



TC05975

Appeal number: TC/2016/04951

VAT default surcharges - insufficiency of funds - Appellant awaiting 'in year' CIS refund from HMRC - whether reasonable excuse - no - whether penalty disproportionate - no - Appeal dismissed

**FIRST-TIER TRIBUNAL
TAX CHAMBER**

EAST MIDLANDS CONTRACTING LIMITED Appellant

- and -

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

**TRIBUNAL: JUDGE: MICHAEL CONNELL
MEMBER: MARYVONNE HANDS**

**Sitting in public at Lincoln County Court, High Street, Lincoln LN5 7PS on 20
April 2017**

**Mr Chris Moyses, Director of the Appellant Company and Ms Joanne Yearsley,
Office Manager, for the Appellant**

Mr Colin Smithson, Officer of HMRC, for the Respondents

DECISION

The Appeal

- 5 1. East Midlands Contracting Limited (“the Appellant”) appeals against VAT default surcharges of:

£7,866.21, for its failure to submit in respect of its VAT period 12/15, by the due date, payment of VAT due. The surcharge was calculated at 5% of the VAT due of £157,324.20.

- 10 £15,865.68, for its failure to submit in respect of its VAT period 03/16, by the due date, payment of the VAT due. The surcharge was calculated at 10% of the VAT due of £173,070.08 less a payment on account of £14,413.25.

£24,960.00, for its failure to submit in respect of its VAT period 06/16, by the due date, payment of the VAT due. The surcharge was calculated at 15% of the VAT due of £166,405.72.

- 15 2. The point at issue is whether the Appellant has a reasonable excuse for making the late payments.

Background

3. The Appellant has been VAT registered since 1998 and trades within the construction industry.
- 20 4. Prior to the defaults under appeal the Appellant had previously defaulted on VAT payments in periods in 03/15 when a TTP agreement was reached, in period 06/15 when a VAT surcharge liability notice was issued and again in period 09/15.
5. Period 06/15 VAT fell due on 31 July 2015. The amount payable of £166,520.13 was finally settled by monthly instalments (no TTP) on 20 May 2016.
- 25 6. Period 09/15 VAT fell due on 31 October 2015. The amount payable of £184,033.00 was finally settled (no TTP arranged) on 12 May 2016 using £154,553.13 from a CIS rebate of £337,837.45 due for the 2015-16 tax year.
7. Period 12/15 VAT fell due on 31 January 2016. The amount payable of £157,324.20 was finally settled in full (again no TTP arranged) on 12 May 2016, from
30 the CIS rebate of £337,837.45.
8. Period 03/16 VAT fell due on 30 April 2016. The amount payable was £145,163.20. A part payment of £14,413.25 using the CIS refund was made on 12 May 2016 (again no TTP arranged). As at 31 October 2016, the sum of £27,906.85 remained outstanding.
- 35 9. Period 06/16 VAT fell due on 31 July 2016. As at 31 October 2016, the full amount of £145,163.20 remained outstanding.

10. The Appellant paid VAT on a quarterly basis. Section 59 of the VAT Act 1994 requires a VAT return and payment of VAT due, on or before the end of the month following the relevant calendar quarter. [Reg 25(1) and Reg 40(1) VAT Regulations 1995].

5 11. The Appellant's preferred method of payment has been electronically via the Faster Payment Service.

12. HMRC have discretion to allow extra time for both filing and payment when these are carried out by electronic means. [VAT Regulations 1995 SI 1995/2518 regs 25A (20), 40(2)]. Under that discretion, HMRC allow a further seven days for filing and
10 payment.

