[2015] UKFTT 0594 (TC)

TC04741

Appeal number: TC/2015/03698

VAT –default surcharge – whether the appellant had a reasonable excuse – whether the surcharge was disproportionate - appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

FARMYARD FUNWORLD LTD **Appellant**

- and -

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

TRIBUNAL: JUDGE HARRIET MORGAN
MEMBER LESLIE HOWARD

Sitting in public at Fox Court, 30 Brooke Street, London on 31 July 2015

Mr Francis McLennan, a director of the Appellant, for the Appellant

Mr Ryder, an officer of the Respondents, for the Respondents ("HMRC")

DECISION

1. The appellant appealed against a default surcharge of £1,198.99 imposed by HMRC under an assessment issued on 15 August 2014 pursuant to s 59 of the Value Added Tax Act 1994 ("**VATA**"). The surcharge relates to the appellant's failure to pay VAT of £7,993.27 due for the accounting period ending on 28 February 2015 (the "**02/15 period**") by the due date for electronic payments of 7 April 2015 (the "**due date**").

Facts

2. We find the following facts based on the information provided to the tribunal and the evidence of Mr McLennan.

3. The appellant submitted its VAT return for the relevant period before the due date on 2 April 2015.

4. The appellant paid the VAT due for the relevant period of £7,933.27 in two instalments, each paid electronically using the Faster Payment System:

   (1) Mr McLennan initiated the first online payment of £5,000 at around 11.15 pm on 7 April 2015. The funds are shown in the appellant's bank statement as debited from his account on 8 April 2015.

   (2) Mr McLennan initiated the second payment of £2,933 at around 1.00am on 8 April 2015. These funds are shown in the appellant's bank statements as debited from his account on 9 April 2015.

5. The appellant's business is operating a small farm attraction and a larger indoor soft play area for children. The appellant has been carrying out this business for around 3 years. On 8 March 2015 there was a break in to the appellant's business premises during the course of which the appellant's safe was stolen which contained paperwork of the business and around £4,300 in cash. In addition there was damage to the premises and its contents with an overall estimated loss of around £8,000. The appellant made a claim for the losses under its insurance policy and £4,300 was recovered from the insurers around six weeks after the break in. However, this was received after the due date. In the interim this had caused a cashflow problem for the business due in particular to the loss of cash of £4,300 and the need to fund emergency repairs of around £2,300. The appellant had been setting aside funds to meet the VAT due for the 02/15 period but had had to use such funds in the business due to the deficit caused by the break in.

6. The appellant's business is a very weather dependent business in the sense that extremes of cold or hot weather affect the number of customers wishing to use the facilities on a particular day. This makes it difficult for the business to predict likely turnover in any period. We were not presented with precise figures but Mr McLennan noted that takings from the business could fluctuate due to weather conditions from around £600 per day to as little as £60 a day.

7. At the time when the break in occurred Mr McLennan had estimated (taking into account weather conditions at that time) that the business would have sufficient takings to compensate for the losses caused by the break in so that the business would be able to account for the VAT due by the due date. However, a heat wave had occurred a few days before the due date of 7 April 2015. This was very unexpected as it was early in the year for the relatively high temperatures which were extreme for the time of year. This lead to a significant downturn in turnover of the business over a period of around 5 days up to the due date. As noted we were not presented with precise figures but Mr McLennan described the takings of the business in the few days before the due date as having "dried up almost completely". Some of the turnover which was generated in that period was received via credit card payments which took 3 to 5 days to clear to the appellant's account.

8. The appellant had been in default (within the meaning of the default surcharge regime as set out below) in each of the VAT accounting periods from 08/13 until the relevant period as follows:

(1) For the period 08/13, the VAT return was submitted by the due date for submission and electronic payment of 7 October 2013 but the VAT due was not paid until 28 October 2013.

(2) For the period 11/13, the VAT return was submitted on 6 January prior to the due date of 7 January 2014 but the VAT due was not paid until 10 January 2014.

(3) For the period 02/14, the return was submitted and part payment of the VAT due (as to £3,000) was made on the due date of 7 April 2014 but the balance of VAT due (of £3,627.97) was not paid until 11 April 2014.

(4) For the period 05/14, the VAT return was submitted on 4 July 2014 prior to the due date of 7 July 2014 but the VAT due was not paid until 2 August 2014.

