[2016] UKFTT 296 (TC)

TC05069

Appeal number: TC/2012/08509

VAT – Default Surcharge – Value Added Tax Act 1994, sections 59 and 71 – The cause of insufficiency of funds – Whether or not a reasonable excuse for late payment – yes for part of the non-payments for two periods – no for the remaining eight periods – allocation of payments - proportionality

FIRST-TIER TRIBUNAL
TAX CHAMBER

GH PRESTON PARTNERSHIP **Appellant**

- and -

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

TRIBUNAL: JUDGE RICHARD CHAPMAN
MRS BEVERLEY TANNER

Sitting in public at Manchester on 24 November 2015 (with further written submissions on 8 December 2015 and 16 December 2015).

Mr Michael Ripley, Counsel, for the Appellant.

Mr Barry Sellers, Presenting Officer, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents.

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DECISION

Introduction

5 1. This is an appeal by GH Preston Partnership ("the Partnership") against default surcharges for the late payment of VAT in the total sum of £74,941.44. The relevant periods, defaults and amounts involved are set out in the following table:

Period:	*Due date:*	*Amount paid by due date:*	*Amount paid after due date:*	*Date of late payment:*	*Amount of surcharge:*
06/09	31/7/09	£0.00	£29,685.61	17/11/09	£4,452.84
09/09	31/10/09	£0.00	£14,722.54 £5,050.00	10/11/09 23/4/10	£2,965.88
12/09	31/1/10	£0.00	£4,847.81 £20,000.00 £8,238.43 £39,827.05	23/4/10 15/9/10 15/10/10 15/10/10	£8,721.11
03/10	30/4/10	£0.00	£14,536.20 £14.25	7/7/10 15/10/10	£2,182.56
06/10	31/7/10	£0.00	£11,022.25 £40,000.00 £14,795.17	15/10/10 21/10/10 25/10/10	£9,872.61
09/10	31/10/10	£25,204.83	£25,204.83 £20,000.00 £30,000.00 £11,182.69	25/10/10 4/1/11 17/6/11 5/7/11	£9,177.41
03/11	30/4/11	£0.00	£3,817.31 £15,000.00 £15,000.00 £37.076.94	5/7/11 5/7/11 22/7/11 29/7/11	£10,634.13
06/11	31/7/11	£0.00	£10,000.00 £50,855.84	7/10/11 21/10/11	£9,128.37
09/11	31/10/11	£38,853.92	£30,000.00 £12,995.55	9/12/11 12/4/12	£6,449.33

12/11	31/1/12	£0.00	£27,004.45	12/4/12	£11,357.20
			£10,897.53	7/6/12	
			£14,234.32	3/8/12	
			£23,578.40	11/9/12	

2. This table takes into account an agreement between the parties at the outset of the hearing that a mistake had been made in respect of the surcharge for 09/10. Contrary to the initial calculations, the appropriate surcharge was £9,177.41 instead of £12,958.12 in order to take into account the fact that £25,204 had been paid on time. The parties also agreed that the returns were all made by their due dates with the exception of 09/09.

3. The appeal was first made on 7 September 2012 but was stayed pending the outcome of the appeal to the Upper Tribunal in *Total Technology (Engineering) Limited v HMRC*. The stay was lifted on 9 March 2013. The appeal had originally also been in respect of eleven further periods between 05/87 and 06/08, together with the period 12/10. However, these periods were struck out by Judge Cannan in a decision released on 13 February 2014.

4. In short, the Partnership claims that there was a reasonable excuse for the remaining defaults. In the alternative, Preston claims that the default surcharges were disproportionate. HMRC refutes both of these contentions.

Evidence and Findings of Fact

5. We heard evidence on behalf of the Partnership from Mr Frank Preston (the Partnership's senior partner) and Mr William Reay (the Partnership's accountant). Both of these witnesses were entirely credible and were doing their best to give accurate evidence. There was no oral evidence on behalf of HMRC. We have also considered a bundle of documents relied upon by both parties.

6. There were no factual disputes between the parties (whether by virtue of express agreement or the absence of challenge), albeit that the Partnership and HMRC inevitably make different submissions as to how those facts affect the outcome of the appeal. With that measure of agreement in mind, we make the following findings of fact.

7. The Partnership is a family business which has been trading since 1945. The partners are now Mr Preston, Mr Preston's brother and Mr Preston's four sons. The Partnership is involved in construction and mechanical engineering and over the years has developed a specialism in welding and steel fabrication, particularly in relation to gas mains. The Partnership's main customers are gas companies. The Partnership has also carried out engineering projects for railway companies.

8. From 2007 onwards, the Partnership has experienced a number of financial pressures.

9. First, Mr Preston informed us (and this was not challenged) that the general downturn in the construction industry adversely affected the demand for the Partnership's services.

10. The Partnership's financial position for the relevant years can be seen from the accounts. For the year ending 31 March 2010, the sales were £1,947,015, the gross profit was £609,580 and the net profit was £134,084. For the year ending 31 March 2011, the sales were £2,154,251, the gross profit was £1,000,066 and the net profit was £375,293. For the year ending 31 March 2012, the sales were £2,215,987, the gross profit was £798,131 and the net profit was £146,864. The parties also drew our attention to a particularly good year ending 31 March 2008 (for which the sales were £2,207,738, the gross profit was £1,291,321 and the net profit was £722,021) and a particularly bad year ending 31 March 2009 (for which the sales were £2,104,072, the gross profit was £641,450 and the net profit was £11,887).

11. Mr Preston said that the net profits for the year ending 31 March 2009 were a big drop and that, at that time, the Partnership was struggling. Although the amount of work decreased, the wages bill remained high as the Partnership paid the workers even though they were staying at home in order to retain their specialised services. They gradually got back to work after about a month.

12. The relevant periods are of course 06/09 to 12/11 and so fall within the years ending 31 March 2010 to 31 March 2012. We find that during these years the Partnership's sales steadily increased and by 31 March 2012 had surpassed the sales in the good year ending 31 March 2008. We also find that the Partnership was making substantial profits. Whilst these were nowhere near the levels of the year ending 31 March 2008, they were still well above the more precarious level of the year ending 31 March 2009. We take on board the point that net profit does not necessarily mean availability of cash. Further, HMRC did not take issue with the assertion that, as a matter of fact, cash was not available at the time that the payments were due.

