[2016] UKFTT 0236 (TC)

TC05011

Appeal number: TC/2015/03606
TC/2015/03908

VAT-default surcharge – late payments – whether reasonable excuse - no – return for 03/13 submitted one day late – whether proportionate – yes - surcharges calculated by reference to VAT on what were later ruled to be exempt supplies - was tax on those exempt supplies outstanding VAT - no - proportionality – was it disproportionate for the respondents to apply the surcharge percentage to the VAT on exempt supplies - yes - impact of appellants being unable to make a valid section 80 claim - none - appeal allowed in part.

FIRST-TIER TRIBUNAL
TAX CHAMBER

KINGSDALE GROUP LIMITED **Appellants**
KINGSDALE UK LIMITED

- and -

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

TRIBUNAL: JUDGE NIGEL POPPLEWELL
MRS NORAH CLARKE

Sitting in public at Bristol on 7 March 2016

Mr William Butchart for the Appellants

Mrs Anne Rees Officer of HM Revenue and Customs for the Respondents

Introduction

1. This is a VAT case. It concerns the default surcharge regime which is a penalty regime which penalises a taxpayer for late delivery of a return, or late payment of VAT.

2. The appellants (Kingsdale UK Ltd ("KUL"), and Kingsdale Group Limited ("KGL") appeal against default surcharges (referred to in this decision as "default surcharges", "surcharges" or "penalties") which the respondents allege are due from them.

3. The amounts in question are alleged by the appellants to be £9524.71 for KGL, and £8620.48 for KUL. These penalties were based on the VAT position which prevailed at the time the supplies which were reflected in the relevant returns were made; namely that the appellants made exclusively taxable supplies. However, it was subsequently agreed, following a ruling by the respondents given after the periods in question, that some of the supplies made during these periods were, in fact, exempt. At the risk of offending VAT purists, we shall describe the "VAT" which was recovered from consumers and paid over to the respondents in the erroneous belief that this was attributable to taxable supplies, as "exempt tax". This is just useful shorthand, and should not be treated as an indication of its VAT status for the purposes of the relevant legislation. We embellish this point later in this decision.

4. The appellants accept that the tax to which the surcharges apply has been paid late. However it is their position that

> (1) There is a reasonable excuse for such late payment, both generally, and in particular as regards the period 03/13;
>
> (2) Payment for the period 03/13 was only one day late, and it is out of proportion to apply a surcharge in these circumstances; and
>
> (3) The tax to which the surcharge percentage was applied is overstated since it was applied to the exempt tax and this should not have been so.

5. It is the respondents position that the exempt tax can be disregarded when computing the surcharge but only where the appellants have made a successful refund claim under section 80 of the Value Added Tax Act 1994 ("VAT Act"), which the appellants have not done in this case. They also say that the appellants have no reasonable excuse and that the penalties for 03/13 are proportionate.

6. In deciding whether the exempt tax should be taken into account, we have had to consider two difficult issues.

7. The first of these concerns the definition of "outstanding VAT" for the purposes of section 59 VAT Act.

8. The second concerns the application of the doctrine of proportionality to the default surcharge regime, both generally, and specifically to the appellants in this case; and in particular whether the default surcharge regime, or its application to the

appellants in this case is disproportionate if the surcharge percentage is applied to the exempt tax.

9. The difference in amounts is modest. For KGL the effect of taking the exempt tax into account reduces the surcharges to £5903.97, a saving of £3620.74. For KUL, the reduction is to £6430.78, a saving of £2189.70. We note that these are based on figures provided by the appellants. We are not clear whether they are agreed by the respondents.

10. We agree with the respondents that the appellants have no reasonable excuse and that the penalties (and in particular the penalty for the period 03/13) were proportionate.

11. However, for the reasons given later in this decision, it is our view that the exempt tax should be taken into account, and so reduce, the tax to which the surcharge percentage should otherwise be applied. And that this is the case notwithstanding that the appellants are unable to make a successful reclaim under section 80.

12. From now on references to sections, subsections and schedules in this decision are references to sections, subsections or schedules of the VAT Act unless otherwise stated.

The Default Surcharge Regime

13. In order to understand the appellants position it is necessary to set out in brief at this stage, a description of the operation of the regime.

14. Judge Bishopp has given such a description in his decision in *Enersys Holdings* [2010] UKFTT 20 TC0335 ("*Enersys*").

> "The first default gives rise to no penalty, but brings the trader within the regime; he is sent a surcharge liability notice which informs him that he has defaulted and warns him that a further default will lead to the imposition of a penalty. A second default within a year of the first leads to the imposition of a penalty of 2% of the net tax due. A further default within the following year results in a 5% penalty; the next, again if it occurs within the following year, to a 10% penalty, and any further default within a year of the last to a 15% penalty. A trader who does not default for a full year escapes the regime; if he defaults again after a year has gone by the process starts again. The fact that he has defaulted before is of no consequence."(emphasis added)

15. The reason for adding the emphasis in the extract will become apparent later. At this stage, it is worth mentioning that where a taxpayer has a reasonable excuse for the default under appeal, he is not liable for it.

The legislation

16. The legislation for the default surcharge regime is found primarily in Section 59

which is set out below:

59 – The default surcharge

59(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.

59(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.

59(2) Subject to subsections (9) and (10) below, subsection (4) below applies in any case where –

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

(b) the Commissioners serve notice on the taxable person (a "surcharge liability notice") specifying as a surcharge period for the purposes of this section a period ending on the first anniversary of the last day of the period referred to in paragraph (a) above and beginning, subject to subsection (3) below, on the date of the notice.

59(3) If a surcharge liability notice is served by reason of a default in respect of a prescribed account 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.

59(4) Subject to subsections (7) to (10) below, if a taxable person on whom a surcharge liability notice has been served-

(a) is in default in respect of a prescribed accounting period ending within the surcharge period specified in (or extended by) that notice, and

(b) has outstanding VAT for that prescribed accounting period,

he shall be liable to a surcharge equal to whichever is the greater of the following, namely, the specified percentage of his outstanding VAT for that prescribed accounting period and £30.

59(5) Subject to subsections (7) to (10) below, the specified percentage referred to in subsection (4) above shall be determined in relation to a prescribed accounting period by reference to the number of such periods in respect of which the taxable person is in default during the surcharge period and for which he has outstanding VAT, so that-

(a) in relation to the first such prescribed accounting period, the specified percentage is 2 per cent;

(b) in relation to the second such period, the specified percentage is 5 per cent;

(c) in relation to the third such period, the specified percentage is 10 per cent; and

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

59(6) For the purposes of subsections (4) and (5) above a person has outstanding VAT for a prescribed accounting period if some or all of the VAT for which he is liable in respect of that period has not been paid by the last day on which he is required (as mentioned in subsection (1) above) to make a return for that period; and the reference in subsection (4) above to a person's outstanding VAT for a prescribed accounting period is to so much of the VAT for which he is so liable as has not been paid by that day.

59(7) If a person who, apart from this subsection, would be liable to a surcharge under subsection (4) above satisfies the Commissioners or, on appeal, a tribunal that, in the case of a default which is material to the surcharge –

(a) the return or, as the case may be, the VAT shown on the return was despatched at such a time and in such a manner that it was reasonable to expect that it would be received by the Commissioners within the appropriate time limit, or

(b) there is a reasonable excuse for the return or VAT not having been so despatched,

he shall not be liable to the surcharge and for the purposes of the preceding provisions of this section he shall be treated as not having been in default in respect of the prescribed accounting period in question (and,

accordingly, any surcharge liability notice the service of which depended upon that default shall be deemed not to have been served).

59(8) For the purposes of subsection (7) above, a default is material to a surcharge if –

(a) it is the default which, by virtue of subsection (4) above, gives rise to the surcharge; or

(b) it is a default which was taken into account in the service of the surcharge liability notice upon which the surcharge depends and the person concerned has not previously been liable to a surcharge in respect of a prescribed accounting period ending within the surcharge period specified in or extended by that notice.

59(9) In any case where –

(a) the conduct by virtue of which a person is in default in respect of a prescribed accounting period is also conduct falling within section 69(1), and

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

the default shall be left out of account for the purposes of subsections (2) to (5) above.

59(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.

59(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.

17. The relevant subsections of Section 80 are set out below:

80 Credit for, or repayment of, overstated or overpaid VAT

80(1) Where a person-

(a) has accounted to the Commissioners for VAT for a prescribed accounting period (whenever ended), and

(b) in doing so, has brought into account as output tax an amount that was not output tax due,

the Commissioners shall be liable to credit the person with that amount.

80(1A) .....

80(1B) …..

80(2) The Commissioners shall only be liable to credit or repay an amount under this section on a claim being made for the purpose.

80(2A) …..

80(3) It shall be a defence, in relation to a claim under this section by virtue of subsection (1) or (1A) above, that the crediting of an amount would unjustly enrich the claimant.

80(3A) …..

80(3B) …..

80(3C) .....

80(4) …..

80(4ZA) …..

80(4ZB) …..

80(4A) …..

80(4AA) …..

80(4C) …..

80(6) A claim under this section shall be made in such form and manner and shall be supported by such documentary evidence as the Commissioners prescribe by regulations; and regulations under this subsection may make different provision for different cases.

