



TC03821

Appeal number: TC/2013/06967

VAT default surcharge - insufficiency of funds - whether reasonable excuse - no - whether penalty disproportionate - no - appeal dismissed

**FIRST-TIER TRIBUNAL
TAX CHAMBER**

CARR GRANGE JOINERY LTD

Appellant

- and -

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

Respondents

**TRIBUNAL: JUDGE MICHAEL S CONNELL
MR JOHN E DAVISON**

Sitting in public at Phoenix House Bradford on 15 May 2014

Mr David Round and Mrs Beverly Round for the Appellant

Mr Tim Fieldsend Officer of HM Revenue and Customs, for the Respondents

DECISION

The Appeal

5 1. This is an appeal by Carr Grange Joinery Limited ('the Appellant') against VAT default surcharges of £27,055.84 for its failure to submit, in respect of twelve VAT periods between 07/09 and 04/13, by the due dates, payment of the VAT due.

2. The point at issue is whether or not the Appellant has a reasonable excuse for making late payments.

Background

10 3. The Appellant Company was formed in 1985. Its main business is the manufacture of joinery items, specifically to the commercial sector. It currently employs thirteen full time staff

15 4. Prior to the default periods under appeal, the Appellant had previously defaulted on VAT payments in period 07/09, when a VAT surcharge liability notice was issued, and again on 10/09. The Appellant was late and did not pay VAT due in twelve of the following thirteen VAT quarter periods. In all of the default periods the Appellant's VAT return was also late.

5. The Appellant appeals surcharges imposed for the following default periods:

	Period	Surcharge
20	07/10	£2,151.00
	10/10	£2,644.72
	01/11	£1,826.34
	04/11	£2,267.62
	07/11	£3,776.85
25	10/11	£3,717.13
	01/12	£2,276.46
	04/12	£1,583.64
	10/12	£2,098.66
	01/13	£3,035.60
30	04/13	£1,677.82

- 5 6. The period 07/10 had a due date of 7 September 2010 for electronic payments and electronic VAT submission. In the absence of the return the Appellant was issued with a Notice of Assessment to Tax and Surcharge V166 on 17 September 2010. The return was received on 14 February 2011 and payment was received on 22 December 2010.
- 10 7. The period 10/10 had a due date of 7 December 2010 for electronic payments and electronic VAT submission. In the absence of the return the Appellant was issued with a Notice of Assessment to Tax and Surcharge V166 on 17 December 2010. The return was received on 14 February 2011 and payment was received on 16 February 2011.
- 15 8. The period 01/11 had a due date of 7 March 2011 for electronic payments and electronic VAT submission. In the absence of the return the Appellant was issued with a Notice of Assessment to Tax and Surcharge V166 on 11 March 2011. The return was received on 4 November 2011 and payment was received on 9 November 2011.
- 20 9. The period 04/11 had a due date of 7 June 2011 for electronic payments and electronic VAT submission. In the absence of the return the Appellant was issued with a Notice of Assessment to Tax and Surcharge V166 on 17 June 2011. The return was received on 4 November 2011 and payment was received in two parts, on 4 April 2012 and 20 April 2012.
- 25 10. The period 07/11 had a due date of 7 September 2011 for electronic payments and electronic VAT submission. In the absence of the return the Appellant was issued with a Notice of Assessment to Tax and Surcharge V166 on 16 September 2011. The return was received on 12 October 2011 and payment was received on 14 October 2011.
- 30 11. The period 10/11 had a due date of 7 December 2011 for electronic payments and electronic VAT submission. The return was received on 14 December 2011 and payment was received on 20 April 2012.
- 35 12. The period 01/12 had a due date of 7 March 2012 for electronic payments and electronic VAT submission. The return was received on 5 March 2012, and payment was received in two parts on 20 April 2012 and 16 May 2012.
13. The period 04/12 had a due date of 7 June 2012 for electronic payments and electronic VAT submission. The return was received on 7 June 2012 and payment was received on 25 June 2012.
14. The period 10/12 had a due date of 7 December 2012 for electronic payments and electronic VAT submission. In the absence of the return the Appellant was issued with a Notice of Assessment to Tax and Surcharge V166 on 14 December 2012. The return was received on 26 February 2013 and payment was received on 8 March 2013.