13. Secondly, in April 2007, HMRC removed CIS 6 status from the Partnership. In June 1999, the Partnership registered for the Construction Industry Scheme. The Partnership was given CIS 6 status, which meant that no deductions for tax were made by main contractors prior to payment to the Partnership as a sub-contractor. In April 2007, the Partnership's status was changed to CIS 4, with the effect that main contractors deduct 20% tax before payment to the Partnership. The tax is then held by HMRC until the partners' tax liability is calculated at the end of the year and returns made. Any excess in the CIS account is refunded to the Partnership and any deficit is paid by the Partnership. Mr Preston accepted that the removal of CIS 6 status was because of the Partnership's default and that this was likely to be late payment of PAYE. There was no evidence that the Partnership had attempted to restore its CIS 6 status between the periods 06/09 and 12/11.

14. The effect of the Partnership having CIS 4 status was that CIS payments were held by HMRC until the end of the tax year and then any excess payments either refunded or set off against other liabilities to HMRC. An unchallenged list of refunds

prepared by the Partnership or its advisors appeared within the bundle to the following effect:

> "The following list shows what we believe to be the amount of "excess" CIS tax collected by HMRC in each of the tax years since the partnership lost its CIS gross payment status. These amounts gradually accumulated in the CIS tax account during the tax years in question, and represent the actual sums either refunded or offset against other tax partnership tax liabilities after deduction of income tax liabilities:
>
> 5th April 2009 £190,834.98 – refunded to the partnership
>
> 5th April 2010 £58,884.24 – offset by HMRC
>
> 5th April 2011 £113,971.23 – offset by HMRC
>
> 5th April 2012 £84,855.00 - offset by HMRC
>
> 5th April 2013 £202,847.00 – offset by HMRC
>
> 5th April 2014 £399,597.00 – offset by HMRC"

15. This raises the question as to what these sums were offset against. The Partnership suggests that these have been offset against debts to HMRC including, PAYE, VAT and VAT default surcharges. Although this has not been challenged by HMRC, it must be said that we have not been given an account by either party of exactly how these offsets have been applied. For the purposes of this decision, we find as a matter of fact that some of the sums making up the CIS refunds were applied to VAT default surcharges, including some of those surcharges in question within these proceedings. However, we are unable to make any findings as to which surcharges these related to and as to what proportion of the refunds were involved. We also find as a matter of fact that the offsets of CIS refunds were not applied to the VAT due for the periods presently under appeal. We have made this finding upon the basis that each of the entries in the schedule of defaults under the heading "Date payment received and method" refers either to a cheque or a CHAPS payment; there is no mention of any offset by HMRC. We also note that although Mr Preston stated in his second witness statement that how HMRC allocated the set-offs was out of the Partnership's hands, he did not go so far as to say that the Partnership had expressly instructed HMRC to apply the offsets against current VAT liabilities in respect of the periods in question. Indeed, the only evidence of a request to apply the CIS refunds in any particular way was a letter dated 25 October 2010 from the Partnership's accountants requesting a set off of the £58,884.21 refund due against PAYE liabilities.

16. Thirdly, it is said that HMRC was pursuing historic debts and, in doing so, allocated VAT payments to historic liabilities (including surcharges) rather than current liabilities.

17. We find that HMRC was placing pressure upon the Partnership to clear its debts. In particular, telephone notes for 21 December 2009, 26 March 2010 and 21 June 2010 refer to distraint being considered. An entry on 16 November 2010 states, "reminded him that Current Paye not been paid, also VAT due, has to pay on time or

all debts due will be enforced. He will sort this." Further, a note dated 23 November 2010 refers to a warning that HMRC were getting close to starting "BY" action, which we take to refer to bankruptcy. In order to deal with this, Mr Preston drew down on his pension in the sum of £20,000 in about November 2010 and in the sum of about £40,000 in about 2012.

18. We also find that HMRC was applying VAT payments to historic VAT liabilities rather then current liabilities. As set out above, this is clear from the schedule of defaults. It is asserted by the Partnership that some of these VAT payments were also applied to VAT default surcharges. We have no evidence as to which of the payments this related to or as to how much, but HMRC did not challenge this assertion and so we accept it.

19. Importantly, the Partnership asserted that a number of the periods would have been paid in full – and the rest paid in part - if payments had been allocated to current liabilities. Mr Ripley's skeleton argument initially restricted this to the 12/09 and 06/10 periods as follows:

> "If GHP's VAT payments relating to HMRC had not been allocated to earlier default surcharges, GHP would have met its obligations on time and in full for all the quarters under appeal except the 12/09 and 06/10 periods."

20. However, at the start of the hearing we were given an updated spreadsheet prepared by or on behalf of the Partnership. This increased the number of periods which would not have been paid in full to four. For 06/09, £8,096 had been paid in the previous three months whereas the VAT due was £29,685.61. For 12/09, £52,554.15 had been paid in the previous three months whereas the VAT due was £72,913.29. For 06/10, £14,536.20 had been paid in the previous three months whereas the VAT due was £65,817.42. For 12/11, £30,000 had been paid in the previous three months whereas the VAT due was £75,714.70.

21. Again, this was not challenged by HMRC and so we accept it as a matter of fact. We treat this as relating to actual payments by the Partnership as distinct from the offsets referred to above. We therefore find that, if payments had been allocated to current liabilities, all periods in the appeal apart from 06/09, 12/09, 06/10 and 12/11 would have been paid in full. We also find (by deducting the amount paid in the previous three months from the VAT due) that for 06/09 the unpaid sum would have been reduced to £21,589.61, for 12/09 the unpaid sum would have been reduced to £20,359.14, for 06/10, the unpaid sum would have been reduced to £51,281.22 and for 12/11 the unpaid sum would have been reduced to £45,714.70.

22. There was no evidence that the Partnership ever instructed HMRC to apply the payments to current VAT liabilities rather than historic liabilities or default surcharges. Mr Ripley confirmed during submissions that it was not part of the Partnership's case that any such instructions had been given.