80(7) Except as provided by this section (and paragraph 16I of Schedule 3B and paragraph 29 of Schedule 3BA), the Commissioners shall not be liable to credit or repay any amount accounted for or paid to them by way of VAT that was not VAT due to them.

The evidence

18. The written evidence comprised a bundle of documents. In addition to the bundle produced at the start of the hearing, additional documents were handed up during its course.

19. Neither party called any witnesses. However, Mr Butchart, as managing director of the appellants, in addition to making submissions, gave oral evidence. We found

him to be a straightforward and honest witness.

Findings of fact

20. We make the following findings of fact:

(1) The appellants are part of a group of companies which are not grouped for VAT purposes, but each is separately registered for VAT.

(2) Their business is the management of retirement homes.

(3) The legal documentation which governs the transfer of an interest in such a retirement home, includes an obligation on the transferor to pay a transfer premium ("the transfer premium") to the landlord. The amount of premium is a function of the price paid for the assignment and the length of time the lease has been hold.

(4) The appellants are landlords of some homes, and act as agent for third party landlords on the transfers of others.

(5) Until May 2013, the appellants had treated a transfer premium as being consideration for a taxable supply. They had charged VAT to the transferors at the standard rate, and accounted for such VAT to the respondents.

(6) In response to a query from a transferor's lawyer, the appellants, through their VAT agents, Centurion, sought a ruling by way of a letter dated 29 May 2013 regarding the VAT treatment of a transfer premium.

(7) In Centurion's view a transfer premium is exempt from VAT. It was their view that the VAT status in respect of which the payments are made should follow the VAT treatment of the transfers to which they relate. Since these are transfers of residential property, they are exempt from VAT.

(8) After some correspondence between Centurion and the respondents, the respondents ruled, in a letter 26 June 2013, that a transfer premium is a payment for an exempt supply (the "ruling").

(9) For the VAT period set out below, the appellants were late in submitting payments of VAT and a default surcharge in the amounts set out were assessed on each appellant by way of default surcharge notices.

KGL

Period	**Description**	**Calculated @**	**Amount**
03/12	Default Surcharge	15%	£3976.36
06/12	Default Surcharge	15%	£2559.89
03/13	Default Surcharge	15%	£2988.61

Period	Description	Calculated @	Amount
09/12	Default surcharge	15%	£2504.29
12/12	Default surcharge	15%	£3482.78
03/13	Default surcharge	15%	£2633.38

(10) The amounts in these tables are calculated on the basis that a transfer premium is consideration for a taxable supply and did not take the ruling into account.

(11) Payment of the VAT due from each appellant for the period 03/13 was made by BACS. And was made one day late (the due date was 7 May 2013 and it was received by the respondents on 8 May 2013).

(12) The weekend of 4 - 6 May 2013 was a bank holiday weekend.

(13) The appellants had initiated payments in respect of the 03/13 return on Friday 3 May via a computer in their accounts department. The person initiating such payment had not taken into account the fact that Monday 6 May 2013 was a bank holiday.

(14) Payment by BACS is received 3 working days after the date of initiation. And so that working day was not Tuesday 7 May 2013 (the due date) but Wednesday 8 May 2013 (a day late).

(15) On 14 October 2013 the appellants wrote to the respondents in light of the ruling, expressing the view that HMRC had been unjustly enriched by the mis-characterisation of the transfer premiums, and asking that the amounts "overpaid" be set off against the default surcharges then outstanding.

(16) The respondents appear to have treated this as a claim under section 80 for a refund of over declared output tax, and accordingly sent an undertaking to the appellants on 29 November 2013. Had the appellants signed the undertaking, the respondents would have refunded to the appellants the overpaid tax.

(17) The amount of VAT alleged by the appellants to have been overpaid by them for the period 03/12 to 03/13 is £37,428.42. The default surcharge penalties for that period amounted to £14,736.

(18) The undertaking required the appellants to pass on to the transferors the refund which it sought. It was the transferors who had originally paid the VAT on the transfer premiums. The purpose of the undertaking was to ensure that the appellants were not unjustly enriched by the refund.

(19) The appellants were and are unable to sign the undertaking. It is not feasible for them to reimburse any refunded VAT to any transferor. In many cases the retirement homes had been transferred following the death of an occupant; and that occupant's estates had paid the transfer premium. Those estates had then been wound up.

(20) Since the appellants were unable to sign the undertaking, the respondents withdrew the offer of a refund by letter dated 6 January 2014.

(21) Following unsuccessful reviews requested by the appellants of the respondents in respect of the default surcharges, the appellant appealed against their imposition by way of notices of appeal dated 3 June 2015 for KGL and 15 June 2015 for KUL.

Jurisdiction and onus and burden of proof

21. The tribunal has power to reduce a surcharge assessment on appeal (and so reduce it to the amount that is appropriate under section 59). This is the effect of section 84(6) which provides as follows:

> "84(6) Without prejudice to section 70, nothing in section 83(1)(q) shall be taken to confer on a tribunal any power to vary an amount assessed by way of penalty, interest or surcharge except in so far as it is necessary to reduce it to the amount which is appropriate under sections 59 to 70 or (as the case requires) paragraph 26 of Schedule 3BA or paragraph 16F of Schedule 3B; and in this subsection "penalty" includes an amount assessed by virtue of section 61(3) or (4)(a)."

22. The respondents accept that the initial burden of proof lies with them to show that VAT was paid late and the liability to a default surcharge has been incurred.

23. Once the respondents have displaced that burden of proof, then the burden shifts to the appellants to show that a reasonable excuse exists, or that the surcharges are disproportionate.

24. The question of who has the burden of proof of establishing that the surcharge percentage was applied to an incorrect amount, and should not have taken into account the exempt tax, has never, as far as we are aware, been considered by a court.

25. On the one hand, since this relates to the accurate computation of the surcharge, it is relevant to establishing that there is a liability to that surcharge, and would suggest that the respondents have the burden of establishing that they have applied the correct percentage to the correct amount.

26. On the other, since the issue has been raised by the appellants as a reason why the surcharges should be reduced, it should be they who need to establish, on the balance of probabilities, that the exempt tax should be excluded from the surcharge calculation.

27. We prefer to adopt the latter approach. At the time the surcharge notices were issued, there was no issue about the VAT due to the respondents under the returns in question. At the time of their service, the respondents could not have known about the exempt tax.

28. It is our view, therefore, that if the appellants are to succeed in their assertion that the surcharge percentage should not apply to the exempt tax, it is they who have to show this, on the balance of probabilities.

All periods – timely despatch reasonable excuse

The law – reasonable excuse

29. Section 59(7)(b) provides that if a taxpayer has a reasonable excuse for the default, it will not be liable to a surcharge.

30. The appellants submit that they have a reasonable excuse for the surcharges.

31. In their notices of appeal, they contend that these apply to all six such surcharges. At the hearing, Mr Butchart did not press the reasonable excuse defence with any vigour, save in respect of the period 03/13.

32. When considering whether the appellants have a reasonable excuse, we adopt, with gratitude, the principles promulgated by Judge Brannan in the case of *Stuart Coales -v- The Commissioners for Her Majesty's Revenue & Customs* [2012] UKFTT (477) ("*Coales*"), set out below:

> *"Meaning of "reasonable excuse"*
>
> 25. Under Section 59C(9)(a) I can, however, set aside the surcharge determination if it appears that, throughout the period of default, the taxpayer had a reasonable excuse for not paying the tax. The onus is on the appellant to satisfy me that there was a reasonable excuse. The statute provides (Section 59C(10)) that inability to pay the tax shall not be regarded as a reasonable excuse.
>
> 26. In this context, I consider the reasonable excuse exception to be an objective test applied the individual facts and circumstances of the appellant in question.
>
> 27. In *Bancroft and another v Crutchfield (HMIT)* [2002] STC (SCD) 347 in relation to Section 59C(9)(a) the learned Special Commissioner (Dr John Avery Jones CBE) stated:
>
> > "A reasonable excuse implies that a reasonable taxpayer would have behaved in the same way. A reasonable taxpayer would at least have read the literature issued by the Revenue…"
>
> 28. The concept of "reasonable excuse" appears throughout VAT and direct tax legislation in respect of the imposition of surcharges on

penalties. There is a considerable amount of case law in this tribunal as well as its predecessors (the VAT and Duties Tribunal and the Special and General Commissioners). It is not possible to do justice to all these decisions but I think that helpful guidance can be obtained from the decision of the VAT Tribunal in *The Clean Car Company Limited v C & E Commissioners* [1991] VATTR 239 and I can do no better than quote from the passage where the Tribunal (HH Judge Medd OBE QC) said:

