[2013] UKFTT 419 (TC)

TC02813

Appeal number: TC/2012/09627 & 10968

VAT – default surcharge – whether reasonable excuse - cash flow difficulties – Appellant taking steps to combat adverse trading conditions - HMRC reliance on dicta in dissenting judgment in C&E Commissioners v Steptoe - correct test to be applied - appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

ELECTRICAL INSTALLATION SOLUTIONS LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE GUY BRANNAN
MR TOBY SIMON

Sitting in public at Cambridge on 4th July 2013

Robert Newey, Solicitor, Robert Newey & Co for the Appellant

Gloria Orimoloye, HMRC Presenting Officer, for the Respondents

DECISION

Introduction

1. This is an appeal against two VAT default surcharges for the periods, respectively, 03/12 and 06/12. The issue in the appeal is, broadly, whether the Appellant had a reasonable excuse for failing to pay its VAT on time in respect of the two VAT periods under appeal.

Facts and background

2. Mr Steve Neeves, a director of the Appellant, gave evidence to the Tribunal. For the most part, except as indicated below, his evidence was unchallenged. We accept his evidence and find it as fact.

3. We find the following facts.

4. The Appellant's business was established in 2006 and specialised in the design, installation and maintenance of electrical equipment for the food industry. The business grew until 2009, by which time the Appellant employed 35 operational staff and eight management/office staff. The business had good clients such as Premier Foods.

5. In 2009, however, the business began to falter as a result of the general downturn in economic activity. Clients were no longer authorising capital expenditure for projects, no new orders were being placed and business began to dry up.

6. The Appellant began to look at other markets in order to generate new business, conscious of its responsibilities to its staff. The Appellant in mid to late 2009 began to focus on the construction industry to generate additional work. At around this period the Appellant's turnover was approximately £3 million per annum, but the company had previously focused on what Mr Neeves described as the "high end" of the electrical market. This made the Appellant attractive to construction companies but, although the Appellant secured some major projects, the Appellant found that the construction industry work paid lower rates and was very competitive.

7. The Appellant was not well equipped to deal with what Mr Neeves described as the "adversarial" aspects of business in the construction industry. The Appellant had been used to dealing with end users (e.g. companies in the food industry), but found that in the construction industry building companies would reserve payments in respect of "claims" and would arbitrarily withhold full payment, leaving the Appellant to negotiate a settlement. This would often leave the Appellant with a total payment less than it had expected to achieve.

8. The upshot was that the Appellant operated on smaller profit margins, was starved of cash flow and received late payment of its invoices. Consequently, the

Appellant had limited working capital. It earned smaller profits and the delay in the payment of its invoices impacted negatively on its cash position.

9. In the course of 2010 it became clear to Mr Neeves that if the business continued in that manner the Appellant would go out of business. Accordingly, the Appellant reduced the number of managerial/office and operational staff through a redundancy programme. In the period 30 June 2010 to 1 March 2011three managerial staff were made redundant. In the period 28 May 2010 to 20 January 2012 four operational staff were made redundant. In the period 1 May 2010 to 30 November 2012 three managerial/office staff left and were not replaced.

10. In addition, the directors took reduced salaries and a moratorium was placed on all capital spending. The Appellant also rationalised its fleet of company vehicles by selling four company cars as managerial staff left its employment. The Appellant also reduced overtime and travel time paid.

11. The result of these measures was that, against a background of falling gross profits, the Appellant reduced its overheads from 11% to 5 – 6% of turnover.

12. At some time prior to 30 September 2010, the Appellant negotiated a bigger overdraft with its bankers. This original overdraft limit was £200,000 and this was increased to £250,000 on the basis of personal guarantees.

13. In addition, Mr Neeves and his co-shareholder (Mr Paul Godfrey) each put into the Appellant an additional £50,000 by way of loan. Mr Godfrey's £50,000 loan was advanced in December 2010 and Mr Neeves injected his £50,000 loan in March 2011.

