# TC01323

**Appeal number: TC/2010/01291**

***VAT default surcharge - whether reasonable excuse - no - penalty of £4,260.26 - whether disproportionate – yes - appeal allowed.***

**FIRST-TIER TRIBUNAL**

**TAX**

**TOTAL TECHNOLOGY (ENGINEERING) LIMITED** **Appellant**

**- and -**

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

**TRIBUNAL: ANNE REDSTON (PRESIDING MEMBER)**
**IAN PERRY (TRIBUNAL MEMBER)**

**Sitting in public at Eastgate House, Newport Road, Cardiff on Thursday 7 July 2011**

**Dean Coughlan, director of Total Technology (Engineering) Limited and Michael Matthews of Mathews Pulman, Accountants, for the Appellant**

**Jack Lloyd, Higher Officer of HM Revenue and Customs, for the Respondents**

## DECISION

1. This is the appeal of Total Technology (Engineering) Limited ("the Company) against a VAT default surcharge of £4,260.26 for the quarter ended 30 June 2009. The Company's VAT payment was received one day late, on 8 July 2009 instead of 7 July 2009.

2. The issues in the case were whether the Company had a reasonable excuse for the late payment and whether the surcharge was disproportionate.

### Legislation and concession

3. The surcharge was levied under s 59 Value Added Tax Act 1994 ("VATA"). The legislation is set out in the Appendix to this Decision.

4. The Company was on a quarterly basis for VAT, so its VAT return and the related payment were due on or before the end of the month following each calendar quarter[1].

5. HMRC have discretion to allow extra time for both filing and payment when these are carried out by electronic means[2]. Under that discretion, HMRC allow a further seven days for such electronic filing and payment.

### Evidence

6. We were provided with a bundle of documents including the correspondence between the parties and a "Schedule of Defaults" provided by HMRC. Mr Coughlan also gave oral evidence on the Company's behalf. From the evidence before us we find the following facts.

### Facts

*Background*

7. The Company runs an employment agency. It has been trading since 1973. Mr Matthews submitted that the Company had an excellent compliance record, not only in relation to VAT but also for other taxes, and this was not disputed.

8. In 2001 Mr Coughlan joined the Company. He purchased a new accounting system. Between 2001 and 2008 the Company's turnover grew by around 25% a year. In the spring of 2009 the company began working on a new contract with the Department of Work & Pensions, which involved significant extra work. One individual was responsible for the book-keeping and accountancy.

9. Although no accounts were provided, we were told that the Company made profits of around £50,000 a year, a profit margin of approximately 12%.

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[1] Reg. 25(1) and Reg. 40(1) Value Added Tax Regulations 1995, SI 1995/2518

[2] Reg. 25A(20) and Reg. 40(2) Value Added Tax Regulations 1995, SI 1995/2518

*The VAT payments and defaults*

10. The Company's VAT payment history, so far as relevant to this Appeal, is as follows:

| Period to | VAT due £ | Due date | Paid by due date £ | Paid after due date £ | Rate of sur-charge | Amount £ | No. of default |
|---|---|---|---|---|---|---|---|
| 31/5/08 | 126,246 | 31/7/08 | 125,769 | 476 | 0% | 0 | 1 |
| 30/11/08 | 108,957 | 7/1/09 | 108,626 | 331 | 2% | 0 | 2 |
| 31/5/09 | 85,205 | 7/7/09 | nil | all | 5% | 4260.26 | 3 |

11. As can be seen from the table, small adjustments to the total VAT due were paid after the due dates in respect of the returns ending May and November 2008. Mr Coughlan said that these arose because of problems with his accounting system. During this two periods, the system produced first the original figure, which was filed with HMRC, and subsequently a slightly increased figure for the same period.

12. The Company informed HMRC of these amendments; because they were after the due date, they were recorded as a late payment.. Despite extensive negotiations with the Company's software supplier, it had been impossible to establish the cause of the problem and the system has now been replaced.

13. The Tribunal asked Mr Lloyd about the zero surcharge for the quarter ending in November 2008, and he said that the surcharge was levied but not collected. In particular, he confirmed that the surcharge had not been withdrawn under VATA 1994, s 59(7).

14. The "Schedule of Defaults" produced by HMRC also included figures for three earlier quarters, but it was confirmed by Mr Lloyd that none of these gave rise to a surcharge.

15. There had been one further default during the two year period between the quarter ended May 2009 (the subject of this Appeal) and the date of this Tribunal hearing.

16. This further default relates to the quarter ending February 2010. Mr Coughlan informed this Tribunal that, during that period, the accountant's sister was diagnosed with a serious and life-threatening illness, of which she subsequently died, and Mr Coughlan's daughter was in hospital with a serious kidney infection.

