



TC02375

Appeal number: TC/2012/04846

CONSTRUCTION INDUSTRY SCHEME – failure to deduct tax from payments made to sub-contractors - refusal of direction to relieve contractor from obligation to withhold – whether contractor took reasonable care – yes whether error made in good faith – yes – appeal allowed – Regulation 9 Income Tax (Construction Industry Scheme) Regulations 2005

**FIRST-TIER TRIBUNAL
TAX CHAMBER**

PDF ELECTRICAL LIMITED

Appellant

- and -

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

**TRIBUNAL: JUDGE NICHOLAS ALEKSANDER
JANE SHILLAKER**

Sitting in public at Bedford Square, London W1 on 30 October 2012

Mr Guy Travers of Daniels, Travers & Co, accountants for the Appellant

Mr David Lewis, an officer of HM Revenue and Customs, for the Respondents

DECISION

1. This is an appeal against a decision by HMRC not to issue a direction under Regulation 9 of the Income Tax (Construction Industry Scheme) Regulations 2005 relieving the appellant, PDF Electrical Limited ("PDF"), of its obligation to deduct tax from payments made to Capitax Limited (formerly N&N Electrical Services Limited) ("N&N") under the construction industry scheme.

2. PDF was represented by its accountant, Mr Travers, and HMRC were represented by Mr Lewis. We heard oral evidence from Mr Paul Finnerty, a director of PDF. In addition a bundle of documents was produced in evidence.

The Law

3. The construction industry scheme ("CIS") provides for payments by contractors to sub-contractors in the construction industry to be subject to the deduction of amounts on account of the sub-contractor's tax. Section 61, Finance Act 2004 imposes the obligation to deduct on contractors.

4. Regulation 9 of the Income Tax (Construction Industry Scheme) Regulations 2005 ("CIS Regulations") provides as follows:

9(1) This regulation applies if—

- (a) it appears to an officer of Revenue and Customs that the deductible amount exceeds the amount actually deducted, and
- (b) condition A or B is met.

(2) In this regulation—

“the deductible amount” is the amount which a contractor was liable to deduct on account of tax from a contract payment under section 61 of the [Finance Act 2004] in a tax period;

“the amount actually deducted” is the amount actually deducted by the contractor on account of tax from a contract payment under section 61 of the Act during that tax period;

“the excess” means the amount by which the deductible amount exceeds the amount actually deducted.

(3) Condition A is that the contractor satisfies an officer of Revenue and Customs—

(a) that he took reasonable care to comply with section 61 of the Act and these Regulations, and

(b) that—

(i) the failure to deduct the excess was due to an error made in good faith, or

(ii) he held a genuine belief that section 61 of the Act did not apply to the payment.

(4) Condition B is that—

(a) an officer of Revenue and Customs is satisfied that the person to whom the contractor made the contract payments to which section 61 of the Act applies either—

5 (i) was not chargeable to income tax or corporation tax in respect of those payments, or

(ii) has made a return of his income or profits in accordance with section 8 of TMA (personal return) or paragraph 3 of Schedule 18 to the Finance Act 1998 (company tax return), in which those payments were taken into account, and paid the income tax and Class 4 contributions due or corporation tax due in respect of such income or profits; and

10 (b) the contractor requests that the Commissioners for Her Majesty's Revenue and Customs make a direction under paragraph (5).

(5) An officer of Revenue and Customs may direct that the contractor is not liable to pay the excess to the Commissioners for Her Majesty's Revenue and Customs.

20 (6) If condition A is not met an officer of Revenue and Customs may refuse to make a direction under paragraph (5) by giving notice to the contractor (“the refusal notice”) stating—

(a) the grounds for the refusal, and

(b) the date on which the refusal notice was issued.

25 (7) A contractor may appeal against the refusal notice—

(a) by notice to an officer of Revenue and Customs,

(b) within 30 days of the refusal notice,

(c) specifying the grounds of the appeal.

(8) For the purpose of paragraph (7) the grounds of appeal are that—

30 (a) that the contractor took reasonable care to comply with section 61 of the Act and these Regulations, and

(b) that—

(i) the failure to deduct the excess was due to an error made in good faith, or

35 (ii) the contractor held a genuine belief that section 61 of the Act did not apply to the payment.

(9) If on an appeal under paragraph (7) that is notified to the tribunal it appears that the refusal notice should not have been issued the tribunal may direct that an officer of Revenue and Customs make a direction under paragraph (5) in an amount the tribunal determines is the excess for one or more tax periods falling within the relevant year.

40 (10) If a contractor has deducted an amount under section 61 of the Act, but has not paid it to the Commissioners for Her Majesty's

5 Revenue and Customs as required by regulation 7 (payment, due date etc. and receipts), that amount is treated, for the purposes of determining the liability of any sub-contractor in respect of whose liability the sum was deducted, as having been paid to the Commissioners for Her Majesty's Revenue and Customs at the time required by regulation 8 (quarterly tax periods).