> "So I may allow the appeal if I am satisfied that there is a reasonable excuse for the Company's conduct. Now the ordinary meaning of the word 'excuse' is, in my view, "that which a person puts forward as a reason why he should be excused".
>
> A reasonable excuse would seem, therefore, to be a reason put forward as to why a person should be excused which is itself reasonable. So I have to decide whether the facts which I have set out, and which Mr Pellew-Harvey [for the Appellant] said were such that he should be excused, do in fact provide the Company with a reasonable excuse.
>
> In reaching a conclusion the first question that arises is, can the fact that the taxpayer honestly and genuinely believed that what he did was in accordance with his duty in relation to claiming input tax, by itself provide him with a reasonable excuse. In my view it cannot. It has been said before in cases arising from default surcharges that the test of whether or not there is a reasonable excuse is an objective one. In my judgment it is an objective test in this sense. One must ask oneself: was what the taxpayer did a reasonable thing for a responsible trader conscious of and intending to comply with his obligations regarding tax, but having the experience and other relevant attributes of the taxpayer and placed in the situation that the taxpayer found himself at the relevant time, a reasonable thing to do? Put in another way which does not I think alter the sense of the question: was what the taxpayer did not an unreasonable thing for a trader of the sort I have envisaged, in the position the taxpayer found himself, to do? … It seems to me that Parliament in passing this legislation must have intended that the question of whether a particular trader had a reasonable excuse should be judged by the standards of reasonableness which one would expect to be exhibited by a taxpayer who had a responsible attitude to his duties as a taxpayer, but who in other respects shared such attributes of the particular appellant as the tribunal considered relevant to the situation being considered. Thus though such a taxpayer would give a reasonable priority to complying with his duties in regard to tax and would conscientiously seek to ensure that his returns were accurate and made timeously, his age and experience, his health or the incidence of some particular difficulty or misfortune and, doubtless, many other facts, may all have a bearing on whether, in

> acting as he did, he acted reasonably and so had a reasonable excuse. Such a way of interpreting a statue which requires a court to decide an issue by judging the standards of the reasonable man is not without precedent of the highest authority, though in a very different field of the law. (See *DPP v Camplin* ([1978] 2 All ER 168)."
>
> 29. I agree with the Tribunal's views. In my view, this decision clearly explains that the test is an objective one: it involves considering the actual circumstances of the taxpayer in question but applying an objective analysis of those circumstances."

Discussion

33. Section 59(7) provides two alternative defences which the appellants might establish to exonerate themselves from the surcharges.

34. The first under subsection 59(7)(a) is that the "VAT shown on the return was dispatched 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".

35. The second under subsection 59(7)(b) is that the appellants have a reasonable excuse for the VAT not having been so dispatched.

36. As we have said above, the appellants, and Mr Butchart on their behalf, did not pursue either of these defences with any vigour for the surcharges in dispute save in respect of that for the period 03/13. In his written correspondence with the respondents he justified failures to pay on time, generally, by pointing to the fact that the companies had grown very quickly because of an opportunity to tender for management contracts on retirement developments at various locations throughout the country. This meant that their administrative staff and systems were put under extreme pressure and it was not possible to simply hire more people to enable them to comply with their VAT obligations.

37. It is our view that this does not comprise a reasonable excuse for late filing, nor indeed late payment, when tested against the criteria set out at paragraph 32 above. The reasonable taxpayer in the position of the appellants, conscious of its obligations to file and pay VAT on time, would have ensured VAT compliance was observed notwithstanding this growth. Whilst it might not have been possible to employ more staff, it was perfectly possible for the appellants to outsource the VAT function, and a reasonable trader, conscious of its obligations under the VAT system, would have done just that. We find, therefore, that failure to file on the basis of commercial pressures does not comprise a reasonable excuse for failing to account for VAT on time. Indeed, as Mr Butchart said in evidence, in the first half of 2013, he had become increasingly frustrated by the penalties that were being paid to HMRC and had resolved that he would put a stop to them. Apart from the penalty for the period 03/13, he has been successful. So the question is why he did not intervene earlier to ensure that the appellants VAT compliance was improved. Once he put his mind to it, he

ensured that it was. It is our view that he should have done this earlier, and failure to do so also means that he has no reasonable excuse for the late payments.

38. Turning now to the period 03/13, the appellants position is that either it was reasonable to expect that the VAT shown on those returns would have arrived on the due date of 7 May 2013 since it was dispatched under the BACS system on Friday 3 May; or that there was a reasonable excuse because the person responsible for initiating payments on Friday 3 May had not realised that Monday 6 May was a bank holiday. And so the third working day after the date of initiation was Wednesday 8 May rather than Tuesday 7 May (with the consequence that the payment arrived a day late).

39. Regrettably for the appellants, we do not consider that this comprises a defence to the penalties under either limb of subsection 59(7). It is our view that, on the balance of probabilities, the individual responsible for initiating payment of the VAT for the period 03/13 would have been well aware of the fact that he or she was about to benefit from a long weekend. That person may not have put two and two together that the bank holiday Monday was not a working day for the purposes of sending payment by the BACS system. But given the literature is very clear on working days, and a reasonable taxpayer (which includes, for this purposes, the appellants agents and employees) could reasonably be expected to have read that literature, it is our view that a reasonable taxpayer would have been on notice that a bank holiday might have an impact on the submission of electronic payment of VAT to the respondents.

40. So it was not reasonable to expect that the VAT would have been received by the Commissioners on Tuesday 7 May. Nor do the appellants have a reasonable excuse for not having initiated the payment in sufficient time to ensure that it was received by the respondents on that due date. The reasonable taxpayer would have taken into account the bank holiday and would have initiated payment on Thursday 2 May.

41. So the appellants have not satisfied us that they fall within either subsections 59(7)(a) or (b) for any of the six periods under appeal.

Proportionality

42. The doctrine of proportionality is central to our discussions later in this decision. In relation to it and its application to the issues in this case, we have reviewed the following cases (all of which, save *Enersys*, are binding on us):

Dyrektor Izby Skarbowej w Biaymstoku v Profaktor Kulesza, Frankowski, Jowiak, Orowski (Case C-188/09) [2010] ECR I-7639 *("Profaktor")*

Paraskevas Louloudakis v Elliniko Dimosio (Case C-262/99) [2001] ECR I-5547 ("*Louloudakis*")

The Commissioners for HMRC v Total Technology (Engineering) Ltd [2012] UKUT 418 (TCC), [2013] STC 681 ("*Total Technology*")

The Commissioners for HMRC v Trinity Mirror plc [2015] UKUT 0421 (TCC)

("*Trinity Mirror*")

International Transport Roth GmbH v Secretary of State for the Home Dept [2003] QB 728 ("*Roth*")

James v UK (Application 8793/79) (1986) 8 EHRR 123 ("*James*")

Wilson v SoS for Trade and Industry [2003] UKHL 40 [2004] 1AC816 ("*Wilson*")

Molenheide and others [1997] ECR I-72181 ("*Molenheide*")

R(on the application of Lumsden and others) (Appellants) v Legal Services Board (Respondent) [2015] UKSC 41 ("*Lumsden"*)

Enersys

43. From them we have derived the following principles:

> (1) Member States are obliged to take all legislative and administrative measures to ensure collection of VAT (*Profaktor* at [21]). This is required to ensure that the tax is collected accurately thus ensuring the normal functioning of the VAT system by, in turn, ensuring tax neutrality (*Profaktor* at [21]).
>
> (2) The measures may not, however, go further than is necessary to achieve the objective of levying and collecting the correct amount of tax (*Profaktor* at [26]).
>
> (3) In the absence of harmonisation of European Union Legislation relating to sanctions which may be applied for non-compliance with such legislative measures, Member States are empowered to choose sanctions which seem to them to be appropriate (*Profaktor* at [29]).
>
> (4) But they must exercise that power in accordance with the principle of proportionality (*Profaktor* at [29]).
>
> (5) Proportionality is a general principle of EU law which is enshrined in article 5 (4) of the Treaty on European Union. Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties (*Lumsden* at [24].
>
> (6) The principle of proportionality is therefore applicable to national measures which are adopted by a Member State in exercise of its powers relating to VAT (*Molenheide* at [48]).
>
> (7) It is for the national court to determine whether such national measures are compatible with the principle of proportionality (*Molenheide* at [49]).

(8) In deciding whether the measures or their application is appropriate and not disproportionate, the court must exercise a value judgment by reference to the circumstances prevailing when the issue is to be decided. It is the current effect and impact of the legislation which matters, not the position when the legislation was enacted or came into force (*Wilson* at [62]).

(9) Proportionality as a general principle of EU law involves a consideration of two questions: first, whether the measure in question is suitable or appropriate to achieve the objective pursued; and secondly, whether the measure is necessary to achieve that objective, or whether it could be attained by a less onerous method (*Lumsden* at [33])

(10) As is the case for other principles of public law, the way in which the principle of proportionality is applied in EU law depends to a significant extent upon the context (*Lumsden* at [23].

(11) In the context of its application to penalties, the principle of proportionality is that:

> (A) penalties may not go beyond what is strictly necessary for the objective pursued; and
>
> (B) a penalty must not be so disproportionate to the gravity of the infringement that it becomes an obstacle to the freedoms enshrined in the Treaty (*Louloudakis* at [67]).

(12) In the field of VAT, the freedoms enshrined in the Treaty means the underlying aims of the EU Directives which govern VAT (the "Directive") (*Trinity Mirror* at [14]).

(13) The objective of the default surcharge penalty (the "penalty") in enforcing the collection of tax is itself a natural consequence of the essential aim of the Directive to ensure the neutrality of taxation of economic activities (*Trinity Mirror* at [56]).

