



TC04064

Appeal number: TC/2012/08871

Value Added Tax – default surcharge – whether reasonable excuse – no – appeal dismissed

**FIRST-TIER TRIBUNAL
TAX CHAMBER**

MELDRUM SOLICITORS LLP

Appellant

- and -

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

Respondents

**TRIBUNAL: DR K KHAN
MR NICHOLAS DEE**

Sitting in Bedford Square, London on 14 October 2013

Carl Woolf, Partner, for Meldrum

Femi Ojo with Bruce Robinson, Presenting Officers for HMRC

DECISION

Matter under appeal

- 5 1. This appeal is against the Default Surcharges for the VAT return periods ending 31 October 2011 (“10/11”), 31 January 2012 (“01/12”) and 30 April 2012 (“04/12”) as follows:

Period	Tax due	Surcharge Amount	Percentage
10/11	£120,310.44	£6,015.52	5%
01/12	£90,981.43	£9,098.14	10%
04/12	£67,793.64	£10,169.40	15%

- 10 2. Following the hearing on 14 October 2013, the Tribunal issued directions allowing the Appellant to make further representations and in particular to show how payment due from the Legal Services Commission (LSC”) for the payment of Legal Aid work affected the cash flow of the firm and resulted in the late payment of VAT.

- 15 3. The Appellant is a firm of criminal defence solicitors and the majority of their clients are funded through Legal Aid. They are therefore reliant on the LSC (HM Government) for the bulk of their funding and fees. The Appellant stated that it could take up to six months to be paid for work and there is no recourse to the LSC for facilitating earlier payment. This late payment caused cash flow difficulties and resulted in the Appellant being late in paying their VAT which resulted in surcharges.

20 Background facts

4. The following facts are not in dispute.

- (1) Period ending 31 October 2011

25 For this period, the due date for the VAT return and payment, if being made electronically, was 7 December 2011. The VAT return was received by HMRC on 21 December 2011. The tax due was £120,310.44. It was paid by the Appellant by way of three BACS transactions, as follows:

- (i) £40,000 was received by HMRC on 23 January 2012;
- (ii) £40,000 was received by HMRC on 8 February 2012; and

(iii) £46,325.96 was received by HMRC on 17 February 2012 (this sum included the payment of the Default Surcharge for this period).

The surcharge liability notice was issued on 21 December 2011 for the sum of £6,015.52 being 5% of the tax unpaid at the due date.

5 (2) Period ending 31 January 2012

For this period, the due date for the VAT return and payment, if being made electronically was 7 March 2012. The VAT return was received on 13 February 2012. The tax due in respect of this period was £90,981.43. This was paid by the Appellant by two BACS transactions which were as follows:

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(i) £56,953.18 was received by HMRC on 25 April 2012; and

(ii) £34,030.25 was received by HMRC on 10 May 2012.

The surcharge liability notice was issued on 16 March 2012 for the sum of £9,098.14 being 10% of the tax unpaid at the due date.

15 (3) Period ending 30 April 2012

For this period, the due date for the VAT return and payment, if being made electronically, was 7 June 2012. The VAT return was received by HMRC on 30 May 2012. The tax due was £67,793.64. This was paid by the Appellant by two BACS transactions, which were as follows:

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(i) £30,000 was received by HMRC on 16 July 2012; and

(ii) £37,793.64 was received by HMRC on 24 August 2012.

The surcharge liability notice was issued on 15 June 2012 for the sum of £10,169.04 being 15% of the tax unpaid at the due date.

Legislation

25 5. Section 59 VATA 1994 provides for Default Surcharges for late submission of VAT returns and/or late payment of VAT.

“59 The Default Surcharge

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(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.

5 (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 -

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

15 (b) the Commissioner 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.

20 (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.

25 (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

30 (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.

35 (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;

40 (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

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

5 (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 that VAT for which he is so liable as has not been paid by that day.