Background Facts

10 5. Having heard Mr Finnerty give evidence before us and be subjected to cross examination, it became apparent that some of the arguments made on behalf of PDF by their accountants in correspondence with HMRC were either wrong or were overstated. However we found Mr Finnerty to be an honest and reliable witness. On the basis of all the evidence before us, we find the background facts to be as follows.

15 6. PDF is an electrical contractor. Mr Finnerty is the owner of the company and the director. He has worked in the construction industry as an electrician for many years and is familiar with the CIS. PDF has been in existence for approximately ten years, and makes payments under the CIS to between 25 and 30 people each week. Other than the payments which are the subject of this appeal, PDF has never before (or since) had any problem with the construction industry scheme. Despite having suffered financial difficulties in the recession (particularly when a client became insolvent two years ago owing the company £246,000), PDF pays its taxes on time each month.

25 7. At the relevant time, operation of the CIS was delegated to PDF's office administrator ("Katie"). Katie was engaged as office administrator in 2008. There was a period of overlap with her predecessor as office administrator ("Kay"), and Kay trained Katie on the operation of the CIS – in particular how to undertake online verification of a sub-contractor's status under the Scheme. During this overlap period, Kay checked Katie's work on the CIS.

30 8. PDF is a busy but small business. Mr Finnerty cannot check everything. Given his background as an electrician, Mr Finnerty focuses in particular on checking the electrical safety of PDF's work and granting safety certificates.

35 9. PDF engaged N&N as a sub-contractor in March 2009. On 1 May 2009 (prior to the payment of N&N's first invoice), Katie undertook online verification of N&N's status under the CIS. This showed that payment should be made to N&N net of tax. However, in error, Katie entered N&N as having gross payment status in PDF's records. This was an error made in good faith.

10. There is nothing on the face of N&N's invoices which indicates that payments should have been made subject to the deduction of tax under CIS.

11. As a result of the error made by Katie, payments were made to N&N without deduction of tax under CIS, when in fact deductions ought to have been made.

40 12. PDF has not benefitted in any way as a result of this error.

13. Following a compliance visit by HMRC to PDF, the error was discovered. PDF applied to HMRC for a direction under Regulation 9 to be relieved of its obligation to account to HMRC for the tax that ought to have been deducted from payments made to N&N. By letter dated 1 December 2011 that application was refused, and the refusal was upheld on a subsequent review. PDF's appeal is against that decision.

Submissions of the parties

14. PDF submits that their failure to deduct tax under CIS from payments made to N&N was because of a mistake made in good faith. As a small business, they cannot afford to put in place the sophisticated systems adopted by large sub-contractors. They take reasonable care to operate the CIS, as is evidenced by the fact that this is the sole mistake that they have ever made in ten years. They undertook online verification of N&N's CIS status – but due to an honest mistake, they mis-recorded N&N's status in their own accounting records. This led to N&N being paid without deduction of tax under CIS.

15. For these reasons, PDF submit that Condition A in regulation 9(3) is met in that PDF took reasonable care to comply with the CIS and that PDF's failure to deduct tax from payments made to N&N was due to an error made in good faith.

16. HMRC do not dispute that PDF undertook online verification of N&N's status, nor that the error was made in good faith. However they submit that PDF did not take reasonable care to comply with the CIS – and in particular did not have systems in place for the office administrator's work to be checked and verified.

Conclusions

17. We are satisfied that:

(1) PDF took reasonable care to comply with the CIS (namely section 61, Finance Act 2005 and the CIS Regulations), and

(2) the failure to deduct the tax due under CIS (namely the "excess" for the purposes of regulation 9) was due to an error made in good faith.

18. The standard required by Regulation 9 is that the business must take reasonable care in its compliance with the CIS. It does not require that mistakes must never be made. We consider that the standard of "reasonable care" is one that must be appropriate and proportionate to the particular contractor's business. The compliance systems to be expected of a substantial multi-national contractor with a large and sophisticated accounting department are very different from the systems to be adopted by a small business. In the case of PDF, we are satisfied that it took reasonable care to meet its obligations under the CIS. The fact that this is the only error that PDF has ever made under the CIS in ten years is the practical evidence of this.

19. We therefore hold that the refusal notice should not have been issued by HMRC, and direct that an officer of Revenue and Customs make a direction under Regulation 9(5) of the CIS Regulations. The amount to be the subject of the direction

is the "excess" arising in respect of the payments made by PDF to N&N. We leave it to the parties to agree the amount, but if they are unable to reach agreement, we give leave for them to apply to the Tribunal for formal determination of the amount by a single judge sitting alone.

- 5 20. 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
10 "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

15 **NICHOLAS ALEKSANDER**
TRIBUNAL JUDGE

RELEASE DATE: 19 November 2012

- 20 Cases mentioned in argument but not mentioned in this decision:

Neil Martin Ltd v HM Revenue & Customs [2007] EWCA Civ 1041
HMRC v Hok Limited [2012] UKUT 363