15. The period 01/13 had a due date of 7 March 2013 for electronic payments and electronic VAT submission. In the absence of the return the Appellant was issued with a Notice of Assessment to Tax and Surcharge V166 on 15 March 2013. The return was received on 19 June 2013 and payment was made as shown on the schedule of Payments Made after Due Date.

16. The period 04/13 had a due date of 7 June 2013 for electronic payments and electronic VAT submission. In the absence of the return the Appellant was issued with a Notice of Assessment to Tax and Surcharge V166 on 14 June 2013. The return was received on 19 June 2013 with part payment totalling £5,996.99 being made as shown on the schedule of Payments Made after Due Date.

17. The Appellant has paid the surcharges, but appeals the decisions to impose them and asks for them to be discharged.

Relevant Legislation

18. Section 59 Value Added Tax Act 1994 (“VATA”) sets out the provisions in relation to the default surcharge regime. Section 59 of VATA requires a VAT return and payment of VAT due on or before the end of the month following the relevant calendar quarter. [Reg 25(1) and Reg 40(1) VAT Regulations 1995].

19. Under s 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 Commissioners may then serve a surcharge liability notice on the defaulting taxable person, which attracts a 0% penalty and brings him within the default surcharge regime, so that any subsequent defaults within a specified period result in assessment to default surcharges at the prescribed percentage rates. The specified percentage rates are determined by reference to the number of periods in respect of which the taxable person is in default during the surcharge liability period. In relation to the first default the specified percentage is 2%. The percentage ascends to 5%, 10% and 15% for the second, third and fourth default.

20. HMRC have discretion to allow extra time for both filing and payment when these are carried out by electronic means. [VAT Regulations 1995 SI 1995/2518 regs 25A (20), 40(2)]. Under that discretion, HMRC allow a further seven days for filing and payment. The due date for the 07/12 period was 7 September 2012.

21. A taxable person who is otherwise liable to a default surcharge may nevertheless escape that liability if he can establish that he has a reasonable excuse for the late payment which gave rise to the default surcharge(s). Section 59 (7) VATA sets out the relevant provisions : -

‘(7) If a person who apart from this sub-section would be liable to a surcharge under sub-section (4) above satisfies the Commissioners or, on appeal, a Tribunal that in the case of a default which is material to the surcharge –

(a) the return or as the case may be, the VAT shown on the return was despatched at such a time and in such a manner that it was reasonable to expect that it would be received by the commissioners within the appropriate time limit, or

5 (b) there is a reasonable excuse for the return or VAT not having been so despatched then he shall not be liable to the surcharge and for the purposes of the preceding provisions of this section he shall be treated as not having been in default in respect of the prescribed accounting period in question ..’

10 22. The burden falls on the Appellant to establish that it has a reasonable excuse for the late payment in question. It is s 59(7)(b) VATA on which the Appellant seeks to rely, on the basis that for reasons set out below the VAT was paid late because it was suffering severe cash flow shortages.

15 23. Section 59(7) must be applied subject to the limitation contained in s 71(1) VATA 1994 which provides as follows : -

‘(1) For the purposes of any provision of section 59 which refers to a reasonable excuse for any conduct –

(a) any insufficiency of funds to pay any VAT is not reasonable excuse.’

20 24. Although an insufficiency of funds to pay any VAT due is not a reasonable excuse, precedent case law has established the principle that the underlying cause of any insufficiency of funds may constitute a reasonable excuse.

25 25. The onus of proof rests with HMRC to show that the surcharges were correctly imposed. If so established, the onus then rests with the Appellant to demonstrate that there was reasonable excuse for late payment of the tax. The standard of proof is the ordinary civil standard of a balance of probabilities.