13. Section 59 Value Added Tax Act 1994 ("VATA") sets out the provisions in relation to the default surcharge regime. Under s 59(1) a taxable person is regarded as being in default if he fails to make his return for a VAT quarterly period by the due date or if he makes his return by that due date but does not pay by that due date the amount of VAT shown on the return. The Commissioners may then serve a surcharge liability notice on the defaulting taxable person, which brings him within the default surcharge regime so that any subsequent defaults within a specified period result in assessment to default surcharges at the prescribed percentage rates. The specified percentage rates are determined by reference to the number of periods in respect of
15 which the taxable person is in default during the surcharge liability period. In relation to the first default the specified percentage is 2%. The percentage ascends to 5%, 10% and 15% for the second, third and fourth default.
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14. A taxable person who is otherwise liable to a default surcharge, may nevertheless escape that liability if he can establish that he has a reasonable excuse for the late payment which gave rise to the default surcharge(s). Section 59 (7) VATA 1994 sets out the relevant provisions : -
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30 '(7) If a person who apart from this sub-section would be liable to a surcharge under sub-section (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

35 (b) there is a reasonable excuse for the return or VAT not having been so despatched then 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 ..'

40 15. It is s 59(7)(b) on which the Appellant seeks to rely. The burden falls on the Appellant to establish that it has a reasonable excuse for the late payment in question.

16. Section 59(7) must be applied subject to the limitation contained in s 71(1) VATA 1994 which provides as follows : -

‘(1) For the purposes of any provision of section 59 which refers to a reasonable excuse for any conduct -

5 (a) any insufficiency of funds to pay any VAT due is not a reasonable excuse.’

17. Although an insufficiency of funds to pay any VAT due is not a reasonable excuse, case law has established the principle that the underlying cause of any insufficiency of funds may constitute a reasonable excuse.

10 18. The initial onus of proof rests with HMRC to show that a surcharge has been correctly imposed. If so established, the onus then rests with the Appellant to demonstrate that there was a reasonable excuse for late payment of the tax. The standard of proof is the ordinary civil standard on a balance of probabilities.

Appellant’s Case

15 19. The Appellant does not dispute that its VAT payments for the periods under appeal were late.

20 20. The Appellant’s stated grounds of appeal in its Notice of Appeal to the Tribunal are that an insufficiency of funds was created by circumstances outside its control. The Appellant says that the shortage of funds significantly impacted upon its ability to discharge VAT on time.

25 21. The Appellant says that HMRC owed the Appellant £337,837.45 in overpaid CIS tax and had this been repaid to the Appellant it would have been able to discharge its VAT on time in each period of default. The Appellant says that it filed its CIS return and requested repayment of the amount due from HMRC prior to each VAT default. It argues that the principle of ‘set off’ should apply.

30 22. At the hearing oral evidence was given by Mr Moyses and Ms Joanne Yearsley, the Office Manager. Mr Moyses said that the Appellant Company was established by him in 1998. The Company replaces gas mains and services. A large part of the work it undertakes is sub-contract work for utility companies. It also specialises in the delivery of design and contracting services for the UK’s gas distribution network – replacing old mains, laying new ones, installing new connections to houses and commercial premises.

35 23. Because of the nature of its work, the Company takes on long term contracts. In 2005 it secured an eight year contract with Amec Utilities on the M1 Gas Alliance. When that contract ended the Company was, as Mr Moyses put it, ‘treading water’ and had its gross status taken away. In 2012 it took on another eight year contract with MUS Skanska UK, as a joint venture [Morrison Utility Services and Skanska UK] called tRIIO, working directly for National Grid, replacing gas mains in the Lincolnshire area.

24. Mr Moyses explained that the Company was now five years into the eight year contract. Under its terms of business with tRIIO, in the first four years the sub-contract rate had to be established. This meant that the sub-contract rates were less than they should have been and could only be revised to more realistic rates after four
5 years once the correct 'going rate' had been established. tRIIO also insisted on large retentions. He conceded that the contract with tRIIO 'was risky', but tRIIO had a monopoly on National Grid work in the north of England.

25. He said that National Westminster Bank has a debenture (fixed and floating charge over the company's assets), but otherwise the company operates free of any
10 secured borrowings or overdraft facilities.

26. Mr Moyses said that the surcharges were unfair, firstly because HMRC had not repaid CIS due to the Company and also because of an insufficiency of funds caused by the terms of business which it had to agree with its main customer tRIIO.

27. The sub-contract rate with tRIIO had now been reviewed. A 7% rise had been
15 agreed for 'dig costs' and a 25% increase had been agreed for backfill costs. Mr Moyses said that as a result, the Company had been able to move back into profit in 2017-18.