(14) The underlying aim of the Directive for this purpose is the fiscal neutrality which protects taxable persons since VAT is intended to tax only the final consumer (*Trinity Mirror* at [59]).

(15) And given that this is achieved by the collection and deduction at each stage of the supply chain, ensuring the timely payment at each stage is a necessary consequence of that aim (*Trinity Mirror* at [60]).

(16) The correct approach, therefore, is to determine whether the penalty goes beyond what is strictly necessary for the objectives pursued by the default surcharge regime (*Trinity Mirror* at [63]).

(17) But a penalty must not become an obstacle to the underlying aims of

the Directive (*Total* at [72]).

(18) An excessive penalty will impose a disproportionate burden on a defaulting trader and distort the VAT system as it applies to him (*Total* at [72]).

(19) For example, the imposition of a flat rate penalty might be proportionate as far as a penalty regime is concerned; but disproportionate in respect of its application to a specific small trader. It might go beyond what is necessary in relation to such trader and would distort the VAT system as far as that trader is concerned. The burden would bear more heavily on him than on a larger trader (*Total* at [76]).

(20) The application of the doctrine of proportionality can be at a high level (is the penalty regime as a whole disproportionate?), or at an individual level (does the penalty regime that applies in a particular case, disproportionate?) (*Total* at [74]).

(21) The margin of appreciation given to law makers in implementing social and economic policy should be a wide one and the courts will respect the law makers judgment as to what is in the public interest unless that judgment is manifestly "without reasonable foundation" (*James* at [46]) or "not merely harsh but plainly unfair" (*Roth* at [26]).

(22) The principles of "devoid of reasonable foundation" or "not merely harsh but plainly unfair" can be applied to a case relating to a particular taxpayer just as much as it can be applied to the regime as a whole (*Total* at [93], *Trinity Mirror* at [72]).

(23) A UK court should be cautious in the extreme in saying that national legislation has overstepped the mark in setting the level of penalty (*Total* at [73]).

(24) But a national measure will not be proportionate if it is clear that the desired level of protection could be obtained equally well by measures which were less restrictive of a fundamental freedom (*Lumsden* at [66]).

(25) The default surcharge regime viewed as a whole is a rational scheme (*Trinity Mirror* at [65]).

(26) A penalty (if it is not a fixed rate penalty) must vary according to some objective criteria. The use of the amount unpaid as an objective criterion is an appropriate if not the most appropriate criterion (*Trinity Mirror* at [65]), (*Total* at [90]).

(27) But this is only so if the amount of the penalty for a failure to file or pay is itself proportionate to that failure (*Total* at [88]).

(28) Since the penalty is for failing to pay and file by the due date, and

not for delay in paying after that date, the fact that a trader is only one day late in paying does not, per se, render an otherwise proportionate penalty, disproportionate (*Total* at [88]).

(29) The absence of any financial limit does not render the regime disproportionate; but may, in a wholly exceptional case, (dependent on its own circumstances), render its application to a particular case, disproportionate (*Trinity Mirror* at [66]).

Proportionality and the 03/13 returns.

44. In respect of their 03/13 returns the appellants submit that the surcharges are "unfair and out of proportion". They point out that the payment was received by the respondents only one day late.

45. The principles which we must apply when considering this have been set out at paragraph 43 above.

46. We remind ourselves, and the appellants, that we are bound by the decisions to which we have referred in that paragraph.

47. It is worth setting out the following passage from *Trinity Mirror*, since in our view it is the kernel of the rationale for the default surcharge regime.

> "59. The underlying aim of the directive that is relevant for this purpose was considered in *Profaktor*. It is the principle of fiscal neutrality in its sense of ensuring a neutral tax burden which protects the taxable person, since the common system of VAT is intended to tax only the final consumer. This is reflected, for example, in the system of deductions, in the UK of input tax, designed to ensure that the taxable person is not improperly charged to VAT. This analysis is derived from *Elida Gibbs Ltd v Customs and Excise Commissioners* (Case C-317/94) [1996] ECR I-5339, [1996] STC 1387, in which the ECJ also said (at [22]):
>
> > "It is not, in fact, the taxable persons who themselves bear the burden of VAT. The sole requirement imposed on them, when they take part in the production and distribution process prior to the stage of final taxation, regardless of the number of transactions involved, is that, at each stage of the process, they collect the tax on behalf of the tax authorities and account for it to them."
>
> 60. It is a necessary concomitant of a system that provides for a system of deduction and collection of tax at each stage in the process, that tax should be accounted for, and paid, on a timely basis. That essential neutrality can itself be undermined by a failure of a taxable person to comply with its obligations. It is in that context that the legislative measures adopted by member states to ensure collection and to deter default, and the question whether those penalties, either generally or in an individual case, are so disproportionate as to constitute an obstacle."

48. In this case the appellants have failed to comply with their VAT obligations. They have failed to pay the VAT for the period 03/13 or time. This undermines the neutrality of the VAT system, which is designed to ensure that the final consumer picks up the VAT tab, and that there should be fiscal neutrality in the intervening stages through the mechanism which permits input tax to be set off against output tax.

49. So we would find that the penalties are not disproportionate for this reason alone. But the specific submission made by the appellants is, of course, dealt with in *Total* at paragraph 88 (see paragraph 43(28) above).

> "88. The issue is not, in our view, whether the absence of a different treatment depending on the extent of the delay in filing the return undermines the system; the issue is whether the amount of the penalty is proportionate to the breach of duty in being a single day late. At the level of the scheme viewed as a whole, a penalty which is incurred as the result of a particular failure is entirely acceptable and compliant with the principle of proportionality provided that the amount of the penalty for that failure (however innocent its cause) is itself proportionate to the failure."

50. We apply this principle to the appellants submission that it is disproportionate to visit a penalty on them because they were only one day late. We accordingly reject this submission, and find that the penalties for the period 03/13 are proportionate.

Outstanding VAT

51. The appellants submit that the surcharge percentage should not be applied to the exempt tax. They accept that whilst they have in their view overpaid approximately £37,428 to the respondents for the period 03/12 to 03/13, they cannot recover it. They cannot make a valid refund claim under section 80.

52. But their submission is that the surcharge percentage have been applied to late payment of VAT which was never properly due to the respondents in the first instance. This is the VAT erroneously accounted for on the transfer premiums, and is what we have described as exempt tax for the purposes of this decision.

53. In considering this, the starting point is the legislation, and in particular subsections 59(4) and (6). These are set out below:

> 59(4) Subject to subsections (7) to (10) below, if a taxable person on whom a surcharge liability notice has been served-
>
> (a) is in default in respect of a prescribed accounting period ending within the surcharge period specified in (or extended by) that notice, and
>
> (b) has outstanding VAT for that prescribed accounting period,
>
> he shall be liable to a surcharge equal to whichever is the greater of the

following, namely, the specified percentage of his outstanding VAT for that prescribed accounting period and £30.

59(6) For the purposes of subsections (4) and (5) above a person has outstanding VAT for a prescribed accounting period if some or all of the VAT for which he is liable in respect of that period has not been paid by the last day on which he is required (as mentioned in subsection (1) above) to make a return for that period; and the reference in subsection (4) above to a person's outstanding VAT for a prescribed accounting period is to so much of the VAT for which he is so liable as has not been paid by that day.

54. So the issues are:

(1) What is the "outstanding VAT", i.e. the amount of VAT for which the appellants were liable for the periods under appeal? ("Amount")

(2) If the VAT ostensibly due at the time was not paid on its due date, is that conclusive? Can you take into account, events which happen after that date (in this case, the ruling)? ("Timing")

Amount

55. Under Section 1 of the VAT Act:

"1(1) Value added tax shall be charged, in accordance with the provisions of this Act –

(a) on the supply of goods or services in the United Kingdom (including anything treated as such as supply),

(b) ……

(c) …..

and references in this Act to VAT are references to value added tax."

56. Section 4 then goes on to say:

"4(1) VAT shall be charged on any supply of goods or services made in the United Kingdom, where it is a taxable supply made by a taxable person in the course or furtherance of any business carried on by him.

"4(2) A taxable supply is a supply of goods or services made in the United Kingdom other than an exempt supply." (emphasis added).

57. Section 24(2) defines output tax.

"Subject to the following provisions of this section "output tax" in relation to a taxable person, means VAT on supplies which he makes….."

58. Section 31(1) states that:

> "A supply of goods or services is an exempt supply if it is of a description for the time being specified in Schedule 9….."

59. Regulation 40 of the VAT General Regulations states that:

> "40(1) Any person making a return shall in respect of the period to which the return relates account in that return for-
>
> (a) all his output tax ...."

60. From the foregoing we take the following principles.

> (1) There is no obligation on a trader to account for VAT on exempt supplies.
>
> (2) Output tax does not include VAT on exempt supplies.
>
> (3) The broad scope of what comprises VAT in section 1 is cut down by the later provisions of the VAT Act.

Output tax only or output tax less input tax

61. If VAT is chargeable on taxable supplies and not on exempt supplies does outstanding VAT simply mean output tax?

62. We do not believe it does. It is our view that properly deductible input tax must be taken into account. We say this for the following reasons.