14. The Appellant's closing debtor schedules for the years ending 30 September 2010, 2011 and 2012 show that invoices ranging from 30 to 60 days peaked in 2011. Mr Neeves attributed this to the Appellant having to undertake increasing amount of business with main contractors (e.g. building companies) and the tendency of end-user clients (food companies) to postpone payment from 30 days to 60 days and often end of the month. "Overdue" debtors rose from just over £200,000 to just over £300,000 in the financial years ending 30 September 2010 to 2011.

15. Mr Neeves' evidence was that if the Appellant had been able to collect monies within its trading terms, it would have had sufficient funds to pay its VAT in a timely manner. By taking decisions about whom the Appellant did business with, the appellant was to some extent able to reduce the high levels of monies owing to it, but this also had the effect of reducing its turnover.

16. The Appellant made a two-year trading loss in excess of £150,000 over the financial years 2010 and 2011. The Appellant managed to produce a pre-tax accounting profit of £41,000 for the financial year 2012 (the accounts were still in the process of being certified) and Mr Neeves considered that the financial position of the Appellant would continue to improve in 2013, albeit with a management team working excessive hours and allowing some of the non-core activities to fall into neglect.

17. Mr Neeves' evidence was that, having taken the measures referred to above to reduce overheads and inject capital, the Appellant had to juggle with its liabilities on a monthly basis. He was conscious of the Appellant's obligations to HMRC, but staff salaries were paid weekly and the Appellant had to pay its suppliers, when, as Mr Neeves put it, "they screamed loudly". The Appellant also negotiated new terms with two larger suppliers whereby payment terms were extended from 30 days to 60 days. However, as noted above, the Appellant's own customers (particularly its food industry customers) were extending payment terms from 60 to 90 days.

18. In the light of these difficulties, the Appellant sought help from HMRC's Business Payment Support Service ("BPSS") and established a "Time to Pay" arrangement. It was not clear when Mr Neeves the first approached the BPSS but the first Time to Pay arrangement covered the quarter 03/10. Another arrangement covered the period 09/10. There were no records of Time to Pay arrangements for the periods 12/10 and 03/11 in which periods the Appellant paid its VAT by instalments (as it had in the 03/10 and 09/10 periods). However, in HMRC's "Schedule of Defaults", no default is recorded for those periods and we infer that those two periods were covered by such arrangements. Most of the discussions with BPSS were over the telephone and Mr Neeves had very few records. In addition, HMRC did not produce records of the various telephone conversations.

19. On or around May 2011, Mr Neeves requested an extension of the Time to Pay arrangement in a conversation with BPSS. At this point HMRC suggested (with Mr Neeves' comments in brackets):

(1) that more capital should be injected – (which the shareholders had already done by way of shareholder loans)

(2) that the Appellant should speak to its bankers – (the Appellant had already done this but was already at the limit of its renegotiated overdraft facility)

(3) that the Appellant should sell some of its vehicles – (which would have brought the Appellant's business to a halt.).

20. In this conversation it was made clear to Mr Neeves that HMRC's support was temporary, that HMRC's support had been exhausted and was now being withdrawn. HMRC had asked for an assurance that it would receive payment on time at the end of the relevant quarter. Mr Neeves, in the light of the Appellant's financial position, had felt unable to give this assurance. HMRC thereupon withdrew its support.

21. Mrs Orimoloye asked Mr Neeves whether, in the conversations in or around May 2011, BPSS had told him that he could not approach them at some stage in the future. Mr Neeves replied that BPSS had made it clear that their support for the Appellant had been exhausted, but said that HMRC had not explicitly said that he could not approach them in the future. However, it seemed to us from the evidence of Mr Neeves that it was reasonable for him to assume from his conversations with HMRC in May 2011 that no further support was available from BPSS. Accordingly, we consider that it was reasonable for him not to approach BPSS seeking further assistance in respect of the periods under appeal.