23. Thirdly, the Partnership experienced customer insolvency and delayed payments. One of the Partnership's customers, Fastline Limited ("Fastline"), went

into administration on or about 31 March 2010 owing the Partnership £19,559.84 plus VAT (therefore totalling £22,922.01). The Partnership had been chasing for payment since November 2009. The more significant impact of Fastline's administration was that the Partnership had been developing a sleeper delivery train for Fastline ("the Project") and had paid its own suppliers £120,881.78 which it would no longer be able to recoup from Fastline. This had an effect upon the Partnership's cash flow. HMRC did not challenge Mr Preston's evidence on this point other than to seek clarification as to whether or not the Project was sold to any other customer, to which Mr Preston answered that nothing had been manufactured as it was still in design phase and so a loss was made. We therefore accept Mr Preston's evidence as to the Partnership's cash flow being affected by the administration of Fastline. We were not given any evidence as to how long this cash flow problem was said to have lasted. We accept that the initial loss of £22,922.01 would have been felt in the 12/09 period, upon the basis that it should have been paid in November 2009. Mr Preston's evidence was that it had been agreed that Fastline would make periodical payments for the Project. However, we were not given any further evidence as to when this would be and in what amounts. As such, we are not in a position to make any findings as to the effect which the administration of Fastline had upon cash flow as compared with the cash flow forecast had the Project continued.

24. Fourthly, the Royal Bank of Scotland reduced the Partnership's overdraft. The Partnership was given 24 days' notice of this, which took effect upon the basis of a reduction of £10,000 per month from February 2011 for ten months in the sum of £100,000. Further, arrangement fees were required in March 2011 in the sum of £1,328 and in July 2011 in the sum of £2,064. The overdraft was increased to £160,000 in March 2012, but this was of course after the periods in question. We find that this did have an effect upon the Partnership's cash flow, as the amount of money available to the Partnership for working capital was reduced accordingly.

25. Mr Preston also gave evidence about difficulties created by a customer known as Southern Gas Networks and the operation of a self-billing system which was introduced in early 2012. However, this was after the periods in question within these proceedings and so we make no findings about this.

The Legal Framework

26. There was broad agreement between the parties as to the legal framework.

27. The default surcharge regime is contained within section 59 of the Value Added Tax Act 1994 ("VATA 1994").

> "59. The default surcharge
>
> (1) Subject to subsection (1A) below if, by the last day on which a taxable person is required in accordance with regulations under this Act to furnish a return for a prescribed accounting period –
>
> (a) the Commissioners have not received that return, or

(b) the Commissioners have received that return but have not received the amount of VAT shown on the return as payable by him in respect of that period,

then that person shall be regarded for the purposes of this section as being in default in respect of that period.

(1A) A person shall not be regarded for the purposes of this section as being in default in respect of any prescribed accounting period if that period is one in respect of which he is required by virtue of any order under section 28 to make any payment on account of VAT.

(2) Subject to subsection (9) and (10) below, subsection (4) below applies in any case where –

(a) a taxable person is in default in respect of a prescribed accounting period; and

(b) the Commissioners serve notice on the taxable person (a "surcharge liability notice") specifying as a surcharge period for the purposes of this section a period ending on the first anniversary of the last day of the period referred to in paragraph (a) above and beginning, subject to subsection (3) below, on the date of the notice.

(3) If a surcharge liability notice is served by reason of a default in respect of a prescribed accounting period and that period ends at or before the expiry of an existing surcharge period already notified to the taxable person concerned, the surcharge period specified in that notice shall be expressed as a continuation of the existing surcharge period and, accordingly, for the purposes of this section, that existing period and its extension shall be regarded as a single surcharge period.

(4) Subject to subsections (7) and (10) below, if a taxable person on whom a surcharge liability notice has been served –

(a) is in default in respect of a prescribed accounting period ending within the surcharge period specified in (or extended by) that notice, and

(b) has outstanding VAT for that prescribed accounting period,

he shall be liable to a surcharge equal to whichever is the greater of the following, namely, the specified percentage of his outstanding VAT for that prescribed accounting period and £30.

(5) Subject to subsections (7) to (10) below, the specified percentage referred to in subsection (4) above shall be determined in relation to a prescribed accounting period by reference to the number of such periods in respect of which the taxable person is in default during the surcharge period and for which he has outstanding VAT, so that –

(a) in relation to the first such prescribed accounting period, the specified percentage is 2 per cent;

(b) in relation to the second such period, the specified percentage is 5 per cent;

(c) in relation to the third such period, the specified percentage is 10 per cent; and

(d) in relation to each such period after the third, the specified percentage is 15 per cent.

(6) For the purposes of subsection (4) and (5) above a person has outstanding VAT for a prescribed accounting period 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 on which he is required (as mentioned in subsection (1) above) to make a return for that period; and the reference in subsection (4) above to a person's outstanding VAT for a prescribed accounting period is to so much of the VAT for which he is so liable as has not been paid by that day.

(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).

(8) For the purposes of subsection (7) above, a default is material to a surcharge if –

(a) it is the default which, by virtue of subsection (4) above, gives rise to the surcharge; or

(b) it is a default which was taken into account in the service of the surcharge liability notice upon which the surcharge depends and the person concerned has not previously been liable to a surcharge in respect of a prescribed accounting period ending within the surcharge period specified in or extended by that notice.

(9) In any case where –

(a) the conduct by virtue of which a person is in default in respect of a prescribed accounting period is also conduct falling within section 69(1), and

(b) by reason of that conduct, the person concerned is assessed to a penalty under that section,

the default shall be left out of account for the purposes of subsections (2) to (5) above.

(10) If the Commissioners, after consultation with the Treasury, so direct, a default in respect of a prescribed accounting period specified in

the direction shall be left out of account for the purposes of subsections (2) to (5) above.

(11) For the purposes of this section references to a thing's being done by any day include references to its being done on that day."

28. Section 71(1) of VATA 1994 provides as follows:

"71. Construction of sections 59 to 70

(1) For the purpose of any provision of sections 59 to 70 which refers to a reasonable excuse for any conduct –

(a) an insufficiency of funds to pay any VAT due is not a reasonable excuse; and

(b) where reliance is placed on any other person to perform any task, neither the fact of that reliance or any dilatoriness or inaccuracy on the part of the person relied upon is a reasonable excuse."

29. The burden of proof in establishing a reasonable excuse is upon an appellant.

30. Although insufficiency of funds cannot of itself constitute a reasonable excuse, the cause of that insufficiency can. The touchstone as to whether or not the cause of the insufficiency of funds is a reasonable excuse is whether or not, "the exercise of reasonable foresight and of 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" (see paragraph 32 below). By way of shorthand, the test has been treated as whether or not the cause of the insufficiency of funds was reasonably avoidable. This test is taken from the judgments of Nolan LJ and Lord Donaldson in *Customs and Excuse Commissioners v Steptoe* [1992] STC 757.