> (1) Section 1 states that VAT is chargeable in accordance with the provisions of the Act. And so the provisions of sections 25 and 26 will apply to give credit to a trader for input tax which is attributable to taxable outputs. So the VAT "for which he is liable" should take into account any properly deductible input tax.
>
> (2) This is reflected in the extract from Enersys, set out at paragraph 14 above, in which Judge Bishopp uses the word "net". Our interpretation is that by this he means the excess of output tax over deductible input tax.
>
> (3) The respondents calculations of the surcharges in these appeals reflect credit for deductible input tax. For example, for the period 03/13 for KGL, the surcharges are calculated as 15% of £19,924. This is the net position, the output tax for that period being £26,764, and deductible input tax being £6,840.

63. And so the expression "VAT for which he is liable" for a period is output tax less deductible input tax.

Was or is the exempt tax output tax?

64. Turning then to the output tax position; section 4 makes it clear that output tax

excludes VAT which might otherwise otherwise chargeable, if it is attributable to an exempt supply.

65. We have no doubt that had the transfer premiums been treated as exempt from the word go, they would not have been taken into account in the surcharge. This would have simply been a consequence of the information which is provided on the VAT returns. The appellants would not have included the exempt tax as it was not attributable to taxable outputs.

66. But in this appeal, the exempt tax has been erroneously recovered from consumers and paid over to the respondents. So what is the VAT "status" of that exempt tax for section 59 purposes? Is it VAT for which the appellants are liable? Can it be VAT for which they are liable, initially, and then following the ruling, it changed its VAT status and became VAT for which the appellants were no longer liable? Is it output tax? Can it be described as VAT at all?

67. We have not found these questions easy to answer. We have found no directly applicable authorities in which this matter has been considered in any detail. Having considered the matter at some length, however, it is our view that the exempt tax is not VAT for which the appellants are liable for the purposes of section 59, for the following reasons.

> (1) There is no obligation on a trader to account for VAT on exempt supplies, and so the exempt tax is not, nor could it ever have been, output tax. The exempt tax cannot be treated as properly chargeable output tax prior to the ruling, but then treated as being attributable to exempt supplies and thus not output tax, thereafter. The effect of the ruling is to confirm that the transfer premiums were consideration for an exempt supply. And so the appellants were never liable to pay it to the respondents, even though they mistakenly did so (and equally mistakenly passed on that charge to their customers).
>
> (2) Regulation 40(1) obliges a person making a return in respect of a period to which that return relates, to account for that return for "all his output tax". There is no obligation, on a trader to account in a return for tax attributable to an exempt supply.

Ab initio?

68. We have suggested above that the effect of the ruling is that the supplies for which the transfer premiums were paid, were always exempt supplies. What support is there for this proposition?

> (1) There is no suggestion that the ruling does not reflect the correct interpretation of the legislation. Furthermore, the ruling (which, "fairly sought and squarely given") has a status higher than that of a decision of the High Court or the Court of Appeal....it represents an irreversible decision that the taxpayer concerned will be taxed on the basis for which he has successfully applied." (Per Lord Justice Nolan in *R v Inland Revenue Commissioners, ex partie Matrix Securities Limited* [1993] STC

774. The ruling is an interpretation of the legislation which should therefore, be so interpreted so as to treat the transfer premiums as consideration for exempt supplies.

(2) If output tax excludes tax on exempt supplies, whatever, therefore, was recovered from the consumers and paid over to HMRC, could not have been output tax. We have found help in this analysis in the judgment of Lord Justice Schiemann in the case of Marks and Spencer which was heard in the Court of Appeal in 1999 (*Marks & Spencer PLC v Commissioners of Customs & Excise* 2000 STC 16).

(3) In that case, Marks & Spencer had supplied teacakes which it and the respondents had considered were standard rated. It was subsequently agreed that the supplies should in fact have been zero rated. Marks & Spencer made a claim for recovery of the overpaid VAT under section 80 but were circumscribed by the time limits in section 80 from making recovery for more than a three-year period. Marks & Spencer asserted that they had a directly effective claim under the Sixth VAT Directive, to a refund which was not so circumscribed. A so called "Becker" claim. In order to establish a Becker claim, it had to fulfil the two Becker criteria, one of which was that the provision of the Directive upon which reliance is placed must be unconditional and sufficiently precise.

(4) An extract from Lord Justice Scheimann's judgment on this point is set out below:

> "M&S submit that they had a right under the Directive in relation to teacakes not to be taxed at a higher rate than zero. The submission is based on Articles 12 and 28 of the Directive. Article 12(1) of the Sixth Directive provides:-
>
> > "the rate applicable to taxable transactions shall be that in force at the time of the chargeable event".
>
> Article 12(3) provides:-
>
> > "the standard rate of VAT shall be fixed by each Member State as a percentage of the taxable amount and shall be the same for the supply of goods and for the supply of services. From 1 January 1997 to 31 December 1998, this percentage may not be less than 15 …….. Member States may also apply either one or two reduced rates. These rates shall be fixed as a percentage of the taxable amount which may not be less than 5% and shall apply only to supplies of the categories of goods and services specified in annex H".
>
> Article 28(2) provides:-
>
> > "notwithstanding Article 12(3) the following provisions shall apply during the transitional period referred to in Article 28 L

(a) Exemptions with refund of the tax paid at the preceding stage and reduced rates lower than the minimum rate laid down in Article 12(3) in respect of the reduced rates, which were in force on 1 January 1991 and which are in accordance with Community law, and satisfy the conditions stated in the last indent of Article 17 of the Second Council Directive of 11 April 1967, may be maintained."

The transitional period has not yet expired and the law of this country maintained at all material times and still maintains an "exemption with refund of tax paid at the preceding stage" in respect of teacakes. During the period in question that was the law, albeit that it was misapplied. M&S submit that whilst that exemption is maintained, the rate of tax applicable to the sale of teacakes was zero and that therefore it had a right under Article 12(1) not to be taxed at a rate higher than zero.

I would reject this argument for two reasons:-

1 Where in respect of any particular transaction there is in force at the relevant time an exemption with refund of tax, there is no "rate applicable to a taxable transaction". The relevant transaction is not in the terms of the Sixth Directive, taxable.

2 M&S cannot rely upon article 12(1) because that provision does not define the content of any right that M&S has under Community law. Article 12(1) defines no right to any particular rate of tax because the fixing of the rate is entirely within the discretion of the UK under Article 28(2)(a). In so far as it is legitimate to describe zero as being the rate applicable to the sale of teacakes that rate is not attributable to Community legislation but rather to UK legislation which is consistent with our obligations under the Treaty."(emphasis added)

(5) In the case of Marks & Spencer, the issue was zero rating. If a zero rated transaction is "not in the terms of the Sixth Directive, taxable" we think that is equally, if not more applicable, to a transaction which is exempt.

(6) We take from this element of the judgment that the transactions for which the transfer premiums were paid were never taxable, and this was the case ab initio, and not from the date of the ruling.

(7) In the case of C Jenkin & Son Limited v HMRC [2015]UKFTT 242(TC), a VAT case relating to the VAT status which affects residential

caravans and pitch agreements, Judge Malachy Cornwell-Kelly said this at paragraph 29 of his judgment:

> 29. "But it is certain that no liability to tax may be imposed except by legislation passed or authorised by parliament. The effect of classifying the taxpayer's supplies as exempt - which is, by definition, an exception to the general charge to value added tax and as such must be established clearly - is in this instance to impose a liability which is not authorised by law. Lacking any legal basis, the assessments must therefore fail and the appeal succeeds".

(8) The appellants in this appeal are having a liability imposed upon them, namely the surcharges computed by reference to the exempt tax. We consider this is not authorised by law. As such, the effect of the ruling can only be that the exempt tax has never been a liability which was authorised by law.

Statutory Construction

69. We have also considered the way in which subsections 59(4) and (6) should be construed.

70. The principles that this tribunal should adopt in construing subsections 59(4) and (6) have recently been helpfully set out by Lord Justice Lewison and in the SDLT case of Pollen Estates **(***The Pollen Estate Trustee Company Limited and another v HMRC 2013 EWCA Civ 753***)**.

> "24 The modern approach to statutory construction is to have regard to the purpose of a particular provision and interpret its language, so far as possible, in a way which best gives effect to that purpose. This approach applies as much to a taxing statute as any other: *Inland Revenue Commissioners v McGuckian* [1997] 1 WLR 991, 999; *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51; [2005] 1 AC 684 (§ 28). In seeking the purpose of a statutory provision, the interpreter is not confined to a literal interpretation of the words, but must have regard to the context and scheme of the relevant Act as a whole: *WT Ramsay Ltd v Commissioners of Inland Revenue* [1982] AC 300, 323; *Barclays Mercantile Business Finance Ltd v Mawson* (§ 29). The essence of this approach is to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description. Of course this does not mean that the courts have to put their reasoning into the straitjacket of first construing the statute in the abstract and then looking at the facts. It might be more convenient to analyse the facts and then ask whether they satisfy the requirements of the statute. But however one approaches the matter, the question is always whether the relevant provision of statute, upon its true construction, applies to the facts as found: (*Barclays Mercantile Business Finance Ltd v Mawson* (§ 32)".