(5) For the period 08/14 the return was submitted and part payment of the VAT due (as to £6,000) was made on 6 October 2014 prior to the due date of 7 October 2014 but the balance of VAT (of £1,469.02) was not paid until 9 October 2104.

(6) For the period 11/14 the return was submitted on the due date of 7 January 2015 but payment of the VAT due was made later in three instalments of £1,300 on 14 January 2015, £1,300 on 21 January 2015 and £1285.40 on 28 January 2015.

9. For each of the periods 08/13, 05/14 and 11/14 the appellant had made a request for time to pay the VAT due. However, in each case the request had been made after the due date for payment of the VAT due by electronic means and therefore no relief was available. Mr McLennan had not made a request as regards the 02/15 period as he had hoped to have sufficient funds and it was only at the very last minute that it was apparent this would not be the case due to the unexpected heat wave.

10. Surcharges which were potentially due from the appellant in respect of the periods ending on 05/14 and 11/14 were, on a review requested by the appellant, removed by HMRC.

Law

11. Where a business makes quarterly returns for VAT purposes, the return must be made and the tax payment is due on or before the end of the month following the end of the relevant quarter (under regulations 25(1) and 40(2) Value Added Tax Regulations 1995 (SI 1995/2518)). Where, however, the taxable person files returns and pays tax electronically, HMRC allow a further seven days from the end of the next month.

12. In outline, the default surcharge regime operates to impose a surcharge where a taxable person is late in paying VAT by the due date as follows:

(1) If a taxable person is in default for any accounting period (a "**default period**"), HMRC can serve a surcharge liability notice on that person stating that the period from the date of the notice until the anniversary of the last day of the default accounting period is a "surcharge period" (sub-s 59(2) VATA).

(2) A person is in default for this purpose if, by the last day on which the person is required to furnish a return for the period (a) HMRC has not received that return or (b) HMRC has received that return but has not received the amount of VAT shown on the return as payable in respect of that period (sub-s 59(1) VATA).

(3) The effect of the service of a surcharge liability notice is that the taxable person is potentially liable to a surcharge for each further default period falling within the surcharge period for which VAT due is not paid in full by the due date for the return. The rate of surcharge is the greater of a specified percentage of the outstanding VAT and £30 (sub-s 59(4) VATA).

(4) The specified percentage of surcharge increases according to how many defaults there are in the surcharge period. The rate is 2% for the first default period, 5% for the second, 10% for the third and a maximum of 15% for all further periods (sub-s 59(5) VATA).

(5) The surcharge default regime operates on an on-going rolling basis if the taxable person continues to be in default. HMRC can serve a surcharge liability notice in respect of each and every default period. Where a notice is served for a default period which falls within an existing surcharge period, the new surcharge period is treated as a continuation of the existing one (sub-s 59(3) VATA). In other words the surcharge period is extended to the new end date specified in the later notice.

13. Under sub-s 59(7) VATA, if a person who would otherwise be liable to a surcharge satisfies 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 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 provision 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)."

14. Sub-section 71(1)(a) VATA provides that:

"(1) For the purposes of any provision of sections 59 to 70 which refers to a reasonable excuse for any conduct –

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

15. Section 108 Finance Act 2009 provides that a default surcharge may be suspended if a person comes to an agreement with HMRC to defer payment. Such an agreement must be reached prior to the due date for this relief to apply.

Submissions

16. Mr McLennan made the following submissions:

(1) The appellant is being penalised for late payments of £5,000 and £2,933 which were made only a few hours late in the case of the first amount and two days late in the case of the second amount. The penalties imposed in these circumstances are excessive and do not represent natural justice or the intention or spirit of the legislation.

(2) The appellant was "down to the wire" in paying the VAT for the relevant period due to the unexpected cash flow crisis caused by the theft of cash and other losses resulting from the break in to the appellant's premises on 8 March 2015. An insurance claim was made and around £4,300 was recovered from the insurers but the funds were received around six weeks after the break in and two weeks after the due date.

(3) Mr McLennan had thought that there would nevertheless be sufficient funds for the appellant to pay the VAT due by the due date. However, the unexpected heat wave which had occurred a few days before the due date had lead to a dramatic drop in business and further cash flow difficulties. Some of the turnover which was generated in that period was received via credit card payments which took 3 to 5 days to clear to the appellant's account.