31. Nolan LJ stated as follows at 768:

"I remain of the view which I expressed in *Salevon* that as a general rule one can trust the commissioners and the tribunal to determine whether in any given case, and having regard to the scheme of the legislation including s 33(2)(*a*), a reasonable excuse for non-payment exists. I would not accept that the reasonable excuse must necessarily involve a wrongful act by another person. My references in *Salevon* to 'the wrongful act of another' and to the distinction between 'the trader who lacks the money to pay his tax by reason of culpable default and the trader who lacks the money by reason of unforeseeable and inescapable misfortune' were directed to the facts of that case. They cannot be regarded as an all-purpose test of what constitutes a reasonable excuse. The test is to be found in the words of ss 19(6)(*b*) and 33(2)(*a*) read in the context of the statutory scheme for the collection of value added tax. As a general rule this scheme has a highly beneficial effect on the cash flow of traders. If I may quote again from my judgment in *Salevon* (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 invoke s 19(6)(*b*). In other words he will 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.'"

32. Similarly, Lord Donaldson stated as follows 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. Prima facie the legislative intention is the same as in the context of s 33(2)(b). This is that, save in so far as Parliament has given guidance, it is initially for the commissioners to decide whether the underlying cause constitutes a reasonable excuse and for the tribunal to decide this on an appeal. That said, there must be limits to what *could* be regarded as a reasonable cause. 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 of 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."

33. Mr Ripley relied upon the "reasonably avoidable" test. We agree that this is the correct test. We note that Mr Sellers' written submissions suggested that the cause of the insufficiency of funds will only be a reasonable excuse if they are unexpected or unavoidable. We assume that this arises from the dissenting judgment of Scott LJ in

Steptoe. However, Mr Sellers (rightly, in our view) did not argue against the "reasonably avoidable" test in his oral submissions.

34. The parties agree that this is an objective test.

35. Further, the parties agree that default surcharges must be proportionate, both at a structural level and an individual level. It is clear from *Revenue and Customs Commissioners v Total Technology (Engineering) Ltd* [2012] UKUT 418 (TCC), [2013] STC 681 (Warren J (P) and Judge Bishopp) ("*Total Technology*") that the default surcharge regime as a whole is proportionate (see in particular [99] and [100]).

36. However, *Total Technology* left open the residual possibility that the absence of a maximum penalty might render an individual case disproportionate. This was addressed by the Upper Tribunal in *HMRC v Trinity Mirror* [2015] UKUT 0421 (TCC) (Rose J (P) and Judge Berner) ("*Trinity Mirror*") as follows at [63] to [67]:

> "[63] The correct approach is to determine whether the penalty goes beyond what is strictly necessary for the objectives pursued by the default surcharge regime, as discussed in detail in *Total Technology* and whether the penalty is so disproportionate to the gravity of the infringement that it becomes an obstacle to the achievement of the underlying aim of the directive which, in this context, we have identified as that of fiscal neutrality. To those tests we would add that derived from *Roth* in the context of a challenge under the Convention to certain penalties, namely "is the scheme not merely harsh but plainly unfair, so that, however effectively that unfairness may assist in achieving the social goal, it simply cannot be permitted?"
>
> [64] In *Total Technology* the Upper Tribunal identified, at [84], features of the regime which supported an argument that the scheme was fair. The tribunal said:
>
> > "However, from HMRC's point of view, the regime has a lot to commend it. It is mechanistic and therefore comparatively easy to administer. There is no need for hard-pressed officers of HMRC to spend scarce time and resources in dealing with a vague and amorphous power to mitigate a penalty. The following factors can be prayed in aid in response to the unfairness alleged by the Company:
> >
> > (a) The simplicity of the system makes it easily understood, as well as being relatively easy to operate.
> >
> > (b) The surcharge is only imposed on a second or subsequent default, and after the taxpayer has been sent a surcharge liability notice warning him that he will be liable to surcharge if defaults again within a year. Taxpayers thus know their positions and should be able conduct their affairs so as to avoid any default.
> >
> > (c) The penalty is not a fixed sum but is geared to the amount of outstanding VAT. Although a somewhat blunt instrument, it does bring about a broad correlation between the size of the business and the amount of the penalty. It does not suffer from the objections which could be made to the fixed penalty in *Urbán*.

(d) The percentage applicable to the calculation of the penalty increases with successive defaults if they occur within 12 months of each other. This is a rational and reasonable response to successive defaults by a taxpayer.

(e) The 'reasonable excuse' exception strikes a fair balance. The gravity of the infringement is reflected in the absence of 'reasonable excuse' and the amount of the penalty reflects the extent of the default, that is to say the amount of tax not paid by the due date.'

[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.

[66] However, we accept that, applying the tests we have described, the absence of any financial limit on the level of surcharge may result in an individual case in a penalty that might be considered disproportionate. In our judgment, given the structure of the default surcharge regime, including those features described in Total Technology, this is likely to occur only in a wholly exceptional case, dependent upon its own particular circumstances. Although the absence of a maximum penalty means that the possibility of a proper challenge on the basis of proportionality cannot be ruled out, we cannot ourselves readily identify common characteristics of a case where such a challenge to a default surcharge would be likely to succeed.

[67] We should, in particular, not be taken to have endorsed the suggestion put forward by Mr Mantle that the exceptional circumstances that might give rise to a disproportionate penalty could include cases, such as *Enersys*, where there had been what was described as a "spike" in profits, such that for a particular VAT period the liability to account for and pay VAT was of a different order of magnitude that was normal for the trader concerned. Attempting to identify particular categories of case in this way is not, in our view, helpful. Whilst it might be tempting to seek to isolate, and thus confine, cases by reference to particular criteria, such cases, by reason of their exceptional nature, are likely to defy such characterisation."

The Parties' Submissions

The Partnership

37. Mr Ripley argued that each of the financial pressures individually, or alternatively when taken together, created a situation in which the defaults could not reasonably be avoided. He dealt with these in four categories.

38. The first category relates to recession based factors. He drew our attention to various authorities to the effect that, although recession is not sufficient in its own right to give rise to a reasonable excuse, the manner in which the recession impacted upon a trader can do so. He accepted that each case turns upon its own facts and that these authorities were in that sense illustrative and, to the extent that they were first instance decisions, not binding.