22. In the light of the withdrawal of BPSS assistance, the Appellant saw no alternative but to pay in instalments as soon as it was able. As its cash position strengthened, and it had extracted itself from dealing with the construction industry, the Appellant had managed to bring its VAT payments up to date. Mr Neeves' evidence was that, having taken all the steps described above to ensure the survival of the business, if the Appellant had paid its VAT debts on time it could not have survived – it would have gone insolvent. As it was, the Appellant's business fortunes had improved and its VAT payments were now made on time.

23. Mr Neeves referred to 6 other local electrical engineering businesses, which he described as well-established and well-respected businesses, which had gone out of business in the last few years. In response to questions from Mrs Orimoloye, Mr Neeves accepted that he did not know the exact financial position of each of these 6 businesses nor how competently they were managed. However, he noted that some of these concerns had been in business for over 30 years.

24. We set out in a schedule to this Decision the summary of payments of VAT provided by the Appellant, which he compiled from the schedule of payments contained in the bundle produced by HMRC and his records of agreements made with BPSS.

25. It was not in dispute that the Appellant's VAT payments in respect of 03/13 and 06/12 were made late. For the quarter 03/12, VAT of £71,338.16 was due on 07/05/12. The Appellant paid £35,000.00 on 07/06/12 and £36,338.16 on 06/07/12. As regards the quarter 06/12 VAT of £86,748.24 was due on 07/08/12. The Appellant paid £60,000 on 03/09/12 and £26,748.24 on 12/10/12.

26. The Appellant made its VAT returns and payments electronically.

27. In correspondence with HMRC, Mr Neeves pointed out that the Appellant contributed in excess of £750,000 per annum in respect of VAT, PAYE, NIC and Corporation tax.

28. Mr Newey noted, and HMRC did not dispute, that the Appellant was not eligible for cash accounting in respect of VAT – a factor which the Court of Appeal considered material in *Steptoe*.

The legislation and case law

29. The relevant legislation is contained in section 59(7)(b) VAT Act 1994 ("VATA"). This provides that a person shall not be liable to a surcharge if he would otherwise be liable but satisfies HMRC or, on appeal, a tribunal that, in the case of a default which is material to the surcharge there was a reasonable excuse for the return or the VAT not having been despatched on time.

30. Section 71(1)(a) VATA further provides that for these purposes an insufficiency of funds to pay any VAT due is not a reasonable excuse.

31. Section 71(1)(a) was considered in the leading case of *Customs and Excise Commissioners v Steptoe* [1992] STC 757. The Court of Appeal held that although insufficiency of funds can never of itself constitute a reasonable excuse, the cause of that insufficiency – the underlying cause of the taxpayer's default – might do so.

32. In *Steptoe* the taxpayer carried on a relatively small business as an electrical contractor. 95% of the taxpayer's work was for a Local Council, which was an extremely slow payer (taking on average 6 weeks to 2 months to pay a bill after its delivery). The taxpayer was late in paying his VAT for two periods in a year (11/86 and 08/87). In each case the delay was about two months. He was again in default for the 11/87 period and for the 02/88, 05/88 and 11/88 periods. The excuse put forward by the taxpayer for late payment in these periods was cash flow difficulties. That was rejected by the Commissioners, but accepted by the tribunal (on the grounds of the Council's conduct in paying late), and, on appeal to the High Court, by Kennedy J. The Commissioners appealed to the Court of Appeal but their appeal was dismissed by a majority (Lord Donaldson MR and Nolan LJ, Scott LJ dissenting).

33. Scott LJ in his dissenting judgment accepted that the underlying reason for an insufficiency of funds could be put forward as a reasonable excuse. However, Scott LJ said (at 765):

> "…the reason [for the insufficiency] must, in my judgment, amount to something more than that the business of the taxpayer has been carried on unprofitably or that conditions of trade produce cash flow problems.
>
> It is the statutory duty of traders to make value added tax returns and pay value added tax in due time. They are not relieved of that duty by the unprofitable or barely profitable nature of their businesses. If the conditions of business produce cash flow problems it is their duty none the less to make financial arrangements that will enable their value added tax to be paid in time. Absent some 'unforeseeable or inescapable' event, cash flow problems are, in my opinion, barred by [section 71(1)(a)] from constituting a 'reasonable excuse'.
>
> … If the normal hazards of a taxpayer's particular business include the late payment of bills, then the taxpayer should make arrangements to finance his cash flow on that footing. If he cannot afford to do so, then, as it seems to me, he is relying on nothing other than an insufficiency of funds. If he can afford to do so but does not do so, the reason for insufficiency of funds can hardly be a reasonable excuse. It is only if the events giving rise to the insufficiency of funds are outside the normal course of the taxpayer's business that a possibility of a reasonable excuse can arise."

