[2015] UKFTT 0415 (TC)

TC 04592

Appeal number: TC/2014/03959

VAT – default surcharge-adverse trading conditions-CIS refund delayed by HMRC-whether reasonable excuse-amount of surcharge

FIRST-TIER TRIBUNAL
TAX CHAMBER

UPR SERVICES LTD **Appellant**

- and -

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

TRIBUNAL: JUDGE MARILYN MCKEEVER
MR DEREK SPELLER

Sitting in public at Fox Court, Grays Inn Road, London on 18 June 2015

Mr Ian Bray, accountant for the Appellant

Mr Mark Ratcliff, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. *Introduction*

2. This case concerns the application of the VAT default surcharge scheme. The Appellant, UPR Services Ltd ("UPR"), filed its VAT returns and paid the tax due late on a number of occasions. HMRC notified UPR that a default surcharge was due in each of the eight three month periods beginning with the period ending July 2011 and ending with the period ending April 2013. The total amount of surcharge is £71,868.15.

3. The Appellant appeals against the surcharge on the grounds that it had a reasonable excuse for late payment in consequence of the difficult economic conditions, exceptionally bad weather over the two winters in the period, difficulties in obtaining credit and the fact that HMRC owed the company money under the Construction Industry Scheme and had delayed setting off the repayments due, resulting in a lack of funds to pay the VAT.

4. *Preliminary matters*

5. The Appellant had applied at short notice to adjourn the hearing in order to allow the parties to explore the possibility of resolving the case by mediation. The Tribunal should facilitate mediation where both parties agree and where it is compatible with the overriding objective of the Tribunal of justice and fairness.

6. We considered a letter from a firm of solicitors acting as a mediation advocate for UPR who referred to a claim against HMRC related to the current matter concerned with HMRC advertising a winding up petition issued against UPR when they had undertaken not to do so.

7. Mr Ratcliff indicated that HMRC did not agree to mediation. He did not consider that mediation was an appropriate forum for determining an appeal against a default surcharge, which is largely a factual matter, and he pointed out that the winding up petition had been issued in May 2014, but the last period to which the appeal relates ended in April 2013, so the petition could not be relevant to the matter before the Tribunal.

8. We considered that the winding up petition was a separate matter from the current appeal and could not affect the case. We therefore decided to refuse the adjournment and continue with the hearing.

9. *The Law*

10. The law is not in dispute.

11. Regulation 25 of the Value Added Tax Regulations 1995 (the "Regulations") requires a person who is registered for VAT to submit a return for every period of

three months. By Regulation 25(1) the return must be made not later than the last day of the month next following the end of the period to which it relates.

12. Regulation 40(2) of the Regulations requires a person who makes a return to pay any VAT payable under the return not later than the last day permitted for submission of the return.

13. Section 59(1) of the Value Added Tax Act 1994 ("VATA") provides that a person is in default if it fails to submit a return and/or pay the VAT due on time. The Commissioners can serve a "surcharge liability notice" on the taxable person specifying a "surcharge period" and if the taxable person is in default during the surcharge period, it is liable for a surcharge of the greater of the "specified percentage" of the outstanding VAT for the relevant period or £30 (section 59(4) VATA). Section 59(5) sets out the specific percentage which varies from 2% for the first default to 15% for the fourth and subsequent defaults.

14. The default surcharge scheme is purely mechanical in its application.

15. Section 59(7) VATA provides two defences to the default surcharge. It states:

(7) If a person who, apart from this subsection, would be liable to a surcharge under subsection (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

(b) there is a reasonable excuse for the return or VAT not having been so despatched,

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 (and, accordingly, any surcharge liability notice the service of which depended upon that default shall be deemed not to have been served).

16. The Appellant seeks to rely on paragraph (b); that it had a reasonable excuse.

17. The Appellant commenced business in 2010 and from 2011, operated a scaffolding business in the course of which it worked for major housebuilders. In March 2011 the Appellant applied for gross payment status under the Construction Industry Scheme. The application was declined meaning that the Appellant's customers were required to deduct 20% of the labour element of its invoices (in

practice virtually the whole of the amounts on the invoices) when making payment to the Appellant. The Appellant was not permitted to make a further application for a year. Gross payment status was finally granted in February 2013 which meant that the Appellant's customers could pay the Appellant without deducting the tax.