17. The Company has appealed the surcharge. The appeal was stayed pending this Appeal, so no decision has yet been made by HMRC. Mr Matthews said that a letter setting out the grounds for a reasonable excuse defence will be sent to HMRC following this hearing.

**Submissions for the Company**

18. Mr Matthews, on behalf of the Company, put forward two grounds of reasonable excuse:

(1) The accounting system was unreliable (in written submissions, the word used was "unwieldy"). It has now been replaced. Although this should have been dealt with more quickly, the Company had been hit by the recession in 2008 and the staff were overstretched – particularly in early 2009 when they won the DWP contract, and it would have been difficult also to implement a major systems change.

(2) The Company had only a single individual who carried the burden of the accounting, including the VAT filing, and it had not been possible to increase staff numbers.

19. Mr Matthews also argued the surcharge was disproportionate. He relied on the First-tier Tribunal decision of *Enersys Holdings UK Ltd v R&C Commissioners* [2010] UKFTT 20 (TC) ("*Enersys*"), and drew attention to the similarities between that case and the Company's position. He said that the Company's payment had been only one day late, as in *Enersys* and that the sum was excessive both in relation to the company's profitability and as an absolute amount.

20. He pointed out that the earlier two defaults had been very small because they were charged on the balancing amounts caused by the systems errors. Over 99.5% of the sums due had been paid on time. The 2% surcharge for the second default was so low as to be not worth collecting.

21. It was disproportionate for a penalty to rise from zero to £4,206. Furthermore, the company had an excellent compliance record and the late payment was not deliberate.

**Submissions for HMRC**

22. Mr Lloyd made very clear and well-argued submissions to the Tribunal on behalf of HMRC. He said, firstly, that the Company did not have a reasonable excuse. In relation to the accounting system, it was clear that there had been longstanding problems which should have been addressed by the Company. Reliance on an individual was precluded from being a reasonable excuse by VATA s 71(1)(b).

23. On proportionality, he drew the Tribunal's attention to the recent First-tier Tribunal decisions of *Scotpackaging Ltd v R&C Commrs* [2010] UKFTT 504(TC) ("*Scotpackaging*"), *Crane Limited v R&C Commrs* [2010] UKFTT 378 (TC) ("*Crane"*) and *1st Glass and Mirror Company Ltd v R&C Commrs* [2011] UKFTT 30 (TC) ("*1st Glass")*. In all these cases, the facts were distinguished from *Enersys*, and the surcharges levied were not found to be disproportionate.

24. In *Scotpackaging* a small company paid its VAT late on several occasions, with those relevant to the surcharge being 36 days late, 5 days late and 4 days late respectively.

25. In *Crane* the payment was one day late. The 2% surcharge amounted to £5,000 on a total liability of £257,000. The Tribunal said that the purpose of the regime was to penalise late submission, and in that context the surcharge was not "wholly outside the realms of what is necessary to achieve that object in this particular case."

26. In *1st Glass* the payment was over two weeks late, and a surcharge of £576 on a liability of £5,768 was found to be not disproportionate.

27. Mr Lloyd drew the Tribunal's attention in particular to *Crane*, noting that, as in the instant case, the payment had been only one day late and the quantum was similar. He distinguished the Company's position from *Enersys*, in particular because in that case the VAT due in the quarter under appeal had been unusually high, but the Company's VAT in the surcharge period was typical.

28. He said that the whole structure of the surcharge legislation was designed to be proportionate to the VAT unpaid. Furthermore, its purpose was to encourage compliance. He told us that around 14-20% of traders were within the default surcharge regime at any one time, and it is thus very necessary.

**Discussion and decision**

*Reasonable excuse*

29. We agreed with Mr Lloyd that neither the defects of the accounting system, nor the Company's reliance on a single accountant, constituted a reasonable excuse, for the reasons he gave.

*Proportionality - the principles*

30. The parties referred us to a number of cases on proportionality. We also considered *Greengate Furniture Ltd v Customs and Excise Commissioners* [2003] VATDR 178 ("*Greengate*"). We were grateful for these decisions, and in particular for the detailed review of legislative history and case law development set out in *Greengate* and *Enersys*, which we do not repeat here.

31. The case law of the ECJ and the European Court of Human Rights ("EctHR") do not disclose material differences in the meaning of proportionality, and UK case law in this area thus relies on cases from both the ECJ and the EctHR.

32. If a penalty is disproportionate to the gravity of the offence, it is clear from the authorities that the Tribunal has a duty under European law to intervene (*Garage Molenheide BVBA and others v Belgium* (Joined cases C-286/94, C-340/95, C-401/95 and C-47/96) [1998] STC 126).

33. The Human Rights Act 1998 obliges the Tribunal to comply with Convention rights, and these also require that there be "a reasonable relationship of proportionality between the means employed and the aim pursued", see *Gasus Dosier-und Fördertechnik GmbH v Netherlands* (Application 15375/89 (1995) 20 EHRR 403).

