens. The Appellant chose the latter course.

23. Mr Orford considered that the VAT surcharge system was counter-productive. There was a lack of discretion and the impact and amount of the default surcharges was disproportionate. There was no means-testing of the system so that a company such as the Appellant which was losing money in its early years still had to pay a large surcharge if it defaulted.

24. Mr Orford said that the Appellant was now up to date with its liabilities and the company was now successful. However, he criticised HMRC's default surcharge regime and compared it with payday lenders. He considered that HMRC had a duty of care in the way it enforced the system and that they had failed in this case. He asked for relief from the two surcharges under appeal because he wished to continue to build the Appellant's business.

25. In response to questions from the Tribunal, Mr Orford said that it was not possible for the Appellant to increase its working capital. He had spoken to various banks which refused to lend the Appellant money. Even when Mr Orford offered collateral, the bank said that the Appellant was not making enough profit regardless of the security. He had put considerable amount of his own money into the business because he did not want to leave other creditors in the lurch.

THE LAW

26. The VAT default surcharge regime is provided for by section 59 of the Value Added Tax Act 1994 ("VATA"). Under section 59(1) a taxable person is regarded as being in default if he fails to make his return for a VAT quarterly period by the due date or if he makes his return by that due date but does not pay by that due date the amount of VAT shown on the return. The Respondents may then serve a surcharge liability notice on the defaulting taxpayer, which brings him within the default surcharge regime so that any subsequent defaults within a specified period result in an assessment to a default surcharge at the prescribed percentage rate.

27. A taxpayer who is otherwise liable to a default surcharge may nevertheless escape liability if he can establish that he has a reasonable excuse for the return or the VAT not having been despatched in time (section 59(7) VATA). While HMRC must show that there has been a default giving rise to the surcharge assessed, the burden falls on the taxpayer to establish that it has a reasonable excuse.

28. Section 71(1)(a) VATA, however, provides that an insufficiency of funds to pay any VAT due is not a reasonable excuse for the purposes of section 59. The difficulty that a

taxpayer faces in this regard was expressed by Nolan LJ in *Commissioners of Customs and Excise v Salevon* [1989] STC 907 when he said at 911:

> "… the cases in which a trader with insufficient funds to pay the tax can successfully invoke the defence of "reasonable excuse" must be rare. That is because the scheme of collection which I have outlined involves at the outset the trader receiving (or at least being entitled to receive) from his customers the amount of tax which he must subsequently pay over to the commissioners. There is nothing in law to prevent him from mixing this money with the rest of the funds of his business and using it for normal business expenses (including the payment of input tax), and no doubt he has every commercial incentive to do so. The tax which he has collected represents, in substance, an interest-free loan from the commissioners. But by using it in his business he puts it at risk. If by doing so he loses it, and so cannot hand it over to the commissioners when the date of payment arrives, he will normally be hard put to it … to persuade the commissioners or the tribunal that he had a reasonable excuse for venturing and thus losing money destined for the Exchequer of which he was the temporary custodian."

29. Nevertheless, as this indicates, the taxpayer's task in this respect is not insurmountable: the underlying cause of the insufficiency of funds may itself provide a reasonable excuse. This appears from the decision of the Court of Appeal in *Customs and Excise Commissioners v Steptoe* [1992] STC 757.

30. The relevant facts of *Steptoe* appear in the decision of Scott LJ. Mr Steptoe was an electrical contractor who did 95 per cent of his work for the London Borough of Redbridge. The Redbridge Council was virtually his only customer and was an extremely slow payer. He was late in paying VAT in several quarters starting with that ending in November 1986 and continuing up to the end of November 1988. The VAT Tribunal concluded that the conduct of the Council was such that Mr Steptoe had a reasonable excuse for three of the four default surcharges that had been imposed but not the fourth because by the time that was incurred the Council had mended its ways and he could not rely on the excuse that in the fourth period his accountants were responsible for the delay.