34. The reference by Scott LJ to "some 'unforeseeable or inescapable' event" was a quotation from the judgment of Nolan J (as he then was) in *Customs and Excise Commissioners v Salevon Limited* [1989] STC 907 in which the misfeasance of the taxpayer company's company secretary, causing the late payment of VAT, was held to constitute a reasonable excuse. We have quoted this passage from Scott LJ in full

because, as we shall see, HMRC placed considerable reliance upon it in argument before us.

35. Nolan LJ reviewed his judgment in *Salevon* and disagreed with Scott LJ's interpretation of it. His use of the phrase an "unforeseeable or inescapable" event in *Salevon* was directed towards the facts of that case (ibid. at 768). In other words, Nolan LJ was making it plain that in *Salevon* he had not been intending to establish foreseeability or inescapability as a general test in the context of reasonable excuse. He accepted (with some misgivings) the finding of fact by the tribunal that the Council's practice of consistently paying late had had the result that the taxpayer had found himself in the situation that at the due date for the relevant accounting periods he was without sufficient funds to pay the tax due. (ibid. at 769).

36. Lord Donaldson MR agreed with Nolan LJ. He expressed the test, which we must apply in this appeal, as follows:

> "… [I]f 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." (ibid. at 770)

37. Lord Donaldson MR disagreed with the test applied by Scott LJ (ibid. at 770):

> "I have come to the conclusion that this [Scott LJ's test] 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."

Submissions of the parties

38. Mr Newey for the Appellant argued that the correct test in respect of "reasonable excuse" to apply was that adopted by Lord Donaldson MR in *Steptoe*. He argued that the test being applied in this case by HMRC was whether the events were exceptional and outside the ordinary course of the Appellant's business. This was not the correct test. In any event, the evidence of Mr Neeves established that the events which affected the Appellant's business were outside its ordinary course and that the exercise of reasonable foresight and due diligence had been unable to avoid the insufficiency of funds and, therefore, the late payment of VAT in respect of the periods under appeal. Mr Newey cited two decisions of this Tribunal: *Mediaclash Limited v HMRC* [2009] UKFTT 306 (TC) and *JMS Aggregate Supplies v HMRC* [2011] UKFTT 426 (TC).

39. Mr Newey argued that the Appellant had done its utmost to exercise reasonable foresight and due diligence. It had found new markets and customers, it had

negotiated an increased overdraft with its bankers, it had cut costs e.g. by making staff redundant and the shareholders had injected new loans into the business. The evidence showed that the Appellant had paid its VAT as quickly as he could. This was not just insufficiency of funds but a deeper problem caused by the fall-off in orders, lower margins and delayed payments by customers.

40. Mrs Orimoloye for HMRC argued that many businesses pleaded the economic downturn as a reasonable excuse for late payment of taxes. To allow the Appellant to use that as a reasonable excuse would undermine the VAT surcharge system. HMRC had provided temporary support to be BPSS for the Appellant and had not specifically told the Appellant that it could not come back for further support.

41. At one point Mrs Orimoloye suggested that HMRC had not been provided with the Appellant's bank statements, but accepted that HMRC had not, in fact, requested the Appellant to provide bank statements. We therefore do not consider the Appellant can be criticised in this regard.

