TC01941

Appeal number TC/2010/00382

CORPORATION TAX – voluntary disclosure giving rise to increased tax liability interest and penalties – managing director aware of fraud allegedly perpetrated by company secretary – withdrawal of profits treated as loans under s 419 ICTA 1988 – company properly assessed to tax – appeal dismissed

FIRST-TIER TRIBUNAL
TAX

T S D DESIGN DEVELOPMENT ENGINEERING LTD **Appellant**

- and -

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

TRIBUNAL: DAVID S PORTER (Judge]
SUSAN STOTT (Member)

Sitting in public at Alexandra House, Manchester on 26 March 2012

Mr T S Drzymalski, managing director, for the Appellant

Mr P O'Reilly, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. Mr Tadeusz Stefan Drzymalski (Mr Drzymalski) appeals on behalf of TSD Design Development Engineering Ltd (the Company) against an agreed assessment arising from omitted profits of £123,299 on the basis that such amounts had been extracted by the company secretary, Mrs Ryszaerda E Drzymalska, without either his or the Company's knowledge. As a result the Company had never received the money and ought not, therefore, to be taxed on it. Mr O'Reilly, on behalf of the Respondents (HMRC), considers that Mr Drzymalski was neglectful in the way he administered the Company, that he was aware of the extractions and did nothing to prevent them and that as a result HMRC took the view that either or both of Mr and Mrs Drzymalski had received the extracted monies and that £123,299 should be treated as loans to them from the Company and taxed accordingly.

Preliminary matter

2. Mr Drzymalski had asked the Tribunal to issue a Witness Summons to Mrs Drzymalska, as he wished to cross-examine her with regard to her activities within the company. The summons was issued on 16 March 2012. The summons was not issued more than 14 days before the hearing on 26 March 2012 and no reason was given for the shorter time scale as required by Rule 16 of the Tribunal Procedure (First-tier) (Tax Chamber) Rules 2009. This Tribunal can direct that the summons was correctly served. Messrs Kerwood, Solicitors, of 7, Church Road, Redditch, Worcestershire, responded on behalf of Mrs Drzymalska indicating that:-

> "… There is a considerable background to this matter in that it related to a substantial matrimonial dispute between their client and her ex-husband. She believes that he is only seeking to involve her in this appeal in order to pursue his obsessive allegation that she mis-managed the Company finances.
>
> Mr Drzymalksi has repeatedly made allegations which have been totally rejected by the Divorce Court at the Worcester County Court"

3. A copy of the Judgment of District Judge Mackenzie of November 2008 was enclosed, which sets out the position in detail and from which it is noted that Mr Drzymalski's allegations were totally rejected by the Court, who found that Mr Drzymalski had, himself, diverted the money from the Company and failed to declare it for tax purposes. Mr Drzymalski sought to appeal the Court's decision, which was rejected by His Honour Judge Mitchell at the Telford County Court. It appears that Mr Drzymalski has also involved the police, but having seen the judgment, no further action was taken by them.

4. The divorce proceedings were heard on the 26 and 27 November 2008. Mr Drzymalski had alleged that in excess of £300,000 had been withdrawn from the Company. As a result District Judge Mackenzie had required that Mr Drzymalski appoint forensic accountants. Alf Parc, a well known local forensic account used regularly by the Court, was appointed. He confirmed that at least £93,363 and may be more had been under declared. Mr Drzymalski indicated that £93,363 was much too

low, but either way District Judge Mackenzie considered it was "hard to imagine that there is the slightest scope for any successful appeal against the assessment". District Judge Mackenzie stated that he did not accept the explanations given by Mr Drzymalski. He stated at paragraph 22:-

> " 22. I find therefore that of the £93,000 odd indentified as being unaccounted for the majority (and I cannot be more precise than that) was retained for the Husband's own use. Some of it was clearly used outside the company accounts for normal joint purposes"

He went further, and at paragraph 45 (d) ordered:-

> " 45 (d) husband to pay a further lump sum to the wife equal to any liability that falls upon her arising out of the liquidation of TSD and/or tax liability arising there from".

In the light of the above we have decided that no useful purpose can be gained by hearing evidence from Mrs Drzymalska and that there is, therefore, no need for her to attend.

The Law

5. The legislation is as follows:

- Schedule 18 Part IV paragraph 24 Finance Act 1998 provides authority for HMRC to enquire into the TAX Returns of a company.

- Schedule 18 part v paragraph 41 Finance Act 1998 provides for the issue of an assessment where a loss of tax is discovered.

- Section 419 Income and Corporation Taxes Act 1988 (ICTA) provides:-

"..Where a close company, otherwise than in the ordinary course of business carried on by it…makes a loan or advances any money to an individual who is a participator in the company…there shall be due from the company, as if it were an amount of corporation tax chargeable on the Company for the accounting period in which the loan or advance is made, an amount equal to 25% of the amount of the loan or advance

- Section 417 ICTA 1988 identifies a shareholder as a participator

- Section 108 Taxes Management Act 1970 (TMA) requires everything to be done by a company under the Taxes Act shall be done by the company acting through the proper officers of the company

- Sections 10 (2), 96 (1), 109 (1) TMA dealt with penalties up to 1998 when schedule 18 Finance Act 1998 replaced the provisions.