31. Scott LJ nevertheless concluded that Mr Steptoe did not have a reasonable excuse because late payment was not an unforeseeable event in the conduct by the taxpayer of his business, such that the taxpayer should have made arrangements to secure his cash flow. If his profit margins were so slim or his financial circumstances such that was unable to secure his cash flow, he was nevertheless caught by what is now section 71(1)(a): "*The reason for the insufficiency of funds is, in such a case, itself an insufficiency of funds.*"

32. Scott LJ was, however, in a minority. Lord Donaldson MR, and Nolan LJ upheld the Tribunal's decision, which had concluded in favour of Mr Steptoe. In doing so Lord Donaldson MR summarised the different approaches of Scott and Nolan LJJ in these terms ([1992] STC 757 at 770):

> "The difficulty which then arises is that Parliament has not specified what underlying causes of an insufficiency of funds which lead to a default are to be regarded as reasonable or as not being reasonable. … Nolan LJ, as I read his judgment explaining and expanding on his judgment in *Customs and Excise Comrs v Salevon Ltd* [1989] STC 907, is saying that if the exercise of reasonable foresight and due diligence and a proper regard for the fact that the tax would become due on a particular date would not have avoided the insufficiency of funds which led to the default, then the taxpayer may well have a reasonable excuse for non-payment, but that excuse will be exhausted

> by the date on which such foresight, diligence and regard would have overcome the insufficiency of funds.
>
> Scott LJ on the other hand is of the opinion that the underlying cause of the insufficiency of funds must be an 'unforeseeable or inescapable event'. I have come to the conclusion that this is too narrow in that (a) it gives insufficient weight to the concept of reasonableness and (b) it treats foreseeability as relevant in its own right, whereas I think that 'foreseeability' or as I would say 'reasonable foreseeability' is only relevant in the context of whether the cash flow problem was 'inescapable' or, as I would say, 'reasonably avoidable'. It is more difficult to escape from the unforeseeable than from the foreseeable."

DECISION

33. It is not in dispute that the Appellant paid its VAT liabilities for the periods periods11/17 and 02/18 late. Nor is it disputed that the effect of previous defaults rendered the Appellant liable to a default surcharge at the rate of 15% in respect of those periods.

34. We sympathise with the cash flow problems that the Appellant suffered at the outset of its business. Nonetheless, it is important that taxpayers comply with their obligations to file their returns and pay their VAT on time.

35. In this case, problems arose in relation to the Appellant's first major contract which caused knock-on cash flow problems which the working capital position of the Appellant could not sustain. The cash flow problems from this first contract lasted well into 2015. The Appellant sustained a loss in the accounting year ended 31 December 2015 of £113,076.

36. Nonetheless, it seems to us that the continuing failure of the Appellant was due to its failure to approach HMRC for "time to pay" arrangements. As Mr Orford recognised, many of the notices which HMRC sent to the Appellant urged taxpayers in difficulties to speak to HMRC, but Mr Orford did not do this.

37. Accordingly, we consider that the Appellant has not established that it had a "reasonable excuse" for its failure to pay its VAT liabilities on time in the VAT periods 11/17 and 02/18.

38. As regards the Appellant's argument that the default surcharge regime is disproportionate, we do not consider that that argument can be sustained in the light of the decision of the Upper Tribunal (Rose J and Judge Berner) in *HMRC v Trinity Mirror* [2015] UKUT 421 (TCC). The Upper Tribunal said at [65]:

> "We agree with the tribunal in *Total Technology* that the default surcharge regime, viewed as a whole, is a rational scheme. The penalties are financial penalties, calculated by reference to the amount of tax unpaid at the due date. Although penalties may vary with the liability of the taxable person for the relevant VAT period, and increase commensurately with an increase in such liability (and, consequently, such default), the penalties are not entirely open-ended. The maximum liability for a fifth or subsequent period of default is 15% of the amount unpaid. In common with the Upper Tribunal in *Total Technology*, we consider that the use of the amount unpaid as the objective factor by which the amount of the surcharge varies is not a flaw in the system; to the contrary, the achievement of the aim of fiscal neutrality depends on the timely payment of the amount due, and that criterion is therefore an appropriate, if not the most appropriate, factor."

39. In view of this decision, it is not open for this Tribunal to hold that either the default surcharge system as a whole or its application in this case is disproportionate.

40. Accordingly, we dismiss this appeal.

RIGHT TO APPLY FOR PERMISSION TO APPEAL

41. 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.

GUY BRANNAN

TRIBUNAL JUDGE

RELEASE DATE: 18 FEBRUARY 2020