42. Mrs Orimoloye argued that the reasons for the insufficiency of funds were not exceptional and were attributable to the ordinary hazards of trade. She relied on HMRC's VAT Civil Penalties Manual paragraph 10534 which quotes parts of the final two paragraphs of the passage from the judgment of Scott LJ quoted in paragraph 33 above:

> "Mr Justice Scott [sic] commented:
>
> It is the statutory duty of traders to make VAT returns and pay VAT in due time. They are not relieved of that duty by the unprofitable or barely profitable nature of the tax-payer's particular business. If the conditions of business produce cash flow problems it is their duty nonetheless to make financial arrangements that will enable their VAT to be paid in time. It is only if the events giving rise to the insufficiency of funds are outside the normal course of the tax-payer's business that a possibility of reasonable excuse can arise."
>
> This judgement introduced the concept of legal distinction between pleading a shortage of funds and pleading, as a reasonable excuse, a series of unforeseeable circumstances which directly lead to the shortage of funds."

Discussion

43. In our view, the correct test to apply in relation to "reasonable excuse" is that found in the judgment of Lord Donaldson MR quoted in paragraph 36 above. We consider this formulation of the test to be binding upon us. The essential question is the application of this test to the facts. This is an area in which every case turns on its own facts.

44. Mr Neeves impressed us as a transparently honest and responsible witness. We considered him to be a conscientious businessman who clearly was committed to preserving the Appellant's business whilst discharging his liabilities as quickly as

possible. We consider on the facts found above that the Appellant exercised reasonable foresight, due diligence and a proper regard for the fact that the tax would become due on the various due dates. Such regard is demonstrated by the fact that its VAT returns were submitted on or before the respective due dates. We also note that the Appellant always paid the VAT which was due, albeit by instalments. We find that the Appellant settled its VAT liabilities when it had the funds to do so. There was no suggestion by HMRC that the Appellant had been deliberately withheld or delayed payments of VAT when it had funds to make payment.

45. In this connection, we have noted that HMRC's Statement of Case seems to suggest that the return for the period 03/12 due, electronically, on 7 May 2012 was received on 20 May 2012, but in HMRC's Schedule of Defaults the due date for the return is shown as 30 April 2012 and the return as having been received on 20 April 2012. In the correspondence between HMRC and the Appellant which was produced to us, HMRC justified the surcharge solely on the basis of late payment of VAT. Moreover in a letter to HMRC dated 31 August 2012 the Appellant points out that its returns have always been submitted in a timely manner – a point which HMRC did not appear to dispute in correspondence. Indeed, in a letter to Mr Henry Bellingham MP (Mr Neeves' Member of Parliament), HMRC accepted that the Appellant's returns had all been made on time. No reference to a late return was made by HMRC at the hearing. Accordingly, we concluded that the apparent reference in the Statement of Case to a late return was an error.

46. The Appellant, however, did not manage to avoid the insufficiency of funds. We find that the insufficiency was caused by the downturn in orders and the cash flow problems caused by customers extending their period of payment of the Appellant's invoices. We find that the Appellant took all reasonable steps to avoid the insufficiency, including cutting its costs by virtue of redundancies, reducing directors' salaries and cutting overtime and travel time and reducing its fleet of managerial cars, seeking new markets (the construction industry), injecting fresh shareholder loans, increasing its overdraft with its bankers and negotiating extended credit with some of its suppliers. In short, the Appellant acted in a proactive manner to keep its business afloat, maintain its cash flow and settle its liabilities as best it could. It is hard to see what more the Appellant could reasonably have done except to go into administration (an outcome which was likely to have been of no benefit to the Appellant or to HMRC). In reaching this conclusion we are fully aware that the Appellant's financial difficulties lasted over two years. In our experience, it is not unusual for a business of the size of the Appellant's to take this period of time to retrench, refocus and turn itself around.

47. As regards support from BPSS, the evidence of Mr Neeves (which we accept) was that HMRC had made it clear in May 2011 that the support which they offered had been exhausted. In those circumstances, we considered that it was reasonable for Mr Neeves in respect of both periods under appeal to consider that that door was now closed to the Appellant. We therefore do not consider the failure by the Appellant to approach BPSS once again seeking fresh support in respect of the periods under appeal to be unreasonable.