Appellant’s Case

30 26. The Appellant does not dispute that its VAT payments for the default periods were late. The Appellant appeals all the surcharges issued for the periods listed in paragraph 5 on the grounds of insufficiency of funds.

35 27. Mr and Mrs Round, who appeared for the Appellant company, said that the company had suffered considerable financial misfortune both before and during the default periods. They say that the causes of their difficulties were entirely beyond their control and were the direct cause of all the defaults. They briefly described the company’s financial problems as below:

40 i. “In July 2007 our first ‘bad debt’ hit our company to the sum of £69,860.91 inclusive of VAT when a major client of ours went into liquidation. Following that, we had a further ‘bad debt’ of £323.13 including VAT. The bank agreed to increase our overdraft facility from £40,000 to £70,000 for a nine month period. In September 2008 we injected £20,000 of personal funds

into the company and in December 2008 a further £5,000 of personal funds to help with the cash flow crisis caused by the bad debt.

- 5 ii. In February 2009 a second major client entered into a CVA owing us £128,720 including VAT. This was followed by the onset of the recession. Redundancies had to be made (four out of nineteen employees) and redundancy payments made to affected employees. We had to scale down our working week to a three day week for some considerable time. This created further financial turmoil as our turnover was insufficient to cover our overheads. On this occasion the bank would not help out. We spoke to an
10 insolvency practitioner who advised us to ‘wind up the company’, but ignored his advice, and between April 2009 and October 2010 injected a further £121,998.73 of personal funds into the company. We had to cash in all our personal ISA’s and PEP’s.
- 15 iii. In April 2010 we had a further bad debt of £4,534.90 including VAT
- iv. In February 2012 there was a further bad debt of £3,910.00 including VAT. We borrowed a total sum of £6,500.00 from our daughter.
- v. The early part of 2012 was make or break for the company. We received a warning from the bailiffs that if an amount of £71,890.59 (inclusive of VAT and surcharges) was not paid, they would take away our
20 machinery/goods/company belongings. On 18 April 2012 we borrowed £50,000 from a friend to pay the VAT surcharge and some of the VAT. In March 2013 we suffered a further bad debt of £44,731.16 including VAT. Legal proceedings are ongoing against the debtor.
- 25 vi. At the end of 2012, the company had the responsibility to pay back the £50,000 loan whilst still recovering from previous debts which was then followed by another company going into receivership.”

28. Mr and Mrs Round say that although they understand an insufficiency of funds is not a reasonable excuse, paragraph 6.3 of HMRC’s Notice 700/50 of July 2013
30 states that situations where a taxpayer “... cannot afford to pay will be looked at in exceptional circumstances”. They feel that their circumstances were exceptional and outside their control.

29. Mr and Mrs Round also say that in the particular circumstances, given the dire financial position of the company, the surcharges are unfair and excessive.

35 30. They cite the case of *Customs & Excise Commissioners –v- Steptoe* [1992] STC 757 J B where the appeal was allowed on the grounds of late payment by the Appellant’s main customer causing him to submit his return and payment late.

31. It has never been their intention not to pay the VAT owing, but the Appellant company did not have the money to pay it.

40 32. Mr and Mrs Round feel aggrieved that government/HMRC support was not there when needed and that their financial plight arose through no fault of the company and its directors. They eventually agreed a six month payment plan with HMRC to avoid a Winding-up Notice order and were able get their VAT up-to-date. Their current trading position is now far better and the company has a full order book.

The company's cash flow situation is improving, but still constrained because the surcharges have crippled them by just adding to the company's cash flow problems.

HMRC's Case

5 33. HMRC contend that the surcharges in respect of all the default periods under appeal have been correctly issued in accordance with VATA 1994 s.59(4), payment having been received after the relevant due dates.

10 34. The potential financial consequences attached to the risk of a default would have been known to the Appellant after the issue of the Surcharge Liability Notice in 11/09, given the information contained in the Notice. Included within the notes on the reverse of the Surcharge Liability Notice, is the following, standard, paragraph:

15 'Please remember: Your VAT returns and any tax due must reach HMRC by the due date. If you expect to have any difficulties contact either your local VAT office, listed under HM Revenue & Customs in the phone book as soon as possible, or the National Advice Service on 0845 010 9000.'