39. In *The Old Tollgate Restaurant Ltd v HMRC* [2007] UKVAT V20504 (Sir Stephen Oliver QC and Shahwar Sadeque) a reduction in turnover of £85,000 from a total turnover of £1,800,000 was treated as a reasonable excuse. The Tribunal stated as follows at [8]:

> "[8] We accept that the explanation given for Tollgate amounts to a reasonable excuse. The insufficiency of funds was attributable to Rio Tinto's late payments associated with Tollgate's loss of Rio Tinto as its single customer for its contract catering business. The cash flow attributable to the hotel business appears to have remained static. But that cash flow could not be relied upon to meet the VAT due at the end of March 2007. The cancellation of the Rio Tinto catering contract and its late payment of fees to Tollgate appears to us to have been sufficiently unforeseen events and ones that could not have been avoided. We conclude therefore that there was a reasonable excuse for the insufficiency of funds. Tollgate has therefore established to our satisfaction that it has a reasonable excuse for the default for the 02/07 period."

40. In *Mediaclash Ltd v HMRC* [2009] UKFTT 306 (TC) (Judge Brooks and Dr Michael James) the FTT accepted that a combination of factors caused by the recession gave rise, on the facts of that case, to a reasonable excuse. This was by reference to what a reasonable businessman would have done. The FTT stated as follows at [15] to [18]:

> "[15] Having considered the Company's circumstances in the light of our findings of fact we find that [that] the underlying cause of the default was a combination of the loss of a major client, the effect of the redundancies and the late payment by the Company's customers as a result of the current recession coupled with the necessity for prompt payment of its suppliers.
>
> [16] In deciding whether these reasons amount to a reasonable excuse we must consider what the reasonable competent businessman (taken for comparison purposes) exercising due diligence and a proper regard

> to his tax obligations, who must be taken to have exercised reasonable foresight, would have done in a similar situation.
>
> [17] We are of the view that such a businessman, in circumstances similar to that of the Company, would not have avoided the insufficiency of funds that led to the default.
>
> [18] As such we find that the Company had a reasonable excuse for the late payment of its VAT and allow its appeal."

41. In *Craighill Services Ltd* [2012] UKFTT 72 (TC) (Kenneth Mure QC), the FTT held that a company suffered various setbacks which affected its turnover. Although individually these were insufficient to constitute a reasonable excuse, they did so when taken together. Similarly, a combination of factors (including the reduction in an overdraft facility) constituted a reasonable excuse for some of the periods in dispute in *Robert P Slight v HMRC* [2015] UKFTT 0016 (TC) (Presiding Member Peter Shepherd and Dr Heidi Poon).

42. Mr Ripley noted that the Partnership had experienced a number of the features treated as reasonable excuses in the above cases. The Partnership had seen customer insolvency, particularly Fastline, and delayed payments. There had also been a reduction in the bank overdraft, although that only affected the periods after February 2011.

43. The second category relates to the removal of CIS 6 status. Mr Ripley noted that this was suggested or required by HMRC as a result of PAYE defaults, even though Mr Preston had thought that it was potentially a good idea at the time. Mr Reay said that the Partnership did not move back to CIS 6 because of the cycle of defaults which had taken hold. The effect of this was that CIS offsets could only be applied at the end of the year (by virtue of the Partnership being a partnership rather than a company) and these were applied against both VAT and PAYE liabilities. Mr Ripley made the point that he was not criticising HMRC for approaching the offsets in this way; instead, the point was the effect of them doing so.

44. The third category relates to HMRC's policy of enforcing previous debts, which prevented the Partnership from meeting its current liabilities. There had been threats of distraint and bankruptcy proceedings, but there was no evidence that any enforcement proceedings had been commenced. Mr Ripley submitted that it was common ground that the Partnership did not have the money to meet its VAT as it fell due (and it is of note that Mr Sellers did not take issue with this either in submissions or by way of cross-examination).

45. Mr Ripley drew our attention to *Longstone Ltd v Commissioners of Customs and Excise* [2001] V & DR 213 (Stephen Oliver QC) as an example of enforcement of debts having the potential to give rise to a reasonable excuse. In particular, the Tribunal stated as follows at [16] and [17]:

> "[16] The second period raises different considerations. The large debt overhang from the first period and the Commissioners' actions to recover the arrears left Longstone with a simple choice. Either allow liquidation to follow or attempt to keep the core business intact at the

expense of paying default surcharges. Had Longstone been credit-worthy it might have borrowed funds and so protected itself against those two extremes. But borrowing was not an option. The Commissioners imposed the full rigour of the penalty regime. In the letter of 3 August 1999 they said:

> 'Whilst appreciating and sympathizing with the difficulties encountered by some businesses, the Commissioners of Customs and Excise cannot make exceptions which might lead to one business gaining an unfair commercial advantage over another.'

[17] Imposing default surcharges, whilst at the same time taking recovery action in relation to outstanding tax liabilities, is a high risk strategy on the part of the Commissioners. It not only erodes the resources of the trader, it is capable also of furnishing that trader with a reasonable excuse for non-payment of current liabilities."

46. The fourth category related to HMRC's process of allocating payments to historic liabilities rather than current liabilities. The effect of this was that the Partnership was effectively paying existing debts at the expense of creating new defaults. The Partnership does not take issue with HMRC's appropriation of payments in this way, notwithstanding that Mr Ripley argues that the Partnership's VAT account with HMRC is a running account. Similarly, the Partnership accepts that it is not now entitled to insist on a different allocation as a matter of common law.

47. Mr Ripley submits that section 59 of VATA 1994 is to be read as requiring VAT payments to be allocated first to current VAT liabilities and then any excess to historic liabilities. This relies upon the reference in section 59(6) to, "so much of the VAT for which he is so liable as has not been paid by that day" as taking into account any payments made in the quarter, regardless as to how they have been allocated.

48. The Partnership also makes the point that the allocation to historical payments caused current liabilities to go unpaid and so gives a reasonable excuse for those defaults. Mr Ripley relied upon *John Francis v HMRC* [2013] UKFTT 477 (TC) as an illustration of this, in which the First-tier Tribunal (Judge Khan) stated as follows:

"(1) The Commissioners allocate payments to the oldest debt first and so the payments made by the Appellant were treated as being late since it was paid in satisfaction of his liability for the year ending 5 April 2011. It seems that the Appellant gave no instructions as to how the payment should be allocated.

(2) In this case the taxpayer would have a reasonable excuse for assuming that HMRC would allocate the payments to the current liability rather than to the oldest debt due.