- Schedule 18 part 11 Paragraph 8 Finance Act 1998 requires a return to include a calculation of the tax due which includes charges under section 419 above.

- Penalties can be determined by an officer of the board and they are tax geared by virtue of paragraph 20 Finance Act 1998

The Cases

6. HMRC referred us to the following cases:

- *Curtis (HM inspector of Taxes) v J & G Oldfield Limited* 9 TC 319 in which Mr Justice Rowlatt found, on appeal from the General Commissioners, that Mr Oldfield, before his death, was in control of the company and it had been found that £14,000 had passed through the company's account and the payment was to be treated as Mr Oldfield's money. The payment could not be treated as a bad debt as the payments were not for the purposes of the trade as it had been made with the full knowledge of Mr Oldfield as the proprietor of the business. The payment fell to be assessed on the company.

- *R v ICR Haulage* [1994] 1 All ER 691. A company can be guilty of negligence in failing to take adequate steps to prevent a loss being suffered by HMRC as a result of the actions of some of its directors or participators. This was even so where a majority of the shares were not held by the defaulting director and other directors were unaware of what was going on.

- *Stephens v Pittas Ltd* [1983] STC 576. Mr O'Reilly suggests that the case supports the view that a misappropriation treated as company income are regarded as a loan in respect of a debt incurred and therefore liable to a charge under what is now section 419 ICTA. That is not correct. The case held that in the absence of any consensus between Mr Pittas and the company, an outright misappropriation of the company's money by Mr Pittas could **not** be treated as the act of the company and accordingly could **not** amount to a loan or advance by the company to Mr Pittas. It appears that Mr Pittas received money from his nephew amounting to £15,000 over ten years which he duly repaid. He also received approximately £2000 from two employees which he treated as loans from them and repayable by him. It appears that many of his employees asked him to operate a savings club on their behalf, which he treated as loans and repaid in due course. Mr Goulding J on appeal from the Special Commissioners by HMRC held that the payments to Mr Pittas could not be considered as loans. He stated, however, that :-

> " …If it could truly be said that the company paid the money in question to Mr Pittas, then I think it might be possible to say that the company had advanced the money to him even if the payments were illegal under the Company Acts or a fraud on the minority shareholder….."

The Facts

7. We explained to Mr Drzymalski that this Tribunal was not prepared to re-hear any evidence which had been exhaustively heard by District Judge Mackenzie. This Tribunal was not an opportunity for him to have those matters re-considered. We understood that his appeal against the assessments was on the basis that the Company had not received any of the money and should not therefore be taxed on it. Mr Drzymalski and the new company secretary, Ms Beata Paw, had brought 5 bundles of evidence in addition to the 4 bundles produced by HMRC. We indicated that as the quantum of the assessments had been agreed with HMRC (and indeed increased by Ms Paw on the basis that Mr Parc's figures were too low) and used as evidence by Mr Drzymalski in the divorce proceedings, there was no prospect of the quantum of the assessments being amended. As he was representing himself, we were prepared to hear argument as to why he thought the Company should not pay the tax, although we were concerned that this should not result in an argument that his ex-wife should pay the assessment. Such a proposition would only arise if the Company were liquidated and HMRC decided to recover the amounts from the Directors. In light of Judge Mackenzie's order Mr Dryzmalski would have to pay the assessment in any event.

8. Mr Drzymalski produced documentation of all his contracts from 1987 to 2003. He told us that he was designer for the automobile industry. We note from the divorce proceedings that he admitted to earning £40,000 plus per annum and that he considered himself to be within the top 10 designers in Europe. We have no doubt of his designing abilities. He confirmed that he had worked for Mercedes, Audi and Bentley amongst others. We do not however accept that he had no mathematical skills. He has shown very complex drawings to the Tribunal, which demonstrated a substantial understanding of the mathematical stresses in vehicle design. The keeping of accounts, as effectively a sole trader, did not, in our view, require extensive mathematical skills beyond his comprehension.

9. Mr Drzymalski confirmed that he negotiated his fees with the various agents who instructed him to work for the motor companies. He accepted that he knew the gross amount but he said that he took no further interest in his financial affairs, which he left to his ex-wife and the Company's accountant. Even though he was a director and a shareholder in the Company, he did not believe that he needed to take any care personally or create systems, which would ensure that the Company's administration was carried out correctly. He denied any knowledge of his ex-wife's activities in with-drawing money from the Company. We have decided that he did not, on his evidence, take any care and that it was not appropriate for him, as managing director, to abrogate all responsibilities for running the Company and to seek to rely on the Company Secretary and the accountant to advise him of any wrong doing.