10 (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 –

15 (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,

20 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).

25 (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

30 (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 –

35 (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 68(1), and

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

40 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.

45 (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.

6. Section 71 VAT Act 1994 construes “reasonable excuse” for the purposes of s 59:

“71 Construction of sections 59 to 70

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

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

10 (b) where reliance is placed on any other person to perform any task, neither the fact of that reliance nor any dilatoriness or inaccuracy on the part of the person relied upon is a reasonable excuse.

(2) In relation to a prescribed accounting period, any reference in sections 59 to 69 to credit for input tax includes a reference to any sum which, in a return for that period, is claimed as a deduction VAT due.”

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The Appellant’s contention

7. The Appellant made the following contentions:

20 (1) The reason for the late payment of VAT was cash flow difficulties. The Appellant noted that s 71(1) (a) VATA 1994 provides that an insufficiency of funds does not provide the basis of a reasonable excuse. However, the Appellant says that they request an exception be made due to the funds being owed from HM Government for Legal Aid fees.

25 (2) The Appellant states that the majority of their clients are funded through Legal Aid and they are reliant on the LSC for the bulk of their fees and it can take up to six months to be paid those fees following changes to the LSC payment system in October 2010 In the relevant VAT periods there was a delay in payment.

30 (3) The Appellant maintained good communication with HMRC to advise on the situation regarding late payments and have made regular payments of VAT as funding was received.

(4) A substantial refund was due from HMRC with regard to the Appellant’s 2009-10 tax return. While the issues were complicated there was no resolution of the matter and up until 25 July 2012 no refund paid at that time.

35 (5) The Appellant say it would be inequitable to charge Default Surcharges at such punitive levels when the cause of the problem is another Government Department. The surcharges only serve to exacerbate the cash flow difficulty of the firm.

- 5 (6) A direction hearing allowed the Appellant to make further representation regarding their cash flow difficulties for the period of 1 April 2011 to 30 April 2013. The Appellant provided approximately 5 pages of cash flow statement, but no bank statements, showing the income and expenses, net cash flow, opening bank balance and closing bank balance and VAT payments for the relevant periods. There was no detailed analysis or explanations provided with the cash flow statement.

Respondents' submissions

- 10 (1) The Respondents say that all three payments with respect of the tax year were received by HMRC after the due date and therefore a liability to a Default Surcharge arose. The Appellant was aware of the consequences of the late payment of VAT and they had received Surcharge Liability Extension Notices in respect of the periods ending 31 October 2011, 31 January 2012 and 30 April 2012. The liability surcharge was correctly issued in accordance with s59 VATA 1994.
- 15 (2) The Appellant states that the reason for the late payment of VAT was cash flow difficulties which is specifically excluded under s71 (1) (a) VATA 1994 as a reasonable excuse. The Respondents have asked for a special exemption from those provisions on the grounds that the payment was due by HM Government. The Respondents say the fact that HM Government is the Appellant's customer and the provider of funds and fees for their payment is an irrelevant consideration when looking at a reasonable excuse. The fact that the Appellant can wait up to six months to be paid is foreseeable and it is well known that there are delays in payments being made by the LSC.
- 20 (3) The Respondents would have expected arrangements to be put in place to ensure the Appellant met their obligations to make their VAT payments on time. In the circumstances, the cash flow difficulties are not an excuse that could be considered an exceptional reason for the payment of VAT under s71 (1) (a) VATA 1994.
- 25 (4) Section 108 Finance Act 2009 specifies that there is no liability to a Default Surcharge for a period where contact is made with HMRC, prior to the due date and an agreed arrangement is made for a late payment. The Respondents say that in all the periods the Appellant contacted HMRC after the due date for payment and did not make any deferred payment arrangements prior to the due date. They had therefore not used the time to pay arrangements to secure their position and to avoid penalties.
- 30 (5) The Appellant state that as of 25 July 2012 they were awaiting a refund from HMRC with regard to their 2009-2010 tax return, which remained unpaid until the appeal was made in September 2012. The Respondents say that the due date for payment of all three periods in question were
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prior to 25 July 2012, which was the earliest date that the refund would have been made by HMRC. This is therefore not a relevant excuse or consideration.