48. We conclude therefore that the Appellant's exercise of reasonable foresight and of due diligence and the Appellant's proper regard for the fact that the tax would become due on a particular date did not avoid the insufficiency of funds which led to the defaults which were material to the surcharges under appeal.

49. In addition, as mentioned above, we find that the Appellant over the period 03/10 – 06/12 settled its VAT liabilities in full by instalments when it was able to do so. In relation to the period 03/12, the liability of £71,338.16 was paid as to £35,000 on 7 June 2012, one month after the due date, and the balance (£36,338.16) on 6 July 2012, two months after the due date. In respect of the period 06/12, the liability of £86,748.24 was paid as to £60,000 on 3 September 2012 and as to £26,748.24 on 12 October 2012 (i.e. respectively slightly under one month and slightly over two months late). We consider, in the circumstances, the Appellant's exercise of reasonable foresight and due diligence and its proper regard for the fact that the tax had become due on a particular date prompted the Appellant to make payment of the tax due as soon as the insufficiency of funds could be overcome. In our view, having regard to the very significant difficulties being experienced in its trade, the Appellant did all that could reasonably have been expected of it to make timely payment of the VAT due.

50. Finally, there was one aspect of this appeal which puzzled us considerably. As we have noted, HMRC's VAT Civil Penalties Manual paragraph 10534 quoted as an authority portions of the final two paragraphs of Scott LJ's judgment in *Steptoe* which we have set out in paragraph 33 above and took these as authority for the proposition that, in the context of insufficiency of funds, a reasonable excuse required a series of unforeseeable circumstances which directly led to the shortage of funds.

51. We could not understand why one of HMRC's official Manuals quoted the dissenting judgment from *Steptoe*, the leading authority on "reasonable excuse" in the context of insufficiency of funds. As regards the doctrine of precedent, a dissenting judgment of a member of the Court of Appeal has no precedent value other than as a potentially persuasive authority. Obviously, such a judgment must be treated with considerable respect as befits any judgment delivered by a member of the Court of Appeal. However, the reasoning which led Scott LJ to his conclusion cannot be regarded as a precedent, or indeed as correct, since it contradicts the reasoning of the majority. Plainly, it is the reasoning of the majority (Lord Donaldson MR and Nolan LJ) that constitutes the *ratio decidendi* of that case and which is binding upon us (and on both the parties to this appeal). As we have already indicated, it is the formulation of Lord Donaldson MR quoted in paragraph 34 above which we consider to represent the holding in that decision and which we have applied in this appeal.

52. We recognise that the Manual extract did not contain the passage containing Scott LJ's formulation of the test as requiring "unforeseeable and inescapable" events. However, the comments of Scott LJ in relation to the normal "hazards of trade" (not referred to in the Manual but put to us in submissions) and events "outside the normal course of the taxpayer's business" were made in the context (and as an amplification) of his remarks in the preceding paragraph that to constitute a reasonable excuse the events pleaded by the taxpayer must be "unforeseeable and inescapable." This was the

test that was clearly rejected by the majority of the Court of Appeal. Therefore, with the greatest respect, we consider that it is not safe to rely on the judgment of Scott LJ in the way in which HMRC have done in their Manual, correspondence, Statement of Case and in their submissions before this Tribunal. Indeed, we consider HMRC's VAT Civil Penalties Manual paragraph 10534 in this respect to be incorrect and misleading.

53. Furthermore, throughout the correspondence leading to this appeal and in the above Manual extract it is clear that HMRC have placed undue emphasis on "foreseeability". We do not deny that "foreseeability" is relevant, but it is relevant not in its own right, as Lord Donaldson MR explained in the quotation from his judgment in *Steptoe* set out in paragraph 37 above, but rather to the question whether the late payment was "reasonably avoidable."

Decision

54. For the reasons given above, we allow this appeal.

55. 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.

GUY BRANNAN
TRIBUNAL JUDGE

RELEASE DATE: 23 August 2013