35. The requirements for submitting timely electronic payments can also be found -

- In notice 700 "the VAT guide" paragraph 21.3.1 which is issued to every trader upon registration.
- On the actual website www.hmrc.gov.uk
- 20 • On the E-VAT return acknowledgement.

36. Also the reverse of each default notice details how surcharges are calculated and the percentages used in determining any financial surcharge in accordance with the VAT Act 1994 s 59(5).

25 37. It is specifically stated in s 71(1) VATA that an insufficiency of funds to pay any VAT is not a reasonable excuse.

38. Therefore HMRC say that the surcharge has been correctly issued in accordance with the VAT Act 1994 s 59(4).

30 39. With effect from the period 01/13, the Surcharge Liability Notice V160, where issued, advises a trader how the surcharges are calculated and the percentages used. Subsequent Surcharge Notices advise the trader of the percentage used to calculate the current surcharge, if one has been issued, and/or the percentage which will be used in calculating the surcharge for any subsequent default.

35 40. HMRC say that it is unclear from the appeal documentation submitted which periods are actually subject to the appeal. Accordingly HMRC have assumed that the appeal refers to all the default periods.

41. Whilst accepting that the Appellant did incur substantial bad debts, the largest arose two years prior to the first default on record and the second six months prior.

42. In both instances the Appellant would have been entitled to claim Bad Debt Relief in respect of the VAT unpaid in accordance with the VAT Act 1994 (VATA 1994) s.36 and Notice 700, The VAT Guide s.18.5. Information on how to make the claim for relief is given on the HMRC website at www.hmrc.gov.uk.

43. The Appellant states in its letter of 11 July 2013 that between April 2009 and October 2010 monies were paid into the company by the Directors in order to negate the bad debts incurred. If the proprietors were able to source funds to cover bad debts incurred, they should have prioritised payment of outstanding VAT.

44. HMRC contend that the principles laid down by the Court in *J B Steptoe* do not apply in this instance, as the customers who defaulted, although major customers, were not the sole customers of the Appellant as was the case in *Steptoe*. Also, in that case the late payments which caused the defaults were ones where invoices had been issued during the periods for which the defaults arose. In this instance the late payments refer to periods after those to which the unpaid invoices refer.

45. The arguments from the Appellant about the effect of the recession are nothing out of the ordinary in the financial climate current at the time of the defaults. In essence they were normal business risks.

46. HMRC contend that whilst it is accepted that a business has other expenses, VAT must be given priority. As a VAT registered company the Appellant charged VAT to their customers and is required by law to pay this with the appropriate return by the due date. The VAT never belonged to the company and should not have been used to supplement its cash flow.

47. The proprietors of the Appellant company said in a letter to HMRC dated 11 July 2013 that they did not consider HMRC to be an essential creditor. This confirms that monies collected in respect of the VAT were being wrongly utilised to settle other liabilities. In fact in 2008, albeit prior to the years in which there had been defaults, the Appellants had incurred considerable expenditure by extending their workshop premises, purchasing new machinery and taking on specialist employees.

48. During a telephone call to HMRC on 30 June 2010 Mrs Round stated that payment of the balance outstanding at that time would be made and that late payment was due to cash flow. However she made no mention of the bad debts to which they now refer. Mrs Round was advised that if there were any further problems she should contact HMRC beforehand i.e. prior to the due date.

49. HMRC has no record of the Appellant contacting them in regard to any further difficulties they were experiencing with a view to seeking Time to Pay agreements for any of the periods under appeal. Had they done so, and if the requests were made prior to the due date and agreed, this may have obviated the need for surcharges to be issued and provided short term assistance to enable them to sort out their cash flow issues.

50. The effect that payment of the surcharges themselves may have on the Appellant's finances is not in itself reasonable grounds for the removal of the surcharges.