- 5 (6) The Respondents' dispute the submission that it is inequitable to charge the surcharges at such punitive levels. The Upper Tribunal in the case of *Total Technology (Engineering) Limited* found that the Default Surcharge regime itself was not fatally flawed or unfair. In the circumstances, the Respondents say that the rates of surcharge are laid down in law and
10 neither the Commissioners nor the Tribunal have power to vary the amount of any surcharge except insofar as it is necessary to reduce it to the amount which is appropriate under sections 59-70 VATA 1994.
- (7) Therefore the Default Surcharges totalling £25,282.70 are correctly charged and payable.
- 15 (8) The Respondents say that the cash flow analysis provided by the Appellant does not support a reasonable excuse and further cannot be used to support an argument based on the decision of *Customs & Excise Commissioners v Steptoe*, Court of Appeal Civil Division [1992] STC 757 ("*Steptoe*").

Conclusion

- 20 8. The Tribunal allowed the Appellant extra time to provide evidence to support a *Steptoe* argument. The *Steptoe* case concerned surcharges under the old regime for the late payment of VAT. The legislation at the time stated that an insufficiency of funds could not amount to a reasonable excuse. In the first instance the Tribunal accepted that *Mr Steptoe*, who was an electrical contractor working for the Local
25 Authority, had a reasonable excuse by virtue of the authority's persistent late payment of his invoices given they were his largest client. The Court of Appeal by a majority of 2:1 held that the statute did not prevent the Tribunal from considering the underlying cause of the insufficiency of funds and such cases were not restricted to matters which were unforeseeable or inescapable events.
- 30 9. While cash flow problems may be outside the control of the Appellant, once such difficulties have occurred, the taxpayer has an onus to properly manage their affairs as a reasonable taxpayer in those circumstances. This means that a taxpayer would, for example, enter into time to pay agreements with HMRC if it is anticipated that financial difficulties would occur in the future. It is a sensible and reasonable step to
35 take considering the circumstances.
10. Where a taxpayer is pleading a shortage of funds as a reasonable excuse, the tribunal must consider several factors which are relevant. First, was the insufficiency of funds reasonably foreseeable or was it a sudden cash crisis. Whether the trader received sufficient funds before the end of the VAT period to pay the VAT due and
40 was an attempt made to pay some of the VAT by the due date. The Tribunal should look to see what steps were taken to overcome the financial difficulties such as an

overdraft facility or alternative finance or time to pay arrangements. If the *Stepto* argument is raised and the underlying cause of the financial difficulties is examined, the fact that the trader is heavily reliant on one large customer is also relevant.

5 11. In answering these questions, the Tribunal would look to the taxpayer to provide information which explains its finances, difficulties and cash flow. The sort of detailed information which a taxpayer can provide which is helpful would include an explanation of its invoicing showing amounts and dates and the period the invoice was raised and paid and monies received in respect of those invoices. In understanding the large picture of the firm's finances, details of payments relating to
10 earlier invoices, issued and paid as well as the period to which they relate and the time delay in making payments. Such information is useful to show a pattern of payment over time and gives a snapshot of the firm's finances, credits and debits. Lastly, details of the action taken to secure payment, overdraft facilities and alternative financial arrangements would complete the picture.

15 12. Let us look at the information provided on a period by period basis.

Period 10/11

13. A surcharge notice was issued for the VAT return (1 August 2011 to 31 October 2011) at the rate of 5% in the sum of £6,015.52 for late payment. In the period before (01/05/11 to 31/07/11) there was no payment made by the due date. In the period
20 before that period (01/02/11 to 30/04/11), £5,000 was paid by the due date with the balance of £45,000 paid after the due date. There was therefore a pattern of late payment in the relevant periods.