71. In adopting a purposive construction, we take into account what is said in *Trinity Mirror* in the extract set out at paragraph 47 above. We are straying into proportionality territory here, but we can see no reason why the rationale for the default surcharge regime set out in that extract in the context of proportionality should not be equally relevant in the context of statutory construction.

72. The purpose of the regime is to ensure that VAT is paid by the final consumer and not borne by traders in the chain who are relieved from paying VAT by the deduction mechanism in sections 25 and 26. That purpose is not served by penalising a trader who makes exempt supplies and who has no obligation to account for output tax to the respondents. Indeed a trader who makes exempt supplies is, to all intents and purposes, the final consumer. And it would seem odd for a regime to levy a tax based penalty from the final consumer who has no obligation to account for VAT to the respondent We deal with this in greater detail in the context of proportionality later, but address it here since it suggests that Parliament were not intending to include exempt tax in the definition of outstanding VAT for the purposes of the default surcharge.

73. It is our decision therefore, for all the foregoing reasons, that the definition of outstanding VAT in subsection 59(4) does not include the exempt tax.

Timing

74. It seems at face value that subsection 59(6) requires one to look at the outstanding VAT at the end of the period to which it relates. Section 59 does not include any mechanism, which enables either the taxpayer or the respondents to take into account circumstances which arise after the due date for payment, which might have an impact on the tax due on that date (and so on any tax geared penalty).

75. Mrs Rees indicated that such circumstances do exist if a successful claim is made under section 80.

76. She did not mention specifically that "over-declarations" are dealt with in HMRC's VAT Manual at VCP 10549, where it says "default surcharges for periods ending after 1 April 1990 are recalculated automatically to take account of over-declarations notified on officer assessments and voluntary disclosures."

77. But in their statement of Case, the respondents appear to be saying that a simple voluntary disclosure of the overpaid VAT is insufficient to justify an error correction. That error correction would only be accepted if a successful section 80 claim were established.

78. What these provisions show is that the respondents believe it is possible for events which occur after the due payment date to be taken into account when determining the outstanding VAT to which the surcharge percentage. So the date on which you test what amount of VAT is outstanding is not limited to the due date for payment. It seems that post due date events can be taken into account.

79. The issue in this case is that the appellants have been unable to make a successful section 80 claim, and the respondents are, as a consequence, denying that the exempt

tax can be taken into account, (and so reduce the surcharges) . For the reasons given below where we consider the section 80 claim, we do not think that a successful section 80 claim is relevant to the analysis of outstanding VAT.

80. For the reasons given above, it is our view that the appellants were never liable to account for the exempt tax to the respondents. And so it should be taken into account when computing the surcharge, irrespective of any refund or corrective mechanics. It is not outstanding VAT for the purposes of the legislation.

Section 80

81. The parties agree that the appellants have made no valid claim under section 80. The appellants are unable to sign the undertaking to pass any refund back to the consumers who had originally paid the exempt tax. In these circumstances the respondents can rightly assert that the appellant would be unjustly enriched if they made a refund; and so they are entirely justified, under section 80, to deny any refund. The appellants accept this.

82. The respondents however link the section 80 claim to the surcharge, by alleging that:

> (1) Firstly, the surcharges cannot be set off against the amounts erroneously paid to the respondents i.e. the exempt tax;
>
> (2) Secondly the outstanding VAT cannot be recalculated in the absence of a successful section 80 claim.

83. As regards the first argument, it is self-evident that if there is no debt due from the respondents to the appellants, there is nothing against which the surcharges can be set off. And there is no debt in the absence of any successful section 80 claim. We are with the respondents on this point.

84. Section 80 applies where a taxpayer "*has brought into account as output tax an amount that was not output tax due*" (emphasis added).

85. There is no doubt that in this case that is exactly what the appellants have done. They have brought into account as output tax the exempt tax, and this was "not output tax due".

86. The appellants have also paid this (albeit late) to the respondents.

87. So the appellants are squarely within the class of taxpayer who can apply to the respondents for credit or refund under section 80.

88. Section 80 deals with credits, refunds, and repayments; it deals with cash flows rather than underlying liability. And this is evidenced by the unjust enrichment defence which prevents a refund being paid to a trader where it will not be passed on by that trader to its consumers.

89. Furthermore, since section 80(7) effectively restricts a trader who wishes to

reclaim VAT, to a claim under section 80, it will necessarily be wide ranging.

90. Marks and Spencer were able to bring a claim under section 80 notwithstanding that in the judgment of Lord Justice Scheimann, the transactions to which the overpaid tax were attributable, were not "taxable transactions". They had overpaid VAT to the Commissioners and so could bring a claim under section 80.

91. The same is true of the appellants in this case. They fall within the ambit of section 80(1) and so can bring a section 80 claim. But this casts no light on the meaning of "outstanding VAT" for the purposes of section 59; nor, more importantly, does it link, let alone determine, whether it is VAT for which the appellants are liable under section 59. It is simply a separate section which allows a trader to recover amounts which have been incorrectly treated as output tax by that trader and erroneously paid to the respondents. Indeed the acceptance by the respondents that the appellants could make an (albeit unsuccessful) section 80 claim suggests that the respondents, too, think that the exempt tax may not have been output tax in the first place. Merely an amount paid as output tax.

92. And so we reject the submission by the respondents that it is only possible to recalculate the surcharge so as to reduce it to the extent that it is calculated by reference to the exempt tax, only if the appellants have made a successful section 80 claim.

Paragraph 5 of Schedule 11

93. In their Statement of Case, the respondents assert that "as the VAT referred to as being overpaid was in fact invoiced to clients, then it should have been paid to the respondents at the time those invoices were issued".

94. Although this is not couched in terms of paragraph 5 of Schedule 11, we thought it right to deal with this point on a "just in case" basis.

95. The provisions of paragraph 5 of Schedule 11 are set out below:

"Recovery of VAT, etc.

> 5(1) VAT due from any person shall be recoverable as a debt due to the Crown.
>
> 5(2) Where an invoice shows a supply of goods or services as taking place with VAT chargeable on it, there shall be recoverable from the person who issued the invoice an amount equal to that which is shown on the invoice as VAT or, if VAT is not separately shown, to so much of the total amount shown as payable as is to be taken as representing VAT on the supply.
>
> 5(3) Sub-paragraph (2) above applies whether or not—
>
> (a) the invoice is a VAT invoice issued in pursuance of paragraph

2(1) above; or

(b) the supply shown on the invoice actually takes or has taken place, or the amount shown as VAT, or any amount of VAT, is or was chargeable on the supply; or

(c) the person issuing the invoice is a taxable person;

and any sum recoverable from a person under the sub-paragraph shall, if it is in any case VAT be recoverable as such and shall otherwise be recoverable as a debt due to the Crown."

96. We have always found the interpretation of this provision difficult. But in our view it is restricted to recovery of VAT, and sheds no light on what comprises VAT for the purposes of the VAT Act and, in particular, section 59.

97. The reason why we believe that the respondents Statement of Case may be referring to these provisions is that they apply (inter alia) if an invoice is given to a customer with an amount identified in it as VAT. This clearly applies to the appellants who invoiced the occupiers wishing to transfer their interests in the retirement homes. Although we were not shown copies of any invoices, we anticipate they would have included VAT at the standard rate. So the question arises as to whether VAT for the purposes of this provision is relevant when considering the definition of outstanding VAT for the purposes of section 59.

98. We do not believe it is. Paragraph 5 permits HMRC to recover "*an amount equal to*" a figure written on a VAT invoice which purports to be VAT, as a debt to the Crown.

99. Paragraph 5 also states that if that figure is in fact VAT, it shall be so recoverable . But it sheds no light on whether the figure is or is not VAT (let alone outstanding VAT). That much must be determined by provisions elsewhere in the VAT Act.

100. HMRC's literature on this paragraph states, having recited subparagraph 5(3), "*it follows then, that it doesn't matter whether a supply has taken place, or, if there was a supply, that it was taxable or if the invoice issuer or supplier was a taxable person. If the sum due is VAT, it is recoverable as VAT. If it is not VAT, it is recoverable as a debt due to the Crown"*.

101. For reasons given elsewhere in this decision, it is our view that the exempt tax is not VAT in that it is not output tax for the purposes of the VAT Act. Whilst paragraph 5 permits the exempt tax to be recovered as a debt due to the Crown, (since it was written on the invoices given to the occupiers) that of itself does not make or deem it to be VAT, (let alone outstanding VAT for the purposes of section 59).

102. Furthermore, in the context of a registered trader who issues a proper invoice, it seems clear as a matter of practice that VAT in paragraph 5 does not mean the output tax identified in the invoice, but the excess of output tax over deductible input tax. Although we did not put this to Mrs Rees, we would be surprised if she were to assert

that HMRC had the right to recover all of the output tax shown on the invoices, and thus identified in the relevant returns, without giving credit for deductible input tax. Indeed the respondents themselves, when computing the amount of tax that was late, have, as previously stated, taking into account that input tax. So it is not HMRC's practice, notwithstanding the provision in the Statement of Case, to seek to recover output tax from a trader (although that is the amount identified on the invoice) without taking into account deductible input tax.