18. Once the Appellant had submitted an employer's end of year PAYE return, HMRC would be able to reconcile the PAYE tax paid by the Appellant with the tax deducted under the CIS scheme and repay the tax deducted.

19. Section 130 Finance Act 2008 makes provision for money owned to a taxpayer by HMRC to be set off against money owed to HMRC by the taxpayer.

20. Section 130 provides:

(1) This section applies where there is both a credit and a debit in relation to a person.

(2) The Commissioners may set the credit against the debit (subject to section 131 and any obligation of the Commissioners to set the credit against another sum).

(3) The obligations of the Commissioners and the person concerned are discharged to the extent of any set-off under subsection (2).

(4) "Credit", in relation to a person, means—

(a) a sum that is payable by the Commissioners to the person under or by virtue of an enactment, or

(b) a relevant sum that may be repaid to the person by the Commissioners.

(5) For the purposes of subsection (4), in relation to a person, "relevant sum" means a sum that was paid in connection with any liability (including any purported or anticipated liability) of that person to make a payment to the Commissioners under or by virtue of an enactment or under a contract settlement.

(6) "Debit", in relation to a person, means a sum that is payable by the person to the Commissioners under or by virtue of an enactment or under a contract settlement.

(7) In this section references to sums paid, repaid or payable by or to a person (however expressed) include sums that have been or are to be credited by or to a person.

(8) This section has effect without prejudice to any other power of the Commissioners to set off amounts.

21. The CIS credit owed to the Appellant was ultimately set off against the VAT owed by the Appellant, but not until many months after the amount was agreed. The Appellant's argument that the difficulties it experienced in obtaining a repayment/set-off amounted to a reasonable excuse for failing to pay its VAT is discussed below.

22. *The facts and evidence*

23. UPR was formed in 2007 but was dormant until 2010 when it began trading. In 2011, the business of the company changed and it became a scaffolding contractor, working for major house builders. The company incurred significant expenditure hiring plant in order to carry our this work. As noted above, deductions were made from payments to it under the Construction Industry Scheme until the company obtained gross status in February 2013.

24. The office staff consisted of members of the director's family. The bookkeeper was supposed to process the accounts information and produce the VAT returns and submit them online. Only the bookkeeper could operate the software and only she knew the necessary procedures.

25. The bookkeeper failed from the outset to keep matters up to date and did not file the VAT returns or pay the VAT due. The company's first period of default was the period ending 30 April 2010 and defaults continued for every three month period up to and including 30 April 2013, the period under appeal. As the actual figures were not available, HMRC issued estimated assessments which greatly overstated the actual liabilities. The figures were subsequently adjusted to the correct amounts, when the VAT returns were eventually submitted and the default surcharges which are under appeal were calculated on the revised figures in the returns.

26. When the director realised that the bookkeeper was not carrying out her duties, in May 2012, he dismissed her and following a discussion about the best way of dealing with the accounting function, the company's accountants were appointed, in June 2012, to sort matters out and deal with future compliance. It became clear that, not only had the VAT returns not been filed, but many of the bank entries were wrong or incomplete and a substantial amount of work was required to reconstruct the company's records.

27. The outstanding returns for the periods up to May 2012 were filed on 31 July 2012, but the next return, due on 31 August 2012 was not submitted until15 April 2013 and returns continued to be submitted late and the VAT paid late throughout the period under consideration.

28. HMRC indicated that the default surcharge notices are computer generated and so were not able to provide copies of the actual documents, but there was no dispute about whether the notices had been served and Mr Bray accepted that on the basis of the figures shown in the VAT returns, the surcharge had been correctly assessed.

29. Mr Bray indicated that the problems with the bookkeeper had been accepted as a reasonable excuse for direct tax purposes.

30. A major part of the Appellant's case is that its cash flow difficulties were compounded by the fact that HRMC owed it money by way of refund under the CIS scheme.

31. Extracts from UPR's PAYE/CIS records were produced to the tribunal. They show that the company's P35 returns were duly submitted. They also show the amount of tax paid, the amount of the deductions made under the CIS and the difference, which is money due to the company. They also show the dates when the excess amounts were refunded to the company by way of set off against its VAT liability and the effective dates when the refund was due.