14. From the cash flow figures and other information provided, the appellant's bank balance for the periods stated above were positive. The bank balances for the periods
25 were as follows:

- (1) For the period to 30/04/11 - £19,384 (with £75,006 owing)
- (2) For the period to 31/07/11 - £37,916 (with £57,538.85 owing)
- (3) For the period to 31/10/11 - £16,965 (with £120,310.44 owing)

15. It would appear therefore that while the bank balances were positive, the
30 Appellant chose, not to make a payment towards their VAT except for the period to 30/04/11 when a payment of £5,000 was made.

16. From the figures provided, the partnership was undoubtedly finding it difficult to meet operating costs. The partners' drawings were down. For the period 10/11, there was £42,000 of drawings. The net receipts from a combination of standard
35 monthly payments, Crown Court bills, private client fees, loans and capital introduced, was roughly £1.322million. The expenses for the same period which included staff salaries, staff travel expenses, partners drawings, utilities, loan repayments, overheads and payments to HMRC showed a cash flow deficit for three of the seven months in the relevant period. In this period there was approximately

£150,000 of loan financing and substantial loan repayments. However, the figures provided did not indicate whether the Legal Aid fees which were being paid were being paid more than 6 months after invoiced. In this sense, the figures were not helpful to the Tribunal. The only figures provided by the Appellant were Crown Court
5 billings and payments relating to the period April 2012 to January 2013. In most of those cases, the Legal Aid fee payments were between 40 and 50 days late (though there was one payment which was 113 days late). The average showed that the payments were approximately two months late which does not accord with the Appellant's submission on late payment.

10 17. The Tribunal drew the following conclusions from the provided figures:

- (1) There is nothing to indicate that the Legal Aid fee payments were made 6 months late.
- (2) The Appellant was operating under financial difficulties. There was some borrowing (approximately £150,000) to help cash flow but this carried
15 loan repayment obligations. Partner drawings were minimal.
- (3) However, no approach was made to HMRC to agree a time to pay arrangement. There is no explanation as to why this was not done.
- (4) A person would normally have a reasonable excuse if they acted
20 reasonably or as someone who seriously intends to honour tax liability and obligations. This requires foresight and due diligence. While it is clear that there was a financial problem which resulted in late VAT payments the actions of the Appellant were not wholly reasonable.
- (5) In the circumstances there is no reasonable excuse because the taxpayer,
25 though anticipating cash flow difficulties, did not act in a reasonable manner in seeking to avoid a Default Surcharge in approaching HMRC to agree more time to make payments of the VAT due. In view of the draconian powers which HMRC has, one would have considered that a firm of solicitors in these financial difficulties would have made such an
30 approach. This is most unfortunate and while some action on seeking short term financing was taken there is not reasonable excuse on the grounds of insufficiency of funds with regard to this surcharge.

Period 01/12

18. In the period 01/12 (from 01/11/11 to 31/01/12) to 04/12 (from 01/02/12 to
35 30/04/12) the business did not make any payment by the due date. It did make payments of approximately £160,000 after the due date but incurred penalties. For the period November 2011 to 7 March 2012, the firm had income of approximately £1million from different sources including standard monthly payments, Crown Court bills, private client fees, loans and capital introduced. These expenses comprise staff salaries, staff travel expenses, partners drawings, utilities, loan repayments, overheads
40 and payments to HMRC. In the period from January 2012 to March 2012 the legal

fees which were paid were paid between 37 and 69 days late or roughly between one and two months.

