[2017] UKFTT 0857 (TC)

TC06252

Appeal number: TC/2017/02109

VALUE ADDED TAX – default surcharge – late payments and late submission of returns within three year period – reasonable excuse for first late payment – no - penalty of £297,845.00 for second late payment proportionate - yes

FIRST-TIER TRIBUNAL
TAX CHAMBER

GLOBAL SWITCH LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE TONY BEARE
MRS JO NEILL

Sitting in public at Taylor House, 88 Rosebery Avenue, London EC1R 4QU on 13 November 2017

Mr Tim Brown appeared for the Appellant

Mr Colin Smithson, officer of HM Revenue and Customs, appeared for the Respondents

DECISION

Introduction

1. This is an appeal made by Global Switch Limited (the "Company") against a VAT default surcharge of £297,845.00 in respect of its final payment on account for the period 09/16.

2. The Company is the representative member of a VAT group which is required to make monthly payments of VAT pursuant to sub-section 28(2A) of the Value Added Tax Act 1994 (the "VATA"). The Company was late in making certain of its payments on account in respect of the period 06/12 and, as a result, became subject to the default surcharge regime. It then was late in making certain of its monthly payments in respect of the periods 03/13 and 12/13. There were no further payment defaults by the Company after the period 12/13 until the default which is the subject of the present appeal – the late payment of its final instalment in respect of the period 09/16. However, although the Company made all of its VAT payments over the intervening period on time, it was late on two occasions in submitting its VAT returns. Those failures led to the extension of the default surcharge period, with the result that the late payment which occurred in respect of the period 09/16 was within an existing default surcharge period.

3. The late payment which is the subject of this appeal was made on 1 November 2016 instead of its due date of 31 October 2016 and, as a result of the earlier defaults mentioned above, the default surcharge was levied at the rate of 10% of the amount which was paid late. The late payment in question was £2,978,459.24. This was not significantly larger than the amounts generally payable by the Company by way of final instalment in respect of its VAT periods.

The Law

4. For traders such as the VAT group headed by the Company, that are subject to the "payments on account" regime, the relevant default surcharge provisions are set out in Section 59A VATA. As the detail of those provisions is not material to this appeal, a brief summary here of the provisions which are material to the facts of this case will suffice.

5. A first default, which may be a default in the making of a VAT return or in making a payment of VAT by the due date, does not give rise to any liability to a surcharge but triggers the issue of a surcharge liability notice. That notice creates a "surcharge period", which begins on the date the notice is issued and ends on the first anniversary of the period for which the default arose (sub-section 59A(2)).

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

aggregate value of the defaults in respect of that period (sub-section 59A(4)). For a first default within a surcharge period, the specified percentage is 2% (sub-section 59A(5)).

7. There is no surcharge if the taxable person demonstrates that there is a reasonable excuse for non-payment (sub-section 59A(8)). However, although HMRC has discretion as to whether or not to assess a default surcharge (Section 76 VATA and the case of *Dollar Land (Feltham) Ltd and others v Customs and Excise Commissioners* [1995] STC 414) neither HMRC nor the First-tier Tribunal has power to mitigate a surcharge.

8. Where a default occurs within a surcharge period, that surcharge period is extended (sub-section 59A(3)). On subsequent defaults within that extended period (as further extended by any such subsequent defaults), the specified percentage applied to the aggregate value of the defaults for the relevant period increases with successive periods of default to 5%, then to 10% and finally to a maximum of 15% (sub-section 59A(5)).

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

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

The Grounds of Appeal

11. Although the subject of this appeal is solely the late payment made by the Company in respect of the period 09/16, the grounds of appeal are twofold.