(3) The practise of the Commissioners does not appear to be covered in the legislation but rather in the Debt Management and Banking Manual (para 210105 and 210120). It does not appear that these were brought to the notice of the taxpayer. In the circumstances therefore a taxpayer should be able to ask the Commissioners to reallocate the payments as they wish.

(4) The failure to make payment on time legislation as contained in Schedule 56 Finance Act 2009 was relatively new. The charges applied to returns for 2010-11 and later years. If HMRC were operating on a non-statutory basis on a practice which was contained in their manuals on new legislation then the taxpayer should be alerted to this practise. There is nothing to indicate this practise was brought to the attention of the taxpayer.

(5) A taxpayer is told in Schedule 56 FA 2009 that a penalty would be incurred if a payment is made after the due date. On a normal reading, there is nothing to suggest that if a payment is made on time it would relate to historic liabilities.

(6) A reasonable person in the circumstances would have thought that they had paid their tax on time and would not have known that their payments would be allocated to earlier periods and a penalty would have arisen. For this reason, where the taxpayer acted reasonably in trying to meet their tax liability a reasonable excuse should be allowed."

49. Mr Ripley also argued that the default surcharges were disproportionate. In essence, his argument was that the Partnership was being repeatedly penalised for the earlier defaults. On one level, money was being applied to historic liabilities and surcharges causing new liabilities to arise. On another level, this circle of defaults was forming a barrier to regaining CIS 6 status. On a further level, the default surcharges were themselves causing an insufficiency of funds. Mr Ripley submitted that the lawfulness of the appropriation had no bearing upon whether or not the surcharges were disproportionate.

HMRC

50. Mr Sellers did not accept that any of the Partnership's arguments constituted a reasonable excuse, whether individually or together.

51. As to the recession based factors, Mr Sellers accepted that in principle the economic climate, and the demise of a major customer, could give rise to a reasonable excuse. However, he submitted that there was nothing in the recession which particularly applied to the Partnership. Further, he submitted that the situation with Fastline was very different to the situations in *Steptoe* and in *Old Tollgate Restaurant Ltd.* He noted that Fastline was not a major customer in comparison to the Partnership's turnover and that the amounts involved were not particularly large. Mr Sellers also made the point that "time to pay" agreements could have been sought.

52. As to the loss of CIS 6 status, Mr Sellers submitted that this was a known event and so its impact was not unexpected or unavoidable. The Partnership would have had a reasonable opportunity to plan and act accordingly. Further, Mr Sellers submitted that CIS 6 status was removed on 6 April 2007 whereas the first relevant default was for the 06/09 period. As such, he argued, the passage of time meant that any reasonable excuse which this might had given had expired by 06/09 as the Partnership had sufficient time to adjust its financial planning. Mr Sellers relied upon *French Polish Limited v HMRC* [2014] UKFTT 091 (TC) (Judge Connell) as an illustration of this. Further, Mr Sellers made the point that there was no legal requirement to set off

CIS deductions for partnerships mid-year and that HMRC had acted lawfully in not doing so.

53. As to enforcement, Mr Sellers' main point was that it was for the Partnership to meet its obligations and a failure to do so did not give rise to a reasonable excuse.

5 54. As to allocation, Mr Sellers submitted that HMRC was entitled to allocate the payments in the way in which it did. Mr Sellers referred us to a number of cases which set out the common law position and the applicability of those principles to tax law. In short, where separate debts are owed, it is open to a debtor to allocate payments as he or she sees fit until the point of payment and, if no allocation has been 10 made, the creditor is entitled to allocate the payment as he or she sees fit. The position is different in the case of the operation of a running account, in which case the payment is allocated to the earliest debt first unless there is an agreement to the contrary (the presumption for running accounts being "the rule in *Clayton's Case*").

55. In *Cory Bros & Co Ltd v Turkish SS Mecca* [1897] AC 286, Lord Macnaghten 15 stated as follows at 293-294:

> "When a debtor is making a payment to his creditor he may appropriate the money as he pleases, and the creditor must apply it accordingly. If the debtor does not make any appropriation at the time when he makes the payment the right of application devolves on the creditor."

20 56. In *Abbey National plc v Commissioners of Customs and Excise* [2005] EWHC 1187 (Ch), Lindsay J stated as follows at [28]:

> "[28] Looking, then, to the rationality or otherwise of reg 170(1) and (2), and recognising the need, to which I have referred, for simplicity and comprehensibility, I do not feel able to say that the time-basis used 25 in reg 170(2), qualified, as it was, by the ability of the consumer to make a specific allocation as there provided, was irrational in *Wednesbury* or similar terms. It is not capricious or arbitrary. Indeed, such an attribution of payments to the first debt owing has been a rule-of-thumb form of accounting since *Clayton's* case in 1816 and the 30 ability of the consumer specifically to allocate reflected the sense of the common law position that, where he owes distinct debts, the debtor has the first right to appropriate."

57. In *AJM Mansell Limited v HMRC* [2012] UKFTT 602 (TC) (Judge Redston and James Midgley), the First-tier Tribunal stated as follows at [53] to [55] and [59]:

> 35 "[53] Given the existence of the statutory obligation on employers to pay over the PAYE to HMRC, we find that the PAYE is a debt due to HMRC and that the employer is a debtor.
>
> [54] Furthermore, as set out above, the employer must pay over the PAYE calculated on a "tax period" basis. We thus find that each 40 month's PAYE was a separate debt and there was no "running account". As a result, the rule in *The Mecca* applies.

> [55] For completeness, we note that were a "running account" to exist, the rule in *Clayton's case* means that the PAYE payments would automatically be allocated to reduce the earliest debt first; the company would have no right of allocation.
>
> …
>
> [59] On the basis of the foregoing, the common law allows the company to appropriate its PAYE and NICs payments in any way it chooses, as long as it does so before the money changes hands. We note that HMRC's guidance and their debt management office appear to have accepted this is the correct position."

58. Mr Sellers further submitted that section 59 of VATA 1994 does not entitle the Tribunal to amend the allocation of the payments made by the Partnership.