19. The pattern of payment in this period was similar to earlier periods and it is fair to say that the cash flow problems were reasonably foreseeable. The Legal Aid fees
5 comprise more than 95% of the firm's fee income and in their submissions the Appellant made clear that they expected payments to be late. They made the point that "the bulk of their funding can take up to six months to be paid". The Tribunal can find no reasonable excuse given the foreseeability of the cash flow difficulties and the fact that the Appellant made no arrangements with HMRC to make payments late.
10 The taxpayer did not act reasonably given the circumstances.

Period 04/12

20. The relevant part of the cash flow statement relates to the period April 2012 to 7 June 2012 (due date). In this period the company made total payments of
15 £100,079.43 to HMRC comprising two payments of £90,981.43 (01/12) and a penalty payment for the period 04/12 of £9,098. The pattern which emerges is similar to the two earlier periods where the company showed a net deficit in its cash flow after meeting all expenses for the relevant period.

21. The clear picture which emerges as a firm in financial difficulties but without
20 any arrangements in place to meet their HMRC obligations. It is beyond comprehension why, given these arrangements are to assist taxpayers in financial difficulties, they were not used.

Tax rebate

22. A tax inquiry was opened into the partnership tax returns for 2010-11 on 2
25 December 2011. Discussions took place from that time until 24 April 2012 when the HMRC Inspector agreed a tax rebate would be due to the firm. Amended tax computations were issued by HMRC and a refund was formally agreed on 19 September 2012. The tax rebate was paid in October 2012 but was only agreed in April 2012 and the inquiry closed in July 2012. The Default Surcharges relate to the period before that time and therefore the tax rebate is not a relevant consideration in
30 considering a reasonable excuse.

Proportionality and fairness

23. The Upper Tribunal in *Total Technology* decided that the VAT Default
35 Surcharge was not devoid of a rational foundation and that while the penalty charge may be harsh is it not unfair. The legislation seeks to provide an incentive to taxpayers to comply with their payment obligations and levies penalties if they fail to do so. The legislation has a reasonable foundation. The taxpayer has not fully explained why they think the penalty is unfair other than it operates as at such "punitive levels and ... the surcharges only serve to exacerbate their cash flow difficulties". There is no evidence of unfairness and the Appellant has not made
40 submissions to show how the penalties were unfair.

24. The Tribunal in the case of *Hok v H&C Commissioners* [2012] UKUT 363 (TC) made clear that the question of fairness can only be addressed on judicial review and not by the First-tier Tribunal. This Tribunal therefore does not have jurisdiction to consider that matter any further.

5 25. What emerges is a firm which has financial difficulties. It had to resort to short term loan financing to supplement the income of the firm and to meet its expenses. There were the Legal Aid payments which were made late but in most cases between 30 and 60 days late, which is one to two months. The Appellant was aware that payments would be made late although they indicated that these payments were made
10 six months late. There is nothing to show in the cash flow information or other information provided that any of the payments were six months late. The cash flow information which was provided was not explained in detail to show how it supported the Appellant's arguments. The information was not presented to show how the changes to the payment of Legal Aid funding affected the business or impacted on the
15 difficulties of the particular firm. What is unexplained is why the company did not approach HMRC to engage a time to pay arrangement. A time to pay arrangement would have eliminated the penalty for the period between the date when the request was made and the period to which the arrangements relate ends. An agreement must be entered into before the due date for payment since the trigger date for the penalty
20 would arise if a time to pay arrangement is made after the due date. This was not done and there is no evidence that it was considered by the Appellant. In the absence of a reasonable excuse or special circumstances HMRC must therefore assess the penalty. There is no reasonable excuse and therefore the penalty is correctly levied and the default surcharges upheld.

25 26. There is nothing on the evidence to show that the underlying reason for the late payment was not foreseeable or something out of the ordinary. The late payment of legal aid fees was a potential difficulty in dealing with the LSC and did not give a *Steptoe* argument on the evidence presented.

27. Accordingly the appeal is dismissed.

30 28. 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
35 "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

DR K KHAN
TRIBUNAL JUDGE

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RELEASE DATE: 7 October 2014