12. First, the Company alleges that it had a reasonable excuse for the late payment which occurred in respect of the period 12/13. The significance of this is that, if the Company did have a reasonable excuse for that late payment, then that default would

fall out of account under the default surcharge regime, with the result that the rate at which the default surcharge in respect of the period 09/16 would fall to be charged would be 2%, instead of 10%. (The Company alleges that, if its late payment in respect of the period 12/13 were to fall out of account on the basis that the Company has a reasonable excuse for that late payment, the percentage at which the default surcharge would be calculated for the late payment in respect of the period 09/16 is 0% because that would have been the first payment default but we do not understand the basis for this contention. The Company's failure to make timely VAT returns in respect of the periods 09/14 and 09/15 would have given rise to, and subsequently caused the extension of, a surcharge period, with the result that the late payment within that surcharge period in respect of the period 09/16 would have been subject to a default surcharge calculated at the rate of 2% pursuant to sub-section 59A(5)(a) VATA).

13. Secondly, the Company alleges that the penalty for its late payment in respect of the period 09/16 is so disproportionate to the gravity of the Company's infringement that to uphold the penalty would be an obstacle to the underlying aims of the directive.

Discussion

Reasonable Excuse

14. The first issue before us is whether the Company had a reasonable excuse for its late payment in respect of the period 12/13. Although the default surcharge in respect of the period 12/13 is technically not the subject of this appeal, the relevant default is "material" to the surcharge in respect of the period 09/16 which is the subject of this appeal (for the purposes of sub-sections 59A(8) and 59A(9) VATA) because it affects the rate at which the latter default surcharge is calculated. It is therefore appropriate to consider whether the Company has a reasonable excuse for its late payment in respect of the period 12/13. The background to that late payment is as follows.

15. In 2012, HMRC carried out a full VAT audit of the Company. At that time, the annual turnover of the VAT group of which the Company was the representative member was in excess of £110 million and the audit resulted in a relatively small VAT assessment of £1,583.11, dated 12 March 2013. That assessment was paid by the Company on 28 March 2013.

16. The amount paid by the Company was shown as an outgoing in its VAT Control Account but no corresponding entry was made in the VAT Control Account in respect of the assessment. As a result, when the VAT Control Account was reconciled at the end of 2013, the Company mistakenly paid £1,583.11 less in respect of the period 12/13 than it should have done. The Company alleges that this mistake is a reasonable one for it to have made and therefore that it has a reasonable excuse for the late payment.

17. There is no dispute between the parties in relation to the law as it applies to determine when a mistake can amount to a reasonable excuse. Both parties agree that

the mere fact that a mistake is honestly and genuinely made is not sufficient in and of itself for the mistake to amount to a reasonable excuse. As outlined by Judge Brannan in *Stuart Coales v The Commissioners for Her Majesty's Revenue and Customs* [2012] UKFTT (477) (TC) at paragraph [32] of his decision:

> "The test contained in the statute is not whether the taxpayer has an honest and genuine belief but whether there is a reasonable excuse. It is true that the absence of a genuine and honest belief would usually indicate that the excuse [is] not reasonable, but its presence does not mean that the excuse is necessarily reasonable".

18. A similar point was made by Judge Medd in *The Clean Car Company Limited v The Commissioners of Customs & Excise* [1991] VATTR 234, when he said that the relevant test is to ask oneself whether "what the taxpayer did [was] 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", to do.

19. Similar sentiments were expressed by the First-tier Tribunal in *County Inns Limited v The Commissioners for Her Majesty's Revenue and Customs* [2015] UKFTT 204 (TC).

20. Mr Brown submits that a mistake of the nature made by the Company in respect of the period 12/13 satisfies the test outlined above, given the amount of the discrepancy in question (just £1,583.11) in comparison to the balancing payment in respect of the period 12/13 (£2,377,763.71).

21. In response, Mr Smithson makes the following points:-

(a) at the time of its default, the Company knew that it was in the default surcharge regime and should have been taking particular care to ensure that it complied with its VAT obligations;

(b) a company of the size of the Company should have had sufficient financial controls in place to identify errors such as the one which was made; and

(c) the assessment of £1,583.11 was issued on 12 March 2013 and paid on 28 March 2013, some nine months before the reconciliation process in relation to the VAT Control Account was effected. If the Company had conducted that exercise at an earlier stage, it might have discovered the fact that there was no corresponding entry in the VAT Control Account for the assessment which gave rise to the relevant payment, with the result that the default would not have occurred.