59. Mr Sellers also submitted that the fact that HMRC were entitled to allocate the payments as they did precludes the surcharges from being disproportionate. Further, Mr Sellers submitted that the regime has already been found to be proportionate in *Total Technology*. Mr Sellers relied on *Swanfield Limited v HMRC* [2015] UKFTT 274 (TC) (Judge Clark) in which the First-tier Tribunal stated as follows:

> "[68] In relation to proportionality, Mr Jenkins did not seek to argue that the system as a whole was disproportionate or unfair. However, he submitted that operating the system without reference to the allocations which the Appellants had sought to make was harsh and unfair, resulting in the imposition of substantial surcharges.
>
> [69] We consider that the position needs to be examined by reference to the actual factual position. It needs to be established to what extent the allocations were made in respect of debts already due, for the reasons explained above. Instances of allocations made to such debts must be examined in the overall context of each Appellant's compliance position. Other allocations, in respect of debts not yet due, are ineffective and therefore irrelevant to the question whether the operation of the system was harsh or unfair.
>
> [70] Mr Jenkins referred to *Total Technology* and *Enersys*. He acknowledged that these cases concerned the questions of the extent to which a payment was late, and the level of that payment in the context of the particular trader's pattern of business. Mrs Carroll submitted that the Appellants' circumstances were entirely different from those in *Enersys,* and that in *Total Technology* the Upper Tribunal had found that the default surcharge system was not fatally flawed. Further, the Upper Tribunal accepted that a substantial default surcharge sum may be found to be proportionate.
>
> [71] We accept Mrs Carroll's submissions on the application of *Enersys* and *Total Technology*. It follows that the only relevance of proportionality to the Appellants' case is to the question whether effective allocations were not acted upon by HMRC. If no effective allocations can be shown to have been requested, the issue of proportionality falls away. We review the factual issues below."

Decision

Reasonable excuse

Period 09/09

60. The parties agreed that the return for the period 09/09 was not received by the relevant due date. No evidence has been given or submissions made as to the reason for this. It follows that there is no reasonable excuse for such default. The remainder of this decision therefore only deals with non-payment or partial payment rather than failure to deliver a return on time.

Whether or not the defaults were reasonably avoidable

61. We agree that the features relied upon by the Partnership ought to be analysed both individually and collectively. However, it is important not to lose sight of the fact that the test is as to whether or not the insufficiency of funds was reasonably avoidable. If it can be said that the reasonable businessman in a similar situation would have acted in a way which would have avoided the defaults, then this must be taken into account.

62. Crucially, the Partnership's own case provides a way in which all but four of the defaults in the present appeal could have been avoided; namely, the allocation of the VAT payments made by the Partnership by cheque and CHAPS to current liabilities rather than historic liabilities. We have already found as a fact (as asserted by the Partnership and not challenged by HMRC) that allocation of payments to current liabilities would have meant the Partnership would not have been in default at all for any of the relevant periods other than 06/09, 12/09, 06/10 and 12/11 ("the Outstanding Periods").

63. It is clear that the proper approach at common law to the Partnership's liabilities is that of *Cory Bros & Co Ltd v Turkish SS Mecca,* above, as opposed to the rule in *Clayton's Case.* This is because the Partnership incurred numerous, separate liabilities. HMRC was not providing credit to the Partnership and was not making advances to them. What the Partnership has referred to as a running account is nothing more than a statement of account. Every time a new debt was incurred it was a separate debt. Although not binding on us, we are reinforced in our view by the extracts from the decision in *AJM Mansell Limited v HMRC,* above, relied upon by Mr Sellers.

64. We do not accept that the proper construction of section 59(6) of the VATA 1994 precludes the common law rule. Section 59(6) relates to the non-payment of liabilities. A liability has not been paid if it has not had a payment allocated to it. In short, a different debt has been paid. In any event, we note that the Partnership's construction would reinforce the Partnership's right to insist upon allocation to current liabilities and the reasonable businessman would have sought to enforce such a right.

65. As such, the Partnership was fully entitled to instruct HMRC to apply the payments to current VAT liabilities. However, the Partnership did not do so. Further, unlike in *John Francis v HMRC,* above, there was a history of HMRC allocating payments to historic liabilities. Further, this was not a situation envisaged in *Swanfield Limited* in which allocations had been made by the Partnership but not acted upon by HMRC.

66. We therefore find that, for all but the Outstanding Periods, the defaults were avoidable.

67. The next question is whether or not it would have been reasonable for the Partnership to instruct HMRC to allocate the payments so as to avoid the defaults. We find that it would have been reasonable for the following reasons:

(1) The Partnership itself complains about the cycle of defaults which this was creating and argues that it would have been more beneficial to it to allocate to current liabilities.

(2) Incurring new surcharges was increasing the amount required to clear the overall liabilities.

(3) The amount required to clear overall liabilities would crystallise, which would assist in financial planning.

(4) By 06/09, the Partnership was or ought to have been well aware that payments had been allocated to historic liabilities and its impact was already being felt.

(5) Although HMRC was threatening enforcement action in respect of historic liabilities, there was no evidence of the extent to which this had happened prior to 06/09 (being the first of the default surcharges in the present appeal and so the date by which the reasonable businessman would have started to allocate payments to current liabilities). Similarly, there was no evidence as to how much the historic liabilities were as at 06/09 and the extent to which money could have been raised by the partners themselves or from third parties in order to meet those liabilities. Indeed, it is of note that in later periods Mr Preston drew down on his pension to make payments; there is no evidence as to whether or not this could have been done earlier and as to the resources of the other partners. Without any such evidence, the Partnership cannot establish that it would not have been reasonable to allocate payments to current liabilities at that stage. This contrasts with *Longstone Ltd v Commissioners of Customs and Excise*, above, in which the enforcement action was more advanced and it was clear that no other funds could be raised.

(6) It is not clear to what extent "time to pay" agreements had been formally sought or pursued. A telephone note for 11 February 2010 says (including any abbreviations and typographical errors), "Trader teli vat dmtc seeking ttp refused referred ff support central." In any event, it is fair to assume that a time to pay agreement would have had more chance of success if further defaults were not taking place.

68. It follows that the other features relied upon cannot constitute reasonable excuses for the periods other than (potentially) for the Outstanding Periods because, even if we were to find that those features taken individually caused cash flow problems, the fact would remain that the insufficiency of funds was avoidable if the Partnership had allocated payments to current liabilities.

69. Nevertheless, we consider the individual factors relied upon by the Partnership in order to reach a decision about the Outstanding Periods.

The economic downturn

70. As set out above, the Outstanding Periods were after the particularly bad year ending 31 March 2010 and came in years in which the net profits were £134,084 and £375,293 respectively. In the light of this, the Partnership has not provided sufficient evidence that the economic downturn caused the insufficiency of funds to be reasonably unavoidable for the Outstanding Periods.