34. In *International Transport Roth GmbH v Home Secretary* [2003] QB 728 at [26] Simon Brown LJ set out the test for assessing proportionality. He said:

> "…it seems to me that ultimately one single question arises for determination by the court: 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? In addressing this question I for my part would recognise a wide discretion in the Secretary of State in his task of devising a suitable scheme, and a high degree of deference due by the court to Parliament when it comes to determining its legality. Our law is now replete with dicta at the very highest level commending the courts to show such deference."

35. The "not merely harsh but plainly unfair" test sets a high threshold before a court or tribunal can find that a penalty, correctly levied on the taxpayer by statutory provisions set by parliament, should be struck down as disproportionate.

*Proportionality - application*

36. The Tribunal is thus required to consider whether the penalty levied on the Company was disproportionate to the gravity of its offence. While we found the approach taken by other Tribunals to be an illuminating, it falls to us to apply the law to the facts of this particular case.

37. When carrying out the similar exercise in *Enersys* Judge Bishopp considered the following factors:

(1) whether the default was "innocent" or "deliberate";

(2) the number of days of the default;

(3) the absolute amount of the penalty, about which he said "The absence of an upper limit may be justifiable upon the basis that it is a necessary consequence of a tax-geared penalty, though in my view there must come a time, even in the case of a large company, when that justification breaks down";

(4) the "inexact correlation of turnover and penalty"; and

(5) the absence of any power to mitigate.

38. Turning to the first of the five elements set out above, in *Enersys* there was clearly a simple mistake. Here, the Company did not provide any evidence as to the reason for the late payment other than to say that it wasn't deliberate and was linked to the "unwieldy" accounting system. It seemed to us that this was a neutral factor.

39. The second factor is the number of days of default. Here the parallels with *Enersys* are exact – in both cases the payment was only a single day late. Although the same was true in *Crane*, we note that this is the minimum possible period of delay and thus must weigh in the Company's favour.

40. Taking the third and fourth factors together we found that a penalty of over £4,000 to be extremely high for a small company with annual profits of around £50,000.

41. In relation to the fifth factor, neither HMRC nor the Tribunal have a power to mitigate the default surcharge regime: in *SKG* the Tribunal said "without such power the [default surcharge] regime arguably goes 'further than is necessary'."

42. In addition to these factors, we also considered the Company's history. This is not a case., like *1st Glass,* where there is a history of defaults. Other than the small adjusting payments, which we discuss below, the Company has an excellent compliance record.

43. We accept Mr Lloyd's argument that the structure of the default surcharge regime is such that the penalties increase in steps, and this makes it more proportionate. However, in this case the Company's previous defaults related only to the tiny balancing amounts. The second surcharge was so minor as to be below HMRC's threshold for collection; although there was no surcharge on the first default, the underpayment was less than half a percent of the total VAT due.

44. The Company thus went directly from zero to £4,260. On the specific facts of the instant case, that part of HMRC's proportionality argument which is based on the graduated nature of the regime is thus weakened.

45. We of course accept that the purpose of default surcharges is to deter, but we echo the comments of Judge Bishopp in *Enersys* at [67] that:

> "What is not clear…is whether the scheme is materially assisted in its purpose by the fixed nature of the penalty, regardless of the period of delay, the absence of any upper limit and the exclusion of a power to mitigate - in other words, the Commissioners have advanced no evidence or other material to show that these are features of the scheme without which it would be materially less effective."

46. In carrying out our balancing exercise we also acknowledge that Mr Lloyd is correct to identify that there is a difference between the situation in *Enersys* where the amount of VAT for the quarter under appeal was unexpectedly high, and here, where the VAT payment in the instant case was in line with previous quarters .

47. Taking these considerations together, while being mindful of the "high degree of deference" which courts and tribunals must properly give to statutory regimes put in place by parliament, we found that on the particular facts of this case, the penalty was "not only harsh but plainly unfair."

48. In coming to our conclusion we noted in particular the lack of correlation between the single day of delay and the quantum of the penalty; the relationship between that quantum and the Company's profits; the sudden jump in surcharge from zero to over £4,000 and the Company's generally good compliance record both before and since this default period. We also considered it relevant that, in the first two default periods, over 99.5% of the amounts due had been paid on time.

49. As stated above, the Tribunal has no power to reduce the penalty, and it is thus discharged.

50. 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.

**Anne Redston**

**TRIBUNAL PRESIDING MEMBER**
**RELEASE DATE: 15 JULY 2011**

# The Value Added Tax Act 1994
# S59 Default Surcharge

**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 subsections (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) to (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 subsections (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.

**S71 Construction of sections 59 to 70**

(1) For the purposes 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 reasonable excuse; and

(b) where reliance is place 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.

(2) …..