10. Ms Paw, who was now acting as the Company Secretary, had carried out further forensic work, which she had produced in the several bundles before the Tribunal. She wished to adduce evidence as to what Mrs Drzymalska had done and she had hoped to be able to cross-examine her. We stopped her evidence because she was seeking to re- address matters which had already been heard in the divorce court and more particularly her evidence was singularly unhelpful to Mr Drzymalski. She

produced a white board on which she indicated 5 separate bank accounts ostensibly owned by the Company. She then proceeded to show how the monies from the payments made by the agents were moved around the accounts. It appeared that Mr Drzymalski knew about two of the undisclosed accounts.

11. He told us that his wife had suggested that the money she had paid into one of those accounts identified as the CFC account for the Company should not be paid into the Company's bank account. He indicated to her, it appears in no uncertain terms, that she should transfer the money immediately into the Company's account, which she did. He appears to have been unable to find out whether she had closed the account, as he said he had requested. He appears to have made very little effort to check whether the account had been closed. There also appeared to be a joint account in their personal names of which Mr Drzymalski had no knowledge. He indicated that he believed Mrs Drzymalska had opened the account on her own. We do not believe him. The bank would not have opened a joint account without Mr Drzymalski having signed for the same. He also indicated that he had opened an account in Germany although he did not enlarge on the same, save to say that he paid money into it from a credit card drawn on the Company's account. HMRC appeared to be unaware of this account

12. Ms Paw also told us that Mr Drzymalski had started another company International Trade Engineering in 1998 as he did not wish his wife to be involved. Mr Drzymalski confirmed that to be the case. Ms Paw produced an envelope, which had Mrs Drzymalska's writing on it, clearly demonstrating that she knew about that company. We were not sure what to make of this evidence save to accept that Mr Drzymalski did not trust his ex-wife in 1998. In the light of that, it is unusual that Mr Drzymaskli was still content to allow his wife to look after the Company's affairs.

13. We believe that both parties were aware of the failure to disclose all of the company's income. There is no doubt that he must have known how much it was earning. He also knew how much of the income he was spending. We do not believe that a man with Mr Drzymalski's stature was unable to keep a track of the Company's financial affairs. It is significant that Mr Drzymalski, during the course of the divorce, alleged that Mrs Drzymalski had stolen anything between £135,000 and about £300,000 (his estimate of the loss) from the Company over the years.

14. We have not been required today to apportion fault between the parties but to confirm that the assessment should stand; that the same be treated as a loan; and that the 15% penalty arising there from should be paid. We find that Mr Drzymalski has been negligent with regard to the Company's affairs. It is clear from the cases that a default by directors can and should be assessed to tax in a company. We are satisfied from the evidence before us that Mr and Mrs Drzymalski were aware that some of the company's income was not being paid to the Company's account and that such amounts withheld should be treated as loans under section 419 ICTA. We, therefore, confirm the assessments as under. Mr Drzymalski suggested in evidence to the Divorce Court that the loss ought to be of the order of £300,000 since he knew what the contract income was and how it was spent, we suspect he may be right. The assessments have, however, been agreed by Mr and Mrs Drzymalski as part of the

divorce settlement and by HMRC for the purposes of this appeal and we see no reason to amend it. The additional profit appears in the company's formally undisclosed bank accounts and, as it does not appear in the bank or elsewhere in the accounts, HMRC can only conclude that Mr and Mrs Drzymalski must have used the money for their own purposes. We accept that the payments should be treated as loans from the Company to Mr and Mrs Drzymalski and the payments should be taxed under section 419 ICTA 1988.

15. We confirm the assessments on the basis of the figures agreed with Ms Paw and HMRC :-

Accounts year ended	Profits returned	Turnover under declared	Revised profits
31 March 1990	Not known	£14,250	£14,250
31 March 1995	£15,242	£26,309	£41,551
31 March 1996	£11,096	£26,124	£37,220
31 March 1997	£0	£31,750	£31,750
31 March 2000	£4,517	£7,443	£11,960
31 March 2002	£2	£17,423	£17,425
Total	£30,857	£123,299	£154,156

16. In addition the penalties as under amounting to 15% are confirmed. The penalty has been reduced to 15% on the following basis:

40% reduction for disclosing the loss voluntarily

30% reduction for co-operation and

15% reduction for the seriousness of the matter

making a total reduction of 15% (100% – 85%).

Account's period	Corporation tax due	S 419 ICTA 1988	Penalty
31 March 1990	£3,562.50	£3,562.50	£1069
31 March 1995	£6,774.25	£6,577.25	£2003

31 March 1996	£9,305	£6,531	£2,375
31 March 1997	£7,620	£7,937.50	£2,334
31 March 2000	£2,392	£1,860.75	£638
31 March 2002	£2,670.62	£4,355.75	£1,054
Total	£32,324.37	£30,824.75	£9,473

17. 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: 4 April 2012