The loss of CIS 6 status

71. We find that the reasonable businessman would have avoided the insufficiency of funds caused by the loss of CIS 6 status by not doing anything to lose the CIS 6 status in the first place. The rider to this is that the insufficiency of funds caused by the loss of CIS 6 status would not be reasonably avoidable if the loss of CIS 6 status itself was not reasonably avoidable.

72. We note that CIS 6 status was lost in April 2007, over two years before the first of the periods to which this appeal relates. We were told that this was because of non-payment of PAYE but were not given any explanation as to why there was such non-payment. Crucially, there was no suggestion that there was a reasonable excuse for such non-payment of PAYE. It follows that there was no evidence that the loss of the CIS 6 status was not reasonably avoidable and so the Partnership has not discharged its burden of proof in this regard.

73. As such, we find that the loss of CIS 6 status does not provide a reasonable excuse for the Outstanding Periods (and for the same reasons would not have done so for any other period).

Fastline

74. Clearly, Fastline's administration is not relevant to the 06/09 period as this pre-dates the cash flow problems blamed upon Fastline.

75. As set out above, we have found that the administration of Fastline did create a cash flow problem for the 12/09 period to the extent of the loss of £22,922.01. HMRC did not challenge the assertion that this caused the insufficiency of funds or that it was reasonably avoidable. Although Fastline was not a major customer it still reduced the available cash flow in this period and there is no evidence as to how it could have been replaced. Given that the 12/09 period was not one of the periods for which the insufficiency of funds could have been completely avoided by the allocation of

payments, it follows that we accept that there was a reasonable excuse for the 12/09 period to the level of £22,922.01. Although in fact a reallocation of payments made in the previous three months would have only left the sum of £21,589.61 outstanding, we give credit for the whole of the £22,922.01 upon the basis that there was no challenge to the assertion that the whole of the payment had been expected. This would reduce the default surcharge to £3,438.30 (being 15% of £22,922.01).

76. However, for the reasons set out above in respect of the sleeper delivery train, the Partnership has not discharged the burden of proof in establishing that it caused the insufficiency of funds for any later period to be reasonably unavoidable. As such, the Partnership has not established that Fastline gives rise to a reasonable excuse for the 06/10 or 12/11 periods.

Withdrawal of the overdraft

77. The withdrawal of the overdraft began in February 2011 and so, of the Outstanding Periods, can only be relevant to the 12/11 period.

78. Mr Sellers' main point about the overdraft was that the Partnership had notice of the reduction and that it should have restructured the business accordingly. However, with the exception of the points which have already been made about allocation, it was not clear to us what the Partnership could have done and what a reasonable businessman could have done differently. By the 12/11 period, the full extent of the reduction in overdraft had taken place. We therefore accept that this had a major impact upon cash flow, and that this was not reasonably avoidable. However, this only applies to the shortfall after an allocation of payment in the previous three months to current liabilities as it was reasonably avoidable to that extent. This means that the shortfall for 12/11 would have been reduced to £45,714.70, thereby reducing the default surcharge to £6,857.20 (being 15% of £45,714.70).

Allocation and the enforcement of historic debts

79. The points which we have made at paragraphs 61 to 68 above equally apply to allocation and enforcement in respect of the Outstanding Periods. As such, they do not provide a reasonable excuse in their own right.

The combined effect of the various factors

80. The combined effect of the various factors does not give any different result for the Outstanding Periods. On one level, this is because for various of the periods in the Outstanding Periods the factors do not all operate at the same time. On another level, this is because our conclusions about the economic downturn and the CIS 6 status preclude these from contributing to a reasonable excuse at all in the present case as well as from being a reasonable excuse individually.

Proportionality

81. We do not accept that the default surcharges in the present case are disproportionate. This is for the following reasons.

82. First, it is clear from *Total Technology* and *Trinity Mirror* that the default surcharge regime is proportionate. In our view, the Partnership's criticisms go to the question of the proportionality of the regime rather than the regime's application in this particular case. This is because there is no provision in the regime for allocation of payments in any particular way and so it is inevitable that this sort of situation may arise. We are of course bound by *Total Technology* and *Trinity Mirror*.

83. Secondly, the potential for individual application of the surcharge regime to be disproportionate is envisaged in *Total Technology* and *Trinity Mirror* to be exceptional. The present case is not exceptional in that the allocation of payments to historic liabilities will be a relatively common situation as it will presumably arise whenever a trader does not request allocation to current liabilities.

84. Thirdly, in *Total Technology* and *Trinity Mirror*, the type of situation in which disproportionality will arise is envisaged as being caused by the absence of a financial limit on the level of surcharge (see *Trinity Mirror* at [66]). The level of each surcharge in the present case is relatively modest and so is not rendered disproportionate by the absence of an upper limit.

85. Fourthly, it is not clear that the Partnership is correct to say that it is being penalised for previous defaults. The surcharges are only dependant upon previous defaults by reference to their rate. The perceived penalisation for previous defaults is instead as a result of the decision to allocate to previous liabilities rather than because of the way in which the default surcharges are imposed.

86. Fifthly, and, to our minds, most importantly, we must consider whether in the present case, the scheme is, "not merely harsh but plainly unfair, so that, however effective that unfairness may assist in achieving the social goal, it simply cannot be permitted" (see *Trinity Mirror* at [63]). The allocation to historic defaults in the present case does not result in default surcharges which are plainly unfair because it was open to the Partnership to instruct HMRC prior to payment to allocate them differently. The reasons for the Partnership not doing this go to the question of reasonable excuse (dealt with above) rather than causing the surcharges to be disproportionate. As set out in *Total Technology* at [84], the very fact of the reasonable excuse exception strikes a fair balance.

Disposition

87. It follows that our decision in respect of the relevant periods is as follows:

(1) The appeal in respect of period 12/09 is allowed to the extent that the default surcharge is reduced to £3,438.30.

(2) Insofar as it has not already been resolved by agreement, the appeal in respect of period 09/10 is allowed to the extent that the default surcharge is reduced to £9,177.41 (to take into account the fact that £25,204 had been paid on time).

(3) The appeal in respect of period 12/11 is allowed to the extent that the default surcharge is reduced to £6,857.20.

(4) The appeal in respect of the remaining periods is dismissed.

88. 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.

RICHARD CHAPMAN

TRIBUNAL JUDGE
RELEASE DATE: