[2016] UKFTT 042 (TC)

TC04841

Appeal number: TC/2012/09106

VALUE ADDED TAX – default surcharge – return submitted one day late – with a penalty of £277,185.00 proportionate - yes

FIRST-TIER TRIBUNAL
TAX CHAMBER

BLUE OCEAN ASSOCIATES LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE TONY BEARE
MRS JO NEILL

Sitting in public at Fox Court, 30 Brooke Street, London EC1N 7RS on 12 January 2016

Mr Stuart Innerdale and Mr Don Camillo appeared for the Appellant

Mrs Rita Pavely, officer of HM Revenue and Customs, appeared for the Respondents

DECISION

Introduction

1. This is an appeal made by Blue Ocean Associates Limited (the "Company") against a VAT default surcharge of £277,185 in respect of its first payment on account for the period 03/12.

2. The relevant facts are as follows. The Company is the representative member of a VAT group which is required to make monthly payments of VAT pursuant to s28(2A) of the Value Added Tax Act 1994 (the "VATA"). The Company defaulted in making a payment in respect of the period 06/11 and, as a result, was issued with a surcharge liability notice in respect of that period pursuant to s59A(2) VATA (although, as discussed further below, it now contends that it did not receive that notice).

3. The Company was then one day late in making the first payment which was due in respect of the period 03/12. The payment was due on 29 February 2012 and was made only on 1 March 2012. No further defaults were made by the Company in respect of its liabilities for the period 03/12. As a result of the late discharge of its first payment, the Company was assessed to a surcharge at the rate of 2% on the amount paid late.

The Law

4. For traders such as the VAT group headed by the Company, that are subject to the "payments on account" regime, the relevant default surcharge provisions are set out in s59A VATA. As the detail of those provisions is not material to this appeal, a brief summary here of the provisions which are material to the facts of this case will suffice.

5. A first default, which may be a default in the making of a VAT return or in making a payment of VAT by the due date, does not give rise to any liability to a surcharge but triggers the issue of a surcharge liability notice. That notice creates a "surcharge period", which begins on the date the notice is issued and ends on the first anniversary of the period for which the default arose (s59A(2)).

6. The significance of the surcharge period is that, if there is a second default in respect of a period which ends within that surcharge period, and the aggregate value of the defaults in respect of that period (taking both defaults in respect of payments on account and a default in respect of the balancing payment) is more than nil, the defaulting trader is liable to a surcharge calculated at a specified percentage of the aggregate value of the defaults in respect of that period (s59A(4)). For a first default within a surcharge period, the specified percentage is 2% (s59A(5)).

7. There is no surcharge if the taxable person demonstrates a reasonable excuse for non-payment (s59A(8)). However, neither HMRC nor the First-tier Tribunal has power to mitigate a surcharge.

8. Where a default occurs within a surcharge period, that surcharge period is extended (s59A(3)). On subsequent defaults within that extended period (as further extended by any such subsequent defaults), the specified percentage applied to the aggregate value of the defaults for the relevant period increases with successive periods of default to 5%, then 10% and finally to a maximum of 15% (s59A(5)).

9. VAT is of course a tax derived from EU Directives which stipulate in detail the persons on whom and the activities for which the tax is to be imposed by the Member States. This ensures that the application of the tax is the same in all EU Member States. The EU Directives require Member States to take all legislative and administrative measures appropriate for ensuring collection of all the VAT due in their respective territories (see *Dyrektor Izby Skarbowej w Biaymstoku* v *Profaktor Kulesza, Frankowski, Jówiak, Orowski* (Case C-188/09) [2010] ECR I-7639, at [21]). There is, however, no harmonisation of enforcement provisions. Member States are thus empowered to choose the penalties which seem appropriate to them, but that power must be exercised in accordance with the principle of proportionality. According to the Court of Justice's decision in *Paraskevas Louloudakis* v *Elliniko Dimosio* (Case C-262/99) [2001] ECR I-5547 ("*Louloudakis*") (at [67]), this means (i) that penalties must not go beyond what is strictly necessary for the objectives pursued, and (ii) that a penalty must not be so disproportionate to the gravity of the infringement that it becomes an obstacle to, in the case of VAT, the underlying aims of the directive.

10. The principle of proportionality also plays an important role in the jurisprudence of the European Court of Human Rights although there are no material differences between the meaning of proportionality in that context and the meaning of proportionality in the context of the EU Directives.

Preliminary issue

11. As the default which is the subject of the present appeal was the first such default by the Company in the surcharge period, the surcharge fell to be calculated at the rate of 2% on the amount which was paid late (£13,859,254.00) and was therefore £277,185.00. The Company appealed against the surcharge on 26 September 2012. Its sole ground of appeal was the surcharge was disproportionate given that the payment giving rise to the surcharge was only one day late. No further grounds of appeal were stated in the notice of appeal. In particular, the Company did not allege that it had not received the original surcharge liability notice in respect of the period 06/11, which triggered the start of the surcharge period. In addition, the Company did not allege that it had a reasonable excuse for the late payment in respect of the period 03/12.

12. At the hearing before us, Mr Innerdale, on behalf of the Company, accepted that the Company did not have a reasonable excuse for the late payment in respect of the period 03/12. However, he said that he would like to amend the stated ground of appeal set out in the notice of appeal to include the fact that, as far as he was aware, the Company had never received the original surcharge liability notice in respect of the period 06/11, which triggered the start of the surcharge period.

13. Mrs Pavely did not formally object on behalf of the Respondents to the Company's amending the grounds for its appeal to include this point and we therefore heard submissions from both parties in relation to it.

14. The present appeal has been stood over for more than three years pending the outcome of the Upper Tribunal decisions which are discussed in further detail below. The Company has at no point in that period given any indication that it did not receive the original surcharge liability notice in respect of the period 06/11.

15. In response to our question as to why the Company had not made this point before, Mr Innerdale said that this was because the Company had only recently obtained legal advice in relation to the matter. We would have thought that, given the long-standing nature of the dispute between the parties and the fundamental importance of the original surcharge liability notice to the commencement of the surcharge period, the Company might have raised this point a little earlier in the process than on the morning of the hearing.

16. Be that as it may, Mrs Pavely, on behalf of the Respondents, pointed us to pages A28 to A35 of the bundle of documents. These included the original surcharge liability notice bearing the name of the Company and the Company's correct address, entries from the Respondents' ledger indicating that the original surcharge liability notice had been issued and extracts from the Respondents' files showing that the Respondents had been in contact with Mr Innerdale in June 2011 in relation to the default which gave rise to the original surcharge liability notice.

17. Mrs Pavely also pointed out that she had reviewed the Company's file in the course of preparing for the present hearing and that there was no record in the file of any returned mail.

18. Finally, Mrs Pavely submitted that, pursuant to s98 VATA, the relevant question is not whether the Company received the original surcharge liability notice but rather whether that notice was sent to the Company at its last or usual residence or place of business.

19. Mr Innerdale's submission was that he did not recall receiving the original surcharge liability notice and that, as the person in charge of VAT at the Company, he would have been sent the original surcharge liability notice had it been received by someone else in the Company. He added that the Company had frequently encountered problems in receiving mail at around this time.

20. We agree with Mrs Pavely that the terms of s98 VATA – particularly when coupled with s7 of the Interpretation Act 1978, which provides that, where an Act authorises or requires any document to be served by post, then unless the contrary intention appears, the service is deemed to be effected by properly addressing, pre-paying and posting a letter containing the document - mean that the relevant question is whether the original surcharge liability notice was sent by post in a letter addressed to the Company at its last or usual residence or place of business and not whether the Company received the original surcharge liability notice. Moreover, based on the

evidence provided to us by Mrs Pavely, we find as a fact that, on the balance of probabilities, the original surcharge liability notice was sent by the Respondents to the Company at the Company's place of business. We therefore conclude that the original surcharge liability notice was served on the Company pursuant to s59A VATA.

21. We would add that, if we are wrong in relation to our interpretation of s98 VATA, we think that the Company has fallen short in establishing that it did not receive the original surcharge liability notice. All of the evidence to date – including the discussions between the Respondents and Mr Innerdale at the time of the original default, the absence of any returned mail on the Respondents' files and the fact that this point was not raised until the morning of the hearing – leads us to conclude that, on the balance of probabilities, the original surcharge liability notice was received by the Company.

22. We therefore hold that this additional ground of appeal by the Company fails.

The proportionality of the surcharge

23. The main issue before us was whether the surcharge in issue in the present case should be struck down on the basis that it is not proportionate to the gravity of the infringement.

24. This question has been the subject of recent decisions by Judge Bishopp in the First-tier Tribunal – *Enersys Holdings UK v The Commissioners for HMRC* [2010] UKFTT 20 (TC) ("*Enersys*") - and by the Upper Tribunal - the decision of Warren J (P) and Judge Bishopp in *The Commissioners for HMRC v. Total Technology (Engineering) Ltd* [2012] UKUT 418 (TCC), [2013] STC 681 ("*Total Technology*") and the decision of Rose J (P) and Judge Berner in *The Commissioners for HMRC v. Trinity Mirror plc* [2015] UKUT 0421 (TCC) ("*Trinity Mirror*").

25. We are of course bound by the decisions of the Upper Tribunal in *Total Technology* and *Trinity Mirror*. The principles which we derive from those cases may be summarised as follows:-

(a) A wide discretion is conferred on the Government and Parliament in devising a suitable scheme for penalties and therefore a high degree of deference is due by courts and tribunals when determining the legality of penalties. The state has a wide margin of appreciation and a court or tribunal must be astute not to substitute its own view of what is fair for the penalty which Parliament has imposed;

(b) A penalty under the default surcharge regime could be disproportionate either if the regime as a whole is disproportionate or if the way in which the regime applies to an individual taxpayer operates in a disproportionate manner;

(c) There is nothing in the default surcharge regime as whole which leads to the conclusion that its architecture is fatally flawed;

(d) Having said that, the regime could operate in a disproportionate manner in an individual case. In this context, the absence of a maximum penalty is a real flaw in the regime;

(e) In respect of penalties, the principle of proportionality is concerned with two objectives - the objective of the penalty itself and the underlying aims of the relevant directive. Of the two objectives, the latter is the more fundamental because it is not enough for a penalty simply to be found to be disproportionate to the gravity of the default. Instead, it must be "so disproportionate to the gravity of the infringement that it becomes an obstacle to [the underlying aims of the directive]" (*Louloudakis* at [70]);

(f) The underlying aim of the relevant directive in this case is the principle of fiscal neutrality since the common system of VAT is intended to tax only the final consumer and it is a necessary concomitant of a system that provides for the deduction and collection of tax at each stage in the process that tax should be accounted for and paid on a timely basis;

(g) The correct approach is to determine whether the penalty goes beyond what is strictly necessary for the objective pursued by the default surcharge regime and whether the penalty is so disproportionate to the gravity of the infringement that it becomes an obstacle to the achievement of the underlying aim of the directive (i.e. fiscal neutrality);

(h) To those tests should be added the question derived from *International Transport Roth GmbH v Secretary of State for the Home Dept* [2003] QB 728 at [26], which is "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?";

(i) The use of the amount unpaid as the objective factor by which the amount of the surcharge varies is not a flaw in the system; on the contrary, as the achievement of the aim of fiscal neutrality depends on the timely payment of the amount due, that criterion is an appropriate, if not the most appropriate, factor;

(j) In addition, as the objective of the default surcharge regime is to penalise a failure to pay VAT on time and not to penalise for a further delay in payment, the fact that a late payment is made only one day after its due date is not sufficient to render an otherwise proportionate penalty disproportionate;

(k) Whilst the absence of any financial limit on the level of the default surcharge may result in an individual case in a penalty that might be considered disproportionate, this is likely to occur only in a “wholly exceptional case” and be dependent upon its own particular circumstances;

(l) It is not possible to identify common characteristics of a case where such a challenge to a default surcharge would be likely to succeed. In particular:

(i) it is not appropriate for a court or tribunal to seek to set any maximum penalty or range of maximum penalties because that would in effect be to legislate;

(ii) the question of whether the taxpayer had a reasonable excuse for its default is not a relevant factor in considering the proportionality of a penalty because it is axiomatic that, in any case where a default surcharge has arisen, the taxpayer will not have a reasonable excuse for its default; and

(iii) the Upper Tribunal in *Trinity Mirror* expressly stated that it should not be taken to have endorsed the suggestion that the exceptional circumstances giving rise to a disproportionate penalty could include cases where there has been a "spike" in profits; and

(m) More generally, the Upper Tribunal in *Trinity Mirror* noted that:-

> "Attempting to identify particular categories of case in this way is not, in our view, helpful. Whilst it might be tempting to seek to isolate, and thus confine, cases by reference to particular criteria, such cases, by reason of their exceptional nature, are likely to defy such characterisation".

26. Just pausing there, it is unfortunate that, having identified the use of the amount unpaid as the objective factor by which the surcharge is calculated to be the most appropriate factor in the calculation of the surcharge but also stated that the absence of any financial limit on the level of the surcharge may result in a disproportionate penalty in certain circumstances, the Upper Tribunal did not provide guidance as to what those circumstances might be. If the principle is that it is entirely appropriate to calculate a surcharge by applying the specified percentage to the amount of tax unpaid even in a case where there has been a “spike” in profits, then it is hard to see what circumstances could lead a surcharge so calculated to be regarded as disproportionate. The Upper Tribunal in *Trinity Mirror* recognised this when it noted at paragraph [66] that, “[although] the absence of a maximum penalty means that the possibility of a proper challenge on the basis of proportionality cannot be ruled out, we cannot ourselves readily identify common characteristics of a case where such a challenge to a default surcharge would be likely to succeed".

27. The facts in the present case are not dissimilar from those in *Trinity Mirror*. In both cases, the default in question was the first default within the surcharge period (so that the surcharge was levied at the rate of 2% on the outstanding tax) and, in both cases, the delay in payment was only one day. The only relevant difference between the two cases is that, whereas the default surcharge in *Trinity Mirror* was £70,906.44, the default surcharge in the present case is £277,185.00, reflecting the fact that the VAT that was paid late in this case was greater than the VAT that was paid late in the case of *Trinity Mirror*.

28. The principles outlined above establish that a particular surcharge can be found to be disproportionate only in "a wholly exceptional case, depending upon its own particular circumstances". They also establish that, although the absence of a

maximum penalty means that the possibility of a proper challenge on the basis of proportionality cannot be ruled out on the basis of quantum, it is extremely hard to identify a situation where that would be the case.

29. In the light of the above, it not clear to us how the surcharge in this case can be distinguished from the surcharge in *Trinity Mirror*, despite the fact that it is a greater amount than the amount of the default surcharge in that case. Once one accepts that it is consistent with the fiscal neutrality aim of the relevant directive to ignore the fact that payment was delayed by only one day and to apply a specified percentage to the amount of tax paid late, it seems to follow inexorably that the penalty must be proportionate.

30. At the hearing, the Company sought to persuade us that the facts in this case are such that this is an example of the "wholly exceptional case" to which reference was made in *Trinity Mirror*.

31. Mr Innerdale and Mr Camillo explained that the nature of the business carried on by the group in question is such that there is an unusually significant difference between the group's turnover and the group's profit margin. The group's turnover is inflated by the inclusion of duty reimbursements and the profit margins are small (generally, around 1% to 1½% of turnover and sometimes, as in this case, not even that). By way of example, the total output liability of the VAT group for the four quarters up to and including 03/12 was in excess of £4,000,000,000.00 whereas, in fact, the company and its subsidiary undertakings recorded a loss of some £9,000,000.00 in the financial year ending 31 December 2012.

32. As evidence to support their argument, Mr Innerdale and Mr Camillo provided us with a copy of the consolidated accounts for the Company and its subsidiary undertakings in respect of the financial year ending 31 December 2012. They pointed out that those accounts included figures for one company – a German subsidiary – which was not a member of the VAT group but that the impact of those figures on the accounts was negligible and therefore that we should assume that the accounts recorded the financial position of the VAT group in the financial year in question. The accounts so submitted did show a loss for the financial year in question of £9,194,000.00. However, the balance sheet included in the accounts also showed that, on 31 December, 2012, the Company and its subsidiary undertakings had over £37,000,000.00 of cash at bank and in hand and had net assets of almost £29,000,000.00.

33. Mr Innerdale and Mr Camillo submitted that support for the proposition that a significant discrepancy between turnover and profit is sufficient to qualify as a "wholly exceptional case" may be found at [44] of the decision in *Enersys*.

34. We have reflected on these submissions and consider that the significant difference between turnover and profit margin in this case is not sufficient to bring this case within the ambit of the "wholly exceptional case" mentioned in *Trinity Mirror*. Our reasons for reaching this conclusion are as follows:-

(a) First, whilst it is true that reference was made at [44] of the decision in *Enersys* to the relationship between the default surcharge liability and profitability, that reference was made in the course of the tribunal's summarising the arguments made by the appellant in that case. It was not expressly adopted by the tribunal as the basis for its decision in the case. Indeed, in the course of summarising the appellant's submission on the point at [44], the tribunal pointed out an example of a penalty in a previous case (*Sony Ericsson Mobile Communications AB v The Customs and Excise Commissioners* (2007, Decision 20513)) which was held to be proportionate despite its scale (some £675,575.00). Significantly, there is nothing in the conclusions section of the judgment in *Enersys* (paragraph [55] onwards) to suggest that the tribunal was basing its decision on the argument described at [44], even though the decision was ultimately in favour of the taxpayer;

(b) Secondly, this very point was addressed by the Upper Tribunal at [90] of the decision in *Total Technology*. The paragraph in question is set out below:-

"The potential hardship to a trader is not a factor to be taken into account. In particular, the amount of the penalty is not related to profitability. We do not consider that there is anything in this point at the level of the regime viewed as a whole or at the level of the individual taxpayer. The penalty is not related to profitability but it is related to the tax unpaid. A penalty, if it is not a fixed-rate penalty, must vary according to some objective criteria. It is not immediately apparent to us why a penalty linked to profitability would be any fairer than one linked to the outstanding tax although some penalty regimes do have that result. It may be possible to design a system which brought into account many factors – turnover, profitability, proportion of exempt or zero rated supplies to name but three – so as to produce a more sophisticated system which would produce a result that some people might perceive as more fair. The fact that that might be done does not make the actual regime non-compliant with the principle of proportionality."

It is clear from this extract that the Upper Tribunal was rejecting the proposition that a significant discrepancy between profitability and the amount of the surcharge can be a ground for concluding that the surcharge is disportionate;

(c) Thirdly, we consider that the question was also addressed, albeit obliquely, at [65] of the decision in *Trinity Mirror*. In that paragraph, the Upper Tribunal made the following statement in relation to the proposition that the default surcharge liability is based on the amount of VAT unpaid:-

"In common with the Upper Tribunal in *Total Technology*, we consider that the use of the amount unpaid as the objective factor by which the

amount of the surcharge varies is not a flaw in the system; to the contrary, the achievement of the aim of fiscal neutrality depends on the timely payment of the amount due, and that criterion is therefore an appropriate, if not the most appropriate, factor."; and

(d) Fourthly, as Mrs Pavely pointed out, regardless of its profitability, a taxpayer receives the money to pay its VAT liabilities from the persons to whom it makes its supplies. Indeed, it would very often receive those monies in advance of the date on which it is required to account for the VAT in question and would thereby derive a cashflow advantage. So, regardless of its profitability, the taxpayer should be able to account for its VAT liabilities in all cases.

35. It follows from the above that, leaving aside the specific circumstances of the Company in this case, we do not think that it is open to us to conclude that a significant disparity between the turnover of a VAT group and the profitability of the VAT group is sufficient to give rise to a "wholly exceptional case" of the kind to which reference was made in *Trinity Mirror*.

36. We would add that, even if we were permitted to reach that conclusion by the decisions which are binding upon us, we are not convinced that this would be an appropriate case to apply that exception. It is true that the Company and its subsidiary undertakings made a loss in the financial year ending 31 December 2012. However, the balance sheet as at 31 December 2012 shows that the Company and its subsidiary undertakings had significant amounts of cash at bank and in hand and had significant net assets, in each case relative to the size of the default surcharge liability.

37. It follows from the above that, in our view, the penalty in this case cannot be regarded as disproportionate. We therefore uphold the surcharge liability of £277,185.00.

38. 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.

TONY BEARE

TRIBUNAL JUDGE
RELEASE DATE: 25 JANUARY 2016