103. And so for the purposes of section 59, and identifying the amount of outstanding VAT, it is our view that paragraph 5 of schedule 11 is neither helpful or determinative.

104. Finally on this topic, section 76(9) states that "*if an amount is assessed and notified to any person under this section, then unless, or except to the extent that, the assessment is withdrawn or reduced, that amount shall be recoverable as if it were VAT due from him*". This subsection applies to default surcharges. But of course it only applies to the extent that the assessment is not withdrawn or reduced. And this tribunal has power to reduce the assessment under section 84(6). So section 79(6) casts no further light on whether the exempt tax is outstanding VAT.

Conclusion

105. This tribunal can consider the situation at the time of the hearing. We have a full appellate jurisdiction circumscribed only by section 84(6), and that permits us to vary the surcharge "*in so far as it is necessary to reduce it to the amount which is appropriate under sections 59…*". We are conscious that this applies only where the appellants have been assessed to a surcharge. We were not given the surcharge notices as part of the documents for this appeal, but our experience is that the surcharge notices themselves include an assessment of the surcharge due thereunder.

106. If they did not, this tribunal is not fettered by section 84(6) since the appeal would be brought under section 83(n) which is not subject to the limitation in section 84(6).

107. So if we consider that the exempt tax is not outstanding VAT, we can reduce the surcharges to take that into account.

108. We have decided that the exempt tax is not outstanding VAT for the purposes of sections 59(4) and (6).

109. The consequence of this is that, pursuant to our power in section 84(6) and irrespective of any corrections to a return, or unsuccessful section 80 claim, the surcharges should be computed without taking into account the exempt tax.

110. The appellants have submitted in the notices of appeal that the penalty should be recalculated in accordance with the tables below:

KGL

VAT Period	VAT Paid	Included in error	Correct VAT due	Penalty applied	Recalculated Penalty	difference
03/12	£26,509.00	(£16,819.54)	£9,689.46	£3,976.35	£1,453.42	(£2,522.93)
06/12	£17,065.00	(£3,346.00)	£13,719.00	£2,559.75	£2,057.85	(£501.90)
03/13	£19,924.00	(£3,972.78)	£15,951.30	£2,988.61	£2,392.70	(£595.91)
					TOTAL	(£3,620.74)

KUL

VAT Period	VAT Paid	Included in error	Correct VAT due	Surcharge applied	Recalculated Penalty	difference
09/12	£16,695.33	(£954.00)	£15,741.33	£2,504.30	£2,361.20	(£143.10)
12/12	£23,218.58	(£8,296.64)	£14,921.94	£3,482.79	£2,238.99	(£1,243.80)
03/13	£17,555.90	(£5,352.00)	£12,203.90	£2,633.39	£1,830.59	(£802.80)
Total	**£57,469.81**	**(£14,602.64)**	**£42,597.17**	**£8,620.48**	**(£6,430.78)**	**(£2,189.70)**

111. We hesitate, however, to say that in consequence of our decision on this issue, the surcharges must be reduced to the amounts suggested by the appellants, as set out in these tables. We say this because it is not clear to us whether those figures take into account input tax which they have deducted for the periods in question, on the basis that they were making fully taxable supplies, but which might no longer be the case given that a proportion of those supplies are (and in our view have always been) exempt. We deal with this in more detail at the end of this decision.

Proportionality and its application to the exempt tax issue

112. We have found that as a matter of statutory construction that the exempt tax is not outstanding VAT and so should be excluded from the amount to which the 15% surcharge rate should be applied. In case we are wrong on the outstanding VAT point, we have gone on to consider how the doctrine of proportionality applies to this aspect of the appeal,

113. We look first at the application of the principles of proportionality to the appellants particular circumstances (rather than to the regime as a whole).

114. We have set out above, in some detail, our view of the principles of proportionality which stem from the relevant authorities and which apply to the penalties which are the subject of this appeal. But we observe that the cases which we have reviewed deal with proportionality in the context of a properly calculated penalty. None of them considers the application of the principle of proportionality to the calculation of the penalty in the first place.

115. The appellants broad submission is that it is unfair for the Exchequer to benefit twice from the mistaken categorisation of the trading premiums as being consideration for taxable supplies. Firstly, the respondents have received output VAT on exempt supplies i.e. VAT which was never due to them. Secondly they have assessed the appellants to a penalty which is calculated by reference to these exempt supplies. To this we would add a third consequence. The appellants may be denied credit for input tax as a result of the re-categorisation of the outputs on which the trading premiums were charged.

116. Of these, the appellants suffer no economic consequences of the first. They have been paid the exempt tax by the consumers and have passed it on to the respondents.

117. And as regards the third, any denial of credit for input tax now attributed to exempt outputs is simply a function of the application of the VAT system. We can see no justifiable complaint from the appellants to any such denial.

118. But the appellants complaint that they are being penalised for a tax geared penalty which is being determined by reference to exempt tax, subject only being permitted to recalculate if a successful section 80 claim is made, is something which may be affected by the application of the principle of proportionality.

119. The principles set out at paragraph 43 above show that the application of these to the circumstances of a penalty visited on a trader require the consideration of two things:

> (1) Firstly the penalty must not go beyond what is strictly necessary for the objective pursued; and
>
> (2) The penalty must not be so disproportionate to the gravity of the infringement that it becomes an obstacle to the freedoms enshrined in the Treaty.

120. The application of these broad principles to the circumstances of this particular case, require us therefore to:

> (1) Firstly, ask whether the calculation of the penalties by reference to the exempt tax goes beyond what is strictly necessary to ensure the timely payment of VAT by the appellants in their supply chain.
>
> (2) Secondly, ask whether a penalty so calculated imposes such a disproportionate burden on the appellants that it distorts the VAT system as it applies to them.

121. As regards the first of these questions, our view is as follows:

> (1) The justification for the penalty is that it ensures the timely collection of VAT at each stage in the supply chain. In other words, tax properly due to the respondents is paid to them on time. But in this appeal, the exempt tax is not due to the respondents. It is not output tax as defined in section 4. So there is no need to apply the penalty to the exempt tax in order to

ensure timely collection of VAT. By doing so, it does not contribute to the timely collection of tax due to the respondents. To the extent that the surcharges are calculated by reference to the output tax owed by the appellants, they have no complaint. However, to the extent that is applied to the exempt tax, we think they have a justifiable complaint.

(2) The objective criterion which is used to compute the penalties is the outstanding VAT. This is an appropriate criterion if that outstanding VAT is VAT (briefly stated) owed to the respondents. We have dealt with the subtleties of this earlier in this judgment. But where the penalties, as is the case of the appellants, are being calculated by reference to the exempt tax which is not due to the respondents, we do not consider this to be a justifiable objective criterion.

(3) As can be seen from the extract from *Trinity Mirror* set out in paragraph 47 above, the VAT regime is intended to tax only the final consumer. A final consumer is someone who cannot benefit from the credit mechanism in sections 25 and 26, and this might arise in a number of circumstances. The trader might not be VAT registered; the trader might make only exempt outputs and so has no outstanding VAT. The trader might be unable to recover any input tax attributable to those exempt outputs. The appellants fall into the second category (and perhaps the third). We have indicated above that there is no need for the default surcharge regime to penalise someone who owes no outstanding VAT to the respondents. We have found that the appellant owe no such outstanding VAT insofar as it includes the exempt tax. So to that extent they are in the position of the final consumer. We are not certain whether they are being, or will be denied, input tax recovery on supplies made to them which are attributable to the exempt tax. If so, then they suffer that tax without any recovery or set off under sections 25 and 26. The system of VAT obliges the final consumer, who ultimately suffers the VAT, to pay that VAT to a supplier. It is not obliged to pay it to HMRC and that is the reason why the default surcharge regime does not apply to the final consumer but only to the intermediate traders in the chain. So there is no justification in this case for the respondents to levy a penalty on the appellants to the extent that they are final consumer.

122. For these reasons, the application of the penalty regime to the appellants circumstances goes beyond what is strictly necessary for ensuring the timely payment of VAT to the respondents. It is not, in the terms identified at paragraph 43(8) above, suitable or appropriate to achieve that objective.

123. The second question raised above, (namely does the penalty so calculated impose a disproportionate burden on the appellants, and so distort the VAT system as it applies to them), is one which we answer in the affirmative for the following reasons:

(1) Firstly, it imposes a penalty for failure to pay tax which is not due to the respondents. This distorts the VAT system as it applies to the

appellants since other traders who owe no tax to the respondents would pay no such penalty.

(2) Secondly, it discriminates between traders who make exempt supplies. Those who identify this before compiling their return, and so who do not account for VAT to the respondents on those supplies, have a default surcharge assessed without taking into account those exempt supplies. Indeed should a further default surcharge be visited on the appellants, that surcharge would be calculated without reference to the exempt supplies on which the trading premiums were charged. But as regards the exempt tax, the appellants are in a worse position than those mentioned above who recognise from the start that they make exempt supplies. The appellants are being assessed to a penalty based on amounts paid for exempt supplies.

124. We remind ourselves of the principle set out in paragraph 43(24) above, namely that a national measure will not be proportionate if it is clear that the desired level of protection could be attained equally well by measures which were less restrictive of a fundamental freedom.

125. Two such fundamental freedoms are non-discrimination and equal treatment. The ECJ has held that the principle of equality is one of the general principles of EC law. Within the sphere of EC law, this principle of equality precludes comparable situations from being treated differently, and different situations from being treated in the same way, unless the treatment is objectively justified.

126. In *Dragos Constantin Tarsia v Statul roman*, ECJ case C-69/14, Advocate General Jaaskinen states:

> "I recall that the principle of equal treatment, whose fundamental nature is affirmed in Article 20 of the Charter, requires that comparable situations must not be treated differently and that different situations must not be treated in the same way unless such treatment is objectively justified."

127. The appellants are being treated differently from traders whose exempt supplies are treated as such to start with, and thus pay no output tax on them to the respondents. Yet the appellants are in a comparable situation to those exempt traders. Both have made exempt supplies. It's just that the appellants didn't realise this at the time.

128. Furthermore, to treat traders making exempt supplies differently from the appellants, runs contrary to the principle of fiscal neutrality.

129. This principle is encapsulated in the ECJ decision in *JP Morgan Fleming Claverhouse v HMRC* [2007] Pens.L.R.265 at paragraph 29 of the judgment:

> "29. An interpretation of Article 13B(d)(6) of the Sixth Directive exempting from VAT the management of open-ended funds, and not the management of closed-ended funds, would be contrary to the principle of fiscal neutrality on which, in particular, the common system of VAT established by the Sixth Directive is based, and which precludes economic operators carrying out the

same transactions being treated differently in relation to the levying of VAT (see, to that effect, Case C-382/02 *Climber Air [2004] ECR I-8379*, paragraphs 23 and 24; Case C-280/04 *Jyske Finans [2005] ECR I-10683*, paragraph 39; and Abbey National, paragraph 56)."

130. Finally, we have tested the application of the surcharge to the appellants situation to see whether it would be any less effective in protecting the integrity of the VAT system as regard the appellants if the surcharge percentage was applied to an amount excluding the exempt tax. We do not think it is affected at all. The integrity of the VAT system as regards the appellants (namely that it requires the timely payment of VAT due to the respondents by the appellants as supplier of taxable supplies) can be achieved equally well, and is unaffected by, excluding the exempt tax from the surcharge calculation.

131. The basis of calculation which takes into account the exempt tax has no reasonable foundation. It is not merely harsh but plainly unfair.

132. And so in applying the 15% penalty rate to the exempt tax, the respondents have operated the default surcharge regime in a disproportionate way as regards these appellants.

The impact of section 80

133. We now consider whether the conclusion we have reached above is affected by the respondents position that they would recalculate the penalties if the appellants were able to make a successful section 80 claim.

134. As we have mentioned above, our view is that section 80 is a regime which operates independently of section 59. The appellants have treated the exempt tax as output tax and have therefore brought it into account. But it was not output tax due.

135. We have reached the conclusion that penalising the appellants for failing to pay tax to the respondents which is not due to them, goes beyond what is necessary to collect VAT which is properly due to the respondents in a timely manner. The appellants are unable to make a successful section 80 claim. This is a result of their inability to pass any refund through to the consumers, and so the appellants will be unjustly enriched by any refund. They are still being penalised for failing to pay tax which is not due to the respondents. Of course if the appellants had made a successful section 80 claim, this appeal would never have been brought. The respondents would have recalculated the penalty. But this has not happened. And so in the circumstances of this case, no section 80 reclaim has been made, and so the appellants are being penalised for failing to pay the exempt tax.

136. As so for these reasons, the fact that the appellants cannot bring a successful section 80 claim does not affect our conclusion at paragraph 132 above.

Proportionality and the default surcharge regime.

137. We have mentioned earlier in this decision, that the principle of proportionality

can be applied at two levels. Firstly to the regime as a whole; and secondly to the application of the regime to the circumstances of a particular case. We have considered the latter, and found that in this particular case, the penalties, to the extent calculated on the basis of the exempt tax, are disproportionate.

138. There is, therefore, no need for us to consider whether the default surcharge regime is generally disproportionate if it applies the surcharge percentage to tax which has been paid to HMRC in the mistaken belief that it was output tax, and which in reality was attributable to exempt supplies (and thus never output tax in the first place). Nor whether (for example) the opportunity of making a successful section 80 claim has an impact on that analysis.

139. We are mindful of the considerable judicial dicta to the effect that; the regime is a rational one; the tribunal should usually intervene only if it considers that the regime is manifestly inappropriate; only most exceptionally should a tribunal strike down national penal legislation simply on the ground that it offends the principle of proportionality; and that a tribunal should show the greatest deference to the will of Parliament when considering a penalty regime.

140. We are also conscious that we have heard no detailed argument on the proportionality point, and that it was not raised, (insofar as it applies to the regime generally), by the appellants. We are therefore reluctant in the extreme to consider (let alone rule on) it, given that a finding that the regime is disproportionate is likely, in our view, to generate an appeal by the respondents, with the concomitant cost consequences for the appellants.

141. Accordingly we have given no consideration to (and so come to no conclusion on) the application of the doctrine of proportionality to the default surcharge regime if it operates to apply the surcharge percentage to output tax erroneously paid in respect of an exempt supply.

Our powers

142. Having reached the decision that the doctrine of proportionality applies in this case to relieve the appellants from their liability to the surcharges to the extent that the default surcharge percentage has been applied to the exempt tax, we now need to consider the impact on the surcharge assessments.

143. It seems to us that our powers are limited to the following:

> (1) Striking down the surcharges completely since they are disproportionate. They have been calculated by reference to the exempt tax. ("Total strike down")
>
> (2) Striking down the surcharges, but only to the extent that they are disproportionate by dint of having been calculated by reference to the exempt tax. ("Partial strike down")
>
> (3) Amending the assessments under section 84(6).

Total strike down

144. At paragraph 38 of *Enersys*, Judge Bishop said as follows:

> "I proceed therefore upon the basis that, in the absence of any power to mitigate or otherwise reduce a penalty, discharge is the only possible course open to a tribunal which does conclude that a penalty is disproportionate. Mr Bird did not argue against that conclusion, nor did he suggest any other remedy should the appellant succeed in its arguments about the proportionality of this penalty……."

145. But in *Enersys* as in *Total* and *Trinity Mirror*, the issues concerned the amount of the penalty and not its method of calculation. There was no dispute in those cases that the correct surcharge percentage had been applied to the correct amount of outstanding VAT. In those circumstances, in the absence of any power to substitute its own decision as to what a proportionate penalty should be, the tribunal has to make an all or nothing (a binary) decision. If the penalty is proportionate, it should be upheld. If it is not, then the taxpayer is liable for none of it.

146. So where the calculation has been correctly performed and there is a proper assessment, the tribunal has no such jurisdiction. It has no power to suggest what a proportionate surcharge should be.

147. However, we are in a different position in this appeal. For the reasons given below we do not believe that we are obliged, as was the case in *Enersys*, to strike down the penalties in their entirety.

Partial strike down

148. In the context of this appeal, we have decided that the penalties are disproportionate to the extent that they are calculated by reference to the exempt tax. And we do have the figures for the surcharges which would arise under assessments to the extent that they are calculated by reference to the exempt tax. We can therefore reduce them, but leave extant the properly computed surcharges which have been levied on the appellants which relate to the VAT properly accountable to the respondents. We are not, in these circumstances, deciding what is a proportionate surcharge. We are simply taking out of account the disproportionate element of the VAT to which the surcharge percentage is applied.

Section 84(6)

149. Alternatively, section 84(6) allows us to adjust a surcharge if we think it is necessary to reduce it to the amount which is appropriate under section 59. We see no reason why this provision does not allow us to adjust the assessments by directing that they are calculated by reference to the outstanding VAT excluding the exempt tax (on the basis that including it in the calculation is disproportionate).

Decision and directions

150. In the light for the foregoing, our decision is as follows:

(1) The appellants have not satisfied us that either subsection 59(7)(a) or subsection 59(7)(b) applies to the six defaults against which they appeal.

(2) The surcharges for the period ending 03/13, (being £2,988.61 for KGL, and £2,633.38 for KUL) are proportionate.

(3) The surcharges should not have been computed by reference to the exempt tax. Firstly because the exempt tax is not outstanding VAT. Secondly, because they are disproportionate to the extent so computed.

151. As a consequence of our decision at paragraph 150(3) above, the assessments of the penalties for all six periods under appeal need to be recalculated, and reduced, on the basis that the exempt tax should be excluded from being outstanding VAT for the purposes of that calculation. As mentioned above, we are not certain whether the numerical differences identified in the tables set at provided by the appellants have been agreed by the respondents.

152. We direct, therefore if and to the extent that the amounts have not been agreed by the respondents, the parties should use their reasonable endeavours to agree the amount of outstanding VAT for the periods under appeal; and if no such agreement has been reached by 31 July 2016, the matter should be relisted for a hearing in Bristol, either before this or a differently constituted tribunal.

Appeal rights

153. 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.

JUDGE NIGEL POPPLEWELL
TRIBUNAL JUDGE

RELEASE DATE: 11 APRIL 2016