32. In 2009-10, the refund due was £731.46. The figures were reconciled on 5 September 2010 but the sum was not reallocated to the VAT liability until 13 November 2012. However, the records show the *effective* date of the reallocation as 19 April 2010-14 days after the end of the tax year when the P35 must be submitted returning the annual tax figures.

33. In 2010-11 the refund due of £8,769.44 was reconciled on 5 June 2011 but not set off against the VAT until 23 November 2012. The effective date was shown as 19 April 2011 and, in this year, repayment supplement was paid as from that date.

34. In 2011-12, the refund was £111,061.74. The figures were reconciled on 31 October 2012 and set off on 12 December 2012, with an effective date of 19 April 2012 and repayment supplement calculated from that date.

35. In 2012-13, the refund was £98,188.36 which was set off on 23 August 2013, effective from 19 April 2013 together with repayment supplement calculated from that date.

36. Mr Bray stated that the company sought to obtain repayment of the CIS tax owing and entered into extensive correspondence with HMRC on the matter, but there were significant delays in making the repayments. As examples, Mr Bray said that it took two and a half years to obtain the refund for the 2009-10 tax year and in subsequent years HMRC failed to make any repayment until all figures were agreed, even when the disagreement was over a relatively small sum. Even when the figures were agreed (in the amounts originally claimed) there were further delays in making the set offs.

37. Mr Ratcliff was unable to explain why the reallocations were not made earlier than they had been. He had used the dates of the actual reallocations to determine the VAT liabilities to be used to calculate the surcharge.

38. Mr Ratcliff pointed out that UPR had not made any request for the CIS tax due to be set off against the VAT until September 2012.

39. It is unclear when the issue of the CIS refunds was raised with the VAT inspector. Mr Bray said that it was mentioned in correspondence in December 2012, but he had told the inspector substantial CIS tax was due to the company before then.

40. *The Appellant's submissions*

41. The Appellant submitted that it had a reasonable excuse for the late submission of returns and late payment of VAT. This comprised a number of elements.

42. First, there were the problems with the bookkeeper, who was the only person in the company who knew how to operate the relevant procedures. She had failed to keep proper records or carry out her duties. When the issues were discovered, she was dismissed and the work handed over to the company's accountants. It took them some time to reconcile all the records and bring them up to date. This was accepted as a reasonable excuse for direct tax purposes.

43. There were other factors which affected the company's business and cashflow also. Mr Bray recognised that, in accordance with section 71 VATA, insufficiency of funds cannot, of itself, constitute a reasonable excuse, but the case law has established that the underlying cause of the insufficiency of funds can constitute a reasonable excuse.

44. The winters of 2011-12 and 2012-13 were exceptionally bad and over 40 working days were lost each winter as a result of freezing weather, snow or heavy rain. Mr Bray contends that the abnormal nature of the weather and its impact on the business is an event outside the company's control which caused the lack of funds.

45. Mr Bray also contended that the period in question saw the biggest downturn in the economy in construction history which was a further abnormal event outside the company's control.

46. As a specific consequence of the economic climate, it was impossible for small companies like UPR to obtain credit from the banks and funds were needed to hire plant in order to operate the business and for other working capital needs, which further eroded the funds available to pay the VAT.

47. HMRC had failed to repay the CIS tax due for many months after it should have been repaid and had it been repaid when it should have been, following submission of the end of year certificate, the Appellant would have had the funds to pay the VAT liabilities.

48. *The Respondent's submissions*

49. Mr Ratcliff submits that the Appellant does not have a reasonable excuse for its default and, accordingly, the surcharge should stand.

50. In relation to the problems with the bookkeeper, Mr Ratcliff submitted that the directors of the company have the ultimate responsibility for the timely submission of the VAT returns and payment of the VAT. Section 71(1)(b) VATA provides that

"where reliance is placed on any other person to perform any task, neither the fact of that reliance, nor any dilatoriness or inaccuracy on the part of the person relied upon, is a reasonable excuse". Mr Ratcliff accordingly submits that the failure of the bookkeeper, on whom the company relied to file returns and pay the VAT cannot be a reasonable excuse.

51. Mr Ratcliff also submits that the company would have been aware of the economic circumstances when it started its business and that the economic downturn and credit shortages were simply normal business risks. Similarly, he argued that the adverse weather conditions are, given the outdoor nature of the business, foreseeable and a normal hazard encountered by most traders in the same line of business, the vast majority of whom trade without default in the same circumstances.

52. Turning to the Appellant's claim that funds were available by way of set off from the CIS deductions held by HMRC, Mr Ratcliff referred to section 62(3) Finance Act 2004 which provides:

"(3) If the sub-contractor is a company—

(*a*) a sum deducted under section 61 and paid to the Board is to be treated, in accordance with regulations, as paid on account of any relevant liabilities of the sub-contractor [here UPR];

(*b*) regulations must provide for the sum to be applied in discharging relevant liabilities of the year of assessment in which the deduction is made;

(*c*) if the amount is more than sufficient to discharge the sub-contractor's relevant liabilities, the excess may be treated, in accordance with the regulations, as being corporation tax paid in respect of the sub-contractor's relevant profits; and

(*d*) regulations must provide for the repayment to the sub-contractor of any amount not required for the purposes mentioned in paragraphs (*b*) and (*c*)."

53. Sub-section (4) defines the "relevant liabilities" of a sub-contractor as "any liabilities of the sub-contractor, whether arising before or after the deduction is made, to make a payment to the Inland Revenue in pursuance of an obligation as an employer or contractor".

54. Mr Ratcliff submits that this means that the sums deducted under the CIS can only be applied elsewhere once the liability to PAYE (or other relevant liabilities) has been ascertained. Under the rules at the time, the earliest time a credit could be available for the deductions would have been after the end of the tax year, when the end of year return was submitted and even then, the figures would have to be verified. Until

HMRC have accepted and agreed any such claim, such funds are not available for set off. In any event, Mr Ratcliff contends that the date of reallocation of the CIS tax to the VAT account is to be taken as the correct date for the purposes of calculating the default surcharge.

55. Mr Ratcliff also argues that section 130(2) Finance Act 2008, set our above, confers a *discretion* on the Commissioners to offset money owed to the taxpayer against another liability of the taxpayer. There is no obligation on them to do so.

56. Mr Ratcliff further submits that that the taxpayer must *request* a set off and a set off cannot be made before that is done. It seems that the Appellant did not request a set off until September 2012. Mr Ratcliff referred us to the case *of C G Structures Limited v HMRC [2014] UKFTT 504*. That case also involved a default surcharge imposed on a company which claimed it had a reasonable excuse for the default by reason of constraints on its cash flow as a result of trading conditions and the fact that a CIS refund due to the company had not been made by HMRC.

57. The tribunal in that case noted the case of *Customs & Excise Commissioners v Steptoe [1992] STC 757* where it was held that, although an insufficiency of funds could not be a reasonable excuse, there might be a reasonable excuse if the insufficiency 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".

58. The Tribunal in *C G Structures* said "…no evidence of a written request for set off prior to the VAT falling due has been provided. Set off cannot be applied unilaterally by a taxpayer in such circumstances….A prudent tax person [*sic*] in similar circumstances would have written to HMRC in advance to explain the tax position and ask for time to pay."

59. Mr Ratcliff argues that there cannot be a reallocation of the CIS refund to VAT unless the taxpayer has requested it.

60. *Discussion*

61. The Appellant does not dispute that the VAT returns were submitted late and that the VAT due was paid late. However, it contends that it had a reasonable excuse for the default. If the Appellant indeed has a reasonable excuse, it is not liable for the surcharge and is not treated as having been in default for the relevant accounting periods.

62. The proximate cause of the default was insufficiency of funds to pay the VAT as it fell due. Insufficiency of funds is prevented by statute from constituting a reasonable excuse. The question is whether the underlying cause of the lack of funds was an unforeseeable or inescapable event which could not have been avoided and which might therefore amount to a reasonable excuse.

63. We have considered carefully the arguments put forward by Mr Bray, but we agree with HMRC that adverse economic conditions, a shortage of credit and bad

weather are all normal hazards of business affecting all businesses in the position of UPR. As such, they cannot be regarded as a reasonable excuse for the default.

64. A major factor in the lack of funds was the retention by HMRC of the CIS deductions which were due to the Appellant.

65. There is no statutory requirement that a set off can only be made if the taxpayer requests it, though it would be prudent for the taxpayer to do so and to ask for time to pay as is suggested in the guidance note VAT 750 in relation to what a taxpayer should do if they cannot pay the VAT. We agree with HMRC that the Commissioners have a discretion under section 130 Finance act 2008 to set the credit against the money owed by the taxpayer; they do not have an obligation to do so. However, they do not have a discretion to retain funds due to the taxpayer.

66. Regulation 56(2) of the Income Tax (Construction Industry Scheme) Regulations 2005 (SI 2005/2045) provides for deductions made from payments to a sub-contractor under section 61 Finance Act 2004 to be applied in payment of the subcontractor's liability for PAYE, NICs and certain other liabilities. Regulation 56(3) provides "So much of any sum deducted under section 61 of the Act as is not required to discharge the sub-contractor's liabilities specified in paragraph (2) shall be repaid to the qualifying sub-contractor". So if the deductions are not required for the specified purposes, HMRC *must* pay them to the sub-contractor.

67. In April 2014, HMRC issued a "CIS helpcard" as part of its Joint Initiative on HMRC Service Delivery. It stated as follows:

"HMRC aims to improve its service for customers who request a CIS repayment. They will process CIS repayment claims received in writing within 25 working days from the date of receipt where the claim matches the information HMRC holds. Where there is a mismatch, HMRC will need to take up the discrepancy with you or the company's agent. The speed at which HMRC can process the full repayment will, in part, depend on how soon you or your agent responds. In these circumstances, HMRC will aim to make a part repayment of the amount they can agree and will do so in the above timeframe."

68. Although this is merely a statement of HMRC's intended practice and is effective from April 2014, after the period under appeal, it represents a recognition by HMRC that excess deductions belong to the sub-contractor and even if there is a discrepancy, any amount not in dispute must be paid out.

69. HMRC's records in the present case reflect this. Although the various repayments were not reconciled until some months after the end of the relevant tax year and were not reallocated to the VAT liability until many months after that, the extracts from HMRC's PAYE/CIS records and the schedule of payments and set-offs show the actual dates of reallocation, but also show an effective date of reallocation which, in each case is 19 April in the relevant year. In addition, repayment supplement, from 19 April to the date of reallocation was applied for the years from

2010-11, This represents an acknowledgement by HMRC that these deductions, should have been available to the Appellant from 19 April in the relevant years.

70. Mr Ratcliff was unable to explain why there was such a long delay in reallocating the deductions to the VAT liabilities and despite the fact that HMRC's records acknowledge that the deductions should have been paid to the Appellant on 19 April in each year, he took the date of actual application against the VAT liabilities as the date to be used for the calculation of the default surcharge.

71. Even if the deductions had been repaid or set-off at the correct time, it would not have prevented there being a default. HMRC's schedule of defaults show that throughout the period under consideration, even after Mr Bray's firm took over responsibility for the VAT returns and even after UPR attained gross payment status, the VAT returns were submitted late and the VAT due was paid late. Accordingly, the failure to reallocate the deductions could not amount to a reasonable excuse for the late filing and late payment.

72. Section 59(4) VATA provides that the amount of the surcharge is to be calculated by reference to the amount of "outstanding VAT" on the return. Subsection (6) provides that a person has outstanding VAT if "some or all of the VAT for which he is liable in respect of that period has not been paid by the last day [for making a return]".

73. While the VAT which should have been paid was not paid at the right time, if the amounts due to the company had been reallocated when HMRC acknowledge that they should have been available to the company, the amount of VAT owing would have been reduced (to nil on some returns) and the amount of the surcharge would accordingly have been reduced. In the circumstances of the case, we consider that the reduced amount should be regarded as the "outstanding VAT" for the purposes of the calculation of the default surcharge.

74. *Conclusion*

75. The Appellant did not have a reasonable excuse for the late filing of its VAT returns and the late payment of the VAT and accordingly, the default surcharge is due.

76. The amount of the "outstanding VAT" in each period should be recalculated on the basis that the CIS deductions owed to the Appellant had been reallocated on 19 April in each of the relevant years and the default surcharge should be amended accordingly. We will make Directions to this effect.

77. 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.

MARILYN MCKEEVER
TRIBUNAL JUDGE

RELEASE DATE: 20 AUGUST 2015