28. The Company's gross status had also been reinstated. He had also reached an agreement in July 2016 to pay £7,500 per week to clear outstanding VAT, the
20 expectation being that on the CIS reconciliation at the end of the 2017 tax year, all VAT liabilities would be cleared. The Company's financial position had improved to such an extent that as at 31 March 2017 all VAT payments were up to date and the Company was completely debt free.

29. Mr Moyses said that the Company had no overdraft facility and had to borrow
25 from finance companies, £117,000 in 2015-16, and £130,000 in 2016-17, just to keep operating. In 2015-16 the Company had made only very marginal profits.

30. Mr Moyses said it was clear that the insufficiency of funds which had caused the VAT defaults arose not from normal hazards of trade but from causes beyond his control.

30 **HMRC's Case**

31. Mr Smithson for HMRC said that the onus of proof rests with HMRC to demonstrate that a penalty is due. Once so established, the onus is then on the Appellant to demonstrate there is a reasonable excuse for late payment. The standard of proof is the ordinary civil standard, which is the balance of probabilities.

32. There is a statutory obligation on a person required to make a return to pay the
35 VAT to HMRC. Value Added Tax Regulations 1995, at Regulation 40, state that any person required to make a return "shall pay" to HMRC "such amount of VAT as is payable by him in respect of the period to which the return relates not later than the last day on which he is required to make that return."

33. There is no provision that allows HMRC to offset CIS deductions against the Company's VAT liability "in year". The Income Tax (Construction Industry Scheme) Regulations 2005 Regulation 56(5) stipulates that HMRC shall not repay any sum deducted under FA 2004 s 61 to a company sub-contractor until:

5 "The tax year in which the deduction was made, has ended and the qualifying sub-contractor has delivered the return required by regulation 73 of the PAYE Regulations (annual return of relevant payments liable to deductions of tax)."

34. Regulation 56(2) stipulates the order in which any CIS credits should be discharged and Regulation 56(3) states any sum deducted as is not required to
10 discharge the sub-contractor's liabilities specified in paragraph (2) shall be repaid to the qualifying sub-contractor.

35. Where the sub-contractor is a company, the legislation states at FA 2004 s 62(3) that deductions are first to be treated as paid on account of any "relevant liabilities" of the sub-contractor. "Relevant liabilities" in this context means the company's
15 obligations to pay over to HMRC any PAYE, NICs, and CIS deductions. Any excess deductions determined at the end of the tax year when the company has submitted its employer's annual return on form P35 for non-Real Time Information ("RTI") year, or Employer Payment Summary returns for RTI years, can be set against corporation tax liabilities or repaid.

20 36. For RTI years, the company will complete monthly Employer Payment Summary returns showing cumulative CIS deductions taken from its own income during the tax year. These amounts are off-set against the PAYE and other deductions it is due to pay for the tax year. Any excess of CIS deductions taken from the company's own income is carried forwarded month by month until all of the CIS deductions for the
25 tax year are used, or the end of the tax year is reached.

37. Repayment and off-set claims for limited company subcontractors can only be dealt with when the company has filed its final Employer Payment Summary and all associated Full Payment Submissions for the tax year. If HMRC cannot agree the company's whole claim, they will ask the company for their payment and deduction
30 statements and supporting evidence of receipt. HMRC can still consider a part repayment/off-set for the deductions they can agree. Where there is a mis-match, HMRC will need to take up the discrepancy with the company.

38. It is not until the end of the tax year that excess CIS deductions which cannot be set-off and are still available may be refunded or set against other liabilities.

35 39. Having CIS deductions is a normal hazard of trade in the construction industry and a foreseeable event. It is a reasonable expectation that a prudent business would put the necessary precautions in place to ensure they meet their legal obligations to submit VAT returns and payment by the due date.

40 40. The Appellant refers to having previously had a payment agreement, in recognition of an overpayment available to be off-set against VAT.

41. HMRC acknowledge a time to pay agreement (which qualified under the provisions of Finance Act 2009 s 108(2)(b)) was made on 6 February 2015 regarding outstanding arrears of £448,050.52. A further agreement was also made for period 03/15. However, after that there were no further TTP agreements.

5 42. The amount of unused CIS deductions, following the end of the previous tax year 2014-15, that is in the tax year prior to the VAT defaults, of £324,785.51 and set off on 11 June 2015, was insufficient to fully satisfy the amount of tax outstanding. As a result, the Appellant entered the default surcharge regime in respect of period 06/15, in the absence of any payment proposals or agreement initiated prior to the relevant
10 due date.

43. HMRC acknowledges that contact with the Appellant was ongoing from September 2015 to February 2016 leading to the TTP agreement specifically with regard to arrears of tax. The subject of CIS credits was discussed in the context of being unable to do an “in year” set off; however it was unclear on what basis the
15 Appellant had calculated that any CIS credit agreed at the year’s end would be sufficient when available to be off-set to satisfy the full amount of VAT arrears. As at 31 October 2016, even after the May 2016 CIS repayment/set off of £337,837.15, the Appellant Company’s HMRC account showed a deficit of £236,580.40.

44. HMRC refer to the Tribunal’s comments that the right to deduct does not arise as soon as a claim to deduct is made. As stated in *R (on the application of UK Tradecorp Ltd) v Customs and Excise Commissioners*:

“there is a distinction between an unadjudicated claim to input tax and an admitted or established claim. Until a claim is accepted or established there is no right to payment. It was incumbent on the Appellant to satisfy HMRC of its entitlement to a deduction. It
25 is not sufficient merely to make a claim, to be entitled or treated by the law as entitled to receive payment. Accordingly, there was no prima facie duty on the part of HMRC to repay input tax unless and until the claim had been agreed or upheld.”

45. HMRC say that the potential financial consequences attached to the risk of further defaults would have been known to the Appellant after issue of the Surcharge Liability Notice for period 06/15, when a Surcharge Liability Notice was issued, particularly given the information contained in the Notice which on the reverse states:

‘Please remember your VAT returns and any tax due must reach HMRC by the due date. If you expect to have any difficulties contact either your local VAT office, listed under HM Revenue & Customs in the phone book as soon as possible, or the National Advice Service on
35 0845 010 9000.’

46. The requirements for submitting timely electronic payments can also be found -

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- In notice 700 “the VAT guide” paragraph 21.3.1 which is issued to every trader upon registration.
 - On the actual website www.hmrc.gov.uk

- On the E-VAT return acknowledgement.

47. Also, the reverse of each default notice details how surcharges are calculated and the percentages used in determining any financial surcharge in accordance with the VAT Act 1994 s 59(5).

5 48. Therefore HMRC say that the surcharge has been correctly issued in accordance with the VAT Act 1994 s 59(4).

49. Although the Appellant was suffering cash flow difficulties, this is not something which was attributable to anything other than the normal hazards of trading. It is specifically stated in s 71(1) VATA 1994 that any insufficiency of funds to pay any
10 VAT is not reasonable excuse. The Appellant had not produced any bank statements, copy accounts or other documentation to substantiate its assertion that it was suffering an insufficiency of funds due to unavoidable and unforeseen circumstances beyond its control.

50. The Appellant's contract and terms of business with tRIIO was something which
15 should have been factored into the Company's business projections. It was not unforeseeable or beyond the Company's control that it would, in the first four years of the eight year contract, have to operate at rates which were expected to be below the rate eventually agreed.

51. Insofar as the Appellant argues that the surcharge is unfair the case of *Total
20 Technology (Engineering) Limited v HMRC* heard in the Upper Tribunal held that:

(1) There is nothing in the architecture of the Default Surcharge system which makes it fatally flawed.

(2) In order to determine whether or not a penalty is disproportionate, the Upper Tier Tribunal addressed the following factors:

25 (a) The number of days of the default

(b) The absolute amount of the penalty

(c) The 'inexact correlation of turnover and penalty'

(d) The 'absence of any power to mitigate'

- and decided that none of these leads to the conclusion that the Default Surcharge
30 regime infringes the principle of proportionality or fairness. The penalty was therefore not excessive, unfair or disproportionate. The penalty is tax geared and levied on the amount of VAT paid late at a percentage applicable to and commensurate with the number of defaults.

Conclusion

35 52. The Appellant was clearly aware of the due date for payments of its VAT and the potential consequences of late payment.

53. The Appellant's grounds of appeal are that it suffered a cash flow shortage caused by constraints on its cash flow as result of both trading conditions and the fact that in year CIS credits due to the company had not been refunded by HMRC.

5 54. The Income Tax (Construction Industry Scheme) Regulations 2005 and Finance Act 2004 ss 61- 62 cover the requirement to deduct amounts under CIS and the treatment of the sums so deducted.

55. There is no provision that allows HMRC to offset CIS deductions against the Company's VAT liability 'in year'. As such a limited company that has an excess of CIS deductions over and above the amount of tax/NIC/CIS that it is due to pay to HMRC, will not be able to claim a repayment of those CIS deductions until:

- the final Employer Payment Summary for the year has been submitted (due by 19 April each year where payments to employees are made in the period 6 March to 5 April)
- 15 • the company has paid all amounts due to HMRC for the tax year, in its capacity as an employer/contractor
- and the tax year in which the CIS deductions were made from the company has ended.

56. Value Added Tax Act 1994 ("VATA"), ss 59 and 71 set out the reasonable excuse provisions which apply to the default surcharge. As regards the Appellant Company's cash flow shortages generally, it is clear from s 71(a) VATA, that an insufficiency of funds to pay any VAT due is not in itself a reasonable excuse.

57. In *Customs & Excise Commissioners –v- Steptoe [1992] STC 757* the tax-payer argued that although the proximate cause of his default was insufficiency of funds, the underlying cause of that insufficiency, namely the unexpected failure by a major customer to pay him on time, amounted to a reasonable excuse. The Court determined on a majority that the statutory exclusion of insufficiency of funds as an excuse did not preclude consideration of the underlying cause of insufficiency and that a trader might have a reasonable excuse if it were caused by an unforeseeable or inescapable event or when, despite the exercise of reasonable forethought and due diligence, it could not have been avoided. The Court nevertheless made it clear that the test had to be applied strictly.

58. To decide whether a reasonable excuse exists where insufficiency of funds causes the failure the Tribunal must take for comparison a person in a similar situation to that of the actual tax-payer who is relying on the reasonable excuse defence. The Tribunal should then ask itself, with that comparable person in mind, whether notwithstanding that person's exercise of reasonable foresight, due diligence and a proper regard for the fact that the tax would become payable on the particular dates, those factors would not have avoided the insufficiency of funds which led to the failures.

59. Having considered the background facts and circumstances leading up to the defaults, the underlying cause of the Company's cash flow shortages, was not an unforeseeable or unexpected event outside its control. The primary cause of the defaults was a cash flow shortage caused by trading conditions arising from the terms of business it had agreed with tRIIO. However, as HMRC say, the Appellant's contract with tRIIO was something which should have been factored into the Company's business projections Whilst CIS credits had built up during the three default periods in 2015-16, these were not repayable to the Company until the year end, and in any event even when applied, left the Company's account with HMRC in deficit.

60. There was also nothing unforeseeable about the CIS deductions. As a sub-contractor within the CIS that did not qualify for 'gross payment' status, the deductions were clearly required by law and without set off. They were an ordinary incident of trade.

61. The Company has not provided any evidence that it could not pay the VAT as it fell due, and was unable to raise funds or arrange borrowing facilities to do so. VAT never becomes the property of the Company. The money belongs to the Crown at all times and must be paid over as the law requires. The Appellant had received payments from tRIIO, including VAT, and should have had in place cash flow controls that ensured VAT was paid on time as and when it fell due.

62. The burden of proof is on the Appellant to show that the underlying cause of its failure to meet its VAT payment obligations was due to unforeseen circumstances or events beyond its control. In the Tribunal's view, for the reasons given above, that burden has not been discharged and there was no reasonable excuse for the Appellant's late payment of VAT for the 06/12 period.

63. The appeal is accordingly dismissed and the surcharges upheld.

64. 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.

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**MICHAEL CONNELL
TRIBUNAL JUDGE**

RELEASE DATE: 27 JUNE 2017