22. At the hearing, a representative of the Company explained that the VAT Control Account in relation to any year contains relatively very few entries. There are three members of the VAT group and the net VAT liability of each company in the VAT group for each quarter comprising the year is entered on one side of the account, so that there are twelve entries on that side of the account in all. On the other side of the account is shown the twelve payments made by the Company in respect of the relevant year. In the case of 2013, the account showed the additional payment of

£1,583.11 resulting from the assessment of 12 March 2013, so that these were thirteen entries on that side of the account in all.

23. On the basis of the facts outlined above, whilst we accept that the mistake which was made in respect of the period 12/13 was genuinely and honestly made, we do not think that it amounts to a reasonable excuse. We believe that the relative paucity of entries in the VAT Control Account for 2013, coupled with the fact that the payment of £1,583.11 was so small in comparison to the other VAT payments which were made in respect of 2013 (i.e. the relevant payments on account), means that it should have been apparent to anyone exercising a reasonable degree of diligence that the £1,583.11 shown in the VAT Control Account was not an instalment payment in the ordinary course. This in turn should have led to an enquiry which would have revealed the fact that the assessment giving rise to that payment had not been included on the other side of the account.

24. We consider the failure to identify this error to fall below the standard required for a mistake to qualify as a reasonable excuse as outlined in the cases listed above and that a responsible trader, conscious of and intending to comply with its obligations in relation to VAT and having the experience and other relevant attributes of the Company, would not have made this mistake. Moreover, we think that this would be the case even if the Company was not already within the default surcharge regime. The fact that the Company was already within the default surcharge regime means that it knew, or should have known, that a payment default could have serious ramifications and we would therefore expect a responsible taxpayer in that position to have shown a higher degree of diligence then was displayed by the Company.

25. We are reinforced in this view by the conclusion reached by the First-tier Tribunal in *Garnmoss Limited T/A Parham Builders v The Commissioners for Her Majesty's Revenue & Customs* [2012] UKFTT 315(TC), where a somewhat similar clerical error – a mis-posting which led the taxpayer to conclude that it had paid more VAT than it should have done so that it erroneously reduced its VAT payment – was considered not to amount to a reasonable excuse (see paragraphs [9] to [12] of that decision).

26. For the above reasons, we have concluded that there is no reasonable excuse for the late payment of £1,583.11 which was made in respect of the period 12/13.

Proportionality

27. The second issue before us is whether the surcharge which is the subject of this appeal should be struck down on the basis that it is not proportionate to the gravity of the infringement.

28. In relation to this question, we are bound by the decisions of the Upper Tribunal in *The Commissioners for HMRC v. Total Technology (Engineering) Ltd* [2012] UKUT 418 (TCC), [2013] STC 681 ("*Total Technology*") and *The Commissioners for HMRC v. Trinity Mirror plc* [2015] UKUT 0421 (TCC) ("*Trinity Mirror*").

29. The principles which we derive from those cases may be summarised as follows:-

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

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

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

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

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

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

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

(h) To those tests should be added the question derived from *International Transport Roth GmbH v Secretary of State for the Home Dept* [2003] QB 728 at [26], which is "is the scheme not merely harsh but plainly unfair, so that, however effectively that unfairness may assist in achieving the social goal, it simply cannot be permitted?";

(i) The use of the amount unpaid as the objective factor by which the amount of the surcharge varies is not a flaw in the system; on the contrary, as the

achievement of the aim of fiscal neutrality depends on the timely payment of the amount due, that criterion is an appropriate, if not the most appropriate, factor;

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

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

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

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

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

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

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

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

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

on the basis of proportionality cannot be ruled out, we cannot ourselves readily identify common characteristics of a case where such a challenge to a default surcharge would be likely to succeed".

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

32. Mr Brown's argument may be summarised as follows. He accepts that:

(a) the gravity of a default must be assessed by reference to the relevant factors (paragraph [70] of *Trinity Mirror*);

(b) it is not enough for a penalty simply to be found to be disproportionate to the gravity of the default;

(c) instead, it must be "so disproportionate to the gravity of the infringement that it becomes an obstacle to [the underlying aims of the directive"] (*Louloudakis*, at [70]) (paragraph [58] of *Trinity Mirror*); and

(d) the underlying aim of the directive that is relevant for this purpose is the principle of fiscal neutrality (paragraph [59] of *Trinity Mirror*).

33. Mr Brown then focuses on the following language in paragraph [60] of *Trinity Mirror*:

> "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 to fiscal neutrality, must be viewed"

and contends that the terms of that paragraph, properly construed, show that the timely submission of VAT returns is not a "necessary concomitant" to the underlying aim of the relevant directive (ie fiscal neutrality). Instead, he says, the "necessary concomitant" to that underlying aim is that the relevant taxpayer prepares its internal VAT accounts on a timely basis.

34. Building on that, Mr Brown points out that, following the late payment in respect of the period 12/13, the Company made thirty-two VAT payments on time before the late payment in respect of the period 09/16 and that the only reason why the Company was still in the default surcharge regime at the later date was that it had submitted two of its VAT returns late within the intervening period. As, on his interpretation of the relevant paragraph in *Trinity Mirror*, the timely submission of VAT returns is not a "necessary concomitant" to the underlying aim of the directive, a penalty which is based in large part on the late submission of VAT returns (because it is that which caused the VAT default surcharge period to be extended to encompass the period 09/16) is so disproportionate relative to the gravity of the infringement as to become an obstacle to the achievement of the underlying aim of the directive.

35. Mr Brown compares the harshness of this outcome to the regime in Schedule 24 Finance Act 2007 which is applicable to innocent errors in a VAT return, where provision is made for a reduction in penalties.

36. In response, Mr Smithson argues that the "necessary concomitant" to the achievement of the underlying aim of timely VAT payments in the light of which the present facts must be weighed is the timely submission of VAT returns because it is the latter, rather than the timely preparation of internal accounts, which is the essential adjunct to the former.

37. A critical difference between the parties is whether the timely submission of VAT returns is a "necessary concomitant" to the underlying aim of the directive in the light of which the relevant infringements must be considered such that it is appropriate to take into account, as pertinent defaults, the failure by the Company to submit its VAT returns on a timely basis on two occasions during the period between its late payment in respect of the period 12/13 and its late payment in respect of the period 09/16.

38. In that regard, Mr Brown's construction of paragraph [60] of *Trinity Mirror* requires the phrase "accounted for ….. on a timely basis" to be taken as referring to the timely preparation of the internal accounts within the relevant taxpayer, as opposed to the timely submission of VAT returns (i.e. accounting to HMRC). We do not agree with this interpretation of the words in question. In our view, it is apparent from the context that "accounted for" means submitted to HMRC in the form of the VAT returns and not some accounting procedure which is internal to the relevant taxpayer. The reason why the submission of VAT returns on a timely basis is an important part of the collection process is that that is how HMRC is informed of the amount of VAT which is due. It is all very well for Mr Brown to say that, in this particular case, the VAT returns were filed only a few days late and therefore that HMRC suffered no detriment but the fact remains that that would not always be the case and that, a matter of the general principles on which the VAT regime is based, the delivery of VAT returns on a timely basis is an important part of the VAT collection process. We would add that, in our view, the timely preparation of internal VAT accounts would seem to be of somewhat lesser importance in terms of the collection process than the timely submission of VAT returns.

39. In light of the above, we do not accept that the Company's failure to file two of its VAT returns on time can simply be disregarded when considering whether or not the default surcharge in this case is objectively proportionate. The timely filing of VAT returns is a necessary feature of a regime which has the timely payment of VAT as its underlying aim and a penalty based, in part, on a failure to do that cannot, in our view, be said to be so disportionate to the gravity of the infringement that it becomes an obstacle to the pursuit of that underlying aim.

40. It follows that, in our view, the present facts do not qualify as a "wholly exceptional case" of the kind to which reference was made in *Trinity Mirror* and that the penalty in this case cannot be regarded as disproportionate. We therefore uphold the default surcharge liability of £297,845.00.

41. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

TONY BEARE
TRIBUNAL JUDGE

RELEASE DATE: 2 DECEMBER 2017