5 51. Insofar as the Appellant argues that the surcharge is entirely excessive or disproportionate to the modest delay which occurred, the case of *Total Technology (Engineering) Limited v HMRC* heard in the Upper Tribunal held that:

(1) There is nothing in the architecture of the Default Surcharge system which makes it fatally flawed.

10 (2) In order to determine whether or not a penalty is disproportionate, the Upper Tier Tribunal addressed the following factors:

(a) The number of days of the default

(b) The absolute amount of the penalty

(c) The 'inexact correlation of turnover and penalty'

(d) The 'absence of any power to mitigate'

15 and decided that none of these leads to the conclusion that the Default Surcharge regime infringes the principle of proportionality.

52. The surcharges are imposed by legislation and calculated by reference to the amount of VAT due and the number of defaults.

Conclusion

20 53. The Appellant was clearly aware of the due date for payments of its VAT and the potential consequences of late payment.

54. The Appellant's main ground of appeal is that it was suffering cash flow shortages caused by significant bad debts and the onset of the recession. In essence, the reason given for the late payment of VAT was insufficiency of funds.

25 55. In *Customs & Excise Commissioners –v- Steptoe [1992] STC 757* the tax-payer argued that although the proximate cause of his default was insufficiency of funds, the underlying cause of that insufficiency, namely the unexpected failure by a major customer to pay him on time, amounted to a reasonable excuse. The Court determined on a majority that the statutory exclusion of insufficiency of funds as an excuse did
30 not preclude consideration of the underlying cause of insufficiency and that a trader might have a reasonable excuse if it were caused by an unforeseeable or inescapable event or when, despite the exercise of reasonable forethought and due diligence, it could not have been avoided. The Court nevertheless made it clear that the test had to be applied strictly.

35 56. To decide whether a reasonable excuse exists where insufficiency of funds causes the failure, the Tribunal must take for comparison a person in a similar

situation to that of the actual tax-payer who is relying on the reasonable excuse defence. The Tribunal should then ask itself, with that comparable person in mind, whether, notwithstanding that person's exercise of reasonable foresight, due diligence and a proper regard for the fact that the tax would become payable on the particular
5 dates, those factors would not have avoided the insufficiency of funds which led to the failures.

57. Having considered the Appellant company's circumstances and the background facts and circumstances leading up to the defaults the Tribunal accepts that the underlying cause of the default was an acute shortage of funds caused mainly by bad
10 debts. However the proprietors had been able to overcome their problems by the injection of personal funds either from borrowings or their own capital. There was no evidence that the company applied to HMRC for time to pay prior to the time of defaults and when the Respondents threatened distraint and bailiff recovery the Appellant found the funds, albeit from borrowings, to discharge the VAT and the
15 surcharges.

58. A prudent tax person in circumstances similar to that of the Appellant would have put in place appropriate precautionary measures sooner than they did. It appears that in 2013 the Appellant put in place more robust credit control mechanisms. Credit is no longer given and customers must make payments up front. The company's VAT
20 compliance record thereafter improved, although that was partly a reflection of the improving economy. Had the Appellant improved its systems earlier than it did, the VAT defaults in all probability could have been avoided.

59. The defaults also occurred over an extended period of time. It is clear that during that time the Appellant was using VAT collected from customers to
25 supplement its cash flow. Indeed the directors said that they did not regard HMRC as an essential creditor. In those circumstances the principles laid down in *Stepto* do not apply.

60. The burden of proof is on the Appellant to show that the underlying cause of its failure to meet its VAT payment obligations was due to unforeseen circumstances or
30 events beyond its control. In the Tribunal's view, for the reasons given above, that burden has not been discharged and there was no reasonable excuse for the defaults.

61. We concur with the Respondents submissions that the surcharges were not unfair or disproportionate for the reasons set out in paragraphs 51 and 52 above.

62. The appeal is accordingly dismissed and the surcharges upheld.

35 63. 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
40 "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

MICHAEL S CONNELL

TRIBUNAL JUDGE

RELEASE DATE: 21 July 2014

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