(4) There has never been any intention to default on VAT payments. In the three years the appellant's business had been trading VAT had always been paid albeit that there had been occasions when payments were late. Mr McLennan is

aware that it is the appellant's legal responsibility to collect VAT and forward it to HMRC and he had followed the advice of HMRC in a previous call by setting up an independent funds account into which transfers are made monthly to ensure that future VAT payments are made on time. However, for this particular period, as a result of the break in and the consequent losses, some of the funds set aside had had to be used to meet the daily running costs to keep the business turning over.

(5) The imposition of the surcharge could threaten the existence of the appellant's business and the employment of the 14 staff of the business.

17. HMRC made the following submissions:

(1) Whilst HMRC accept the break in on 8 March 2015 would have occasioned the appellant some degree of financial hardship, as this had occurred one month prior to the due date, the appellant had sufficient time to look to secure funds from elsewhere to make the VAT payment by the due date.

(2) The stolen cash of £4,300 and repairs of around £2,300 equates to only 10 per cent of the total VAT outputs for the period.

(3) In any event sub-s 71(1)(a) VATA excludes an insufficiency of funds from providing a reasonable excuse.

(4) The nature of the business indicates that it is a cash business so that any VAT would be collected at the point of sale and so prior to the due date. This cash should therefore have been available to the business to meet its VAT obligations. By not paying the VAT due by the due date in effect the business was treating the VAT as an interest free loan and had taken the risk that it would not have sufficient funds to pay the VAT should circumstances change.

(5) The payment made on 7 April 2015 at around 11.15 pm did not leave sufficient time for the payment to reach HMRC's account on that day. HMRC has no explanation as to why the payment initiated on 8 April 2015 was not received by HMRC until 9 April 2015 but in any event the payment would have been late even if received on 8 April 2015. The appellant had been using the Faster Payment System for some time and should have been aware that payments could not be made instantaneously.

(6) HMRC had informed the appellant in a decision letter on a previous default surcharge which the appellant had successfully appealed against that should a similar situation arise in future then the appellant should make contact with the Business Payment Support Service ("**BPSS**") prior to the due date. HMRC also noted that Notice 700 (The VAT Guide) at section 21.2.2 (b) and Notice 700/50 at 3.2 each advise a business to contact this service in advance if it knows it will have difficulty paying VAT in which case extra time to pay may be granted. If the appellant had contacted the BPSS prior to the due date an extension of time to pay would have been agreed under section 108 of the Finance Act 2009.

(7) The appellant would have been aware that a surcharge of this level would be due as the appellant had received four earlier surcharge liability notices each

of which contained details of how the surcharges are calculated and the percentages used in calculating the amount of the surcharge.

(8) The rates of surcharge are laid down in law and neither HMRC nor the tribunal have the power to reduce the amount due to mitigating circumstances.

(9) On the basis of the decision of the Upper Tribunal in the case of *Total Technology (Engineering) Ltd* the default surcharge system is not of itself disproportionate and nor is the particular surcharge in this case.

Discussion

18. The tribunal considered that the appellant's appeal against the default surcharge for the period 02/15, although not couched in technical terms as the appellant was not legally represented, was essentially made on the basis (a) the appellant had a reasonable excuse for the late payment of VAT due for that period and (b) the imposition of the penalty was disproportionate. The surcharge for the period 02/15 was otherwise correctly imposed.

19. We note that in correspondence with HMRC the appellant had initially seemed to argue that in using the Faster Payment Service for payment of the VAT it was reasonable to expect that it would be received by HMRC within the appropriate time limit (within sub-s 59(7)(a) VATA). However, at the hearing the appellant accepted that this was not the case and did not pursue this argument.

Reasonable excuse

20. There is no statutory definition of what constitutes a reasonable excuse. On the basis of the wording and the approach taken in other cases in this tribunal, we understand the term to require consideration of what can reasonably be expected of a prudent business person exercising reasonable foresight and due diligence as regards its VAT obligations in the light of all the circumstances of the taxpayer's particular case. For example in the case of *The Clean Car Company Ltd v Custom and Excise Commissioners* [1991] VATTR 234 HH Judge Medd QC put the test as follows:

> "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 judgement 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 attributes of the taxpayer and placed in the situation that the taxpayer found himself at the relevant time, a reasonable thing to do".

21. Essentially the excuse put forward by the appellant was that the appellant had suffered an unexpected cash flow shortage due to the losses of around £8,000 caused by the break in on 8 March 2015 and further exacerbated by the drop in the appellant's turnover due to a heatwave occurring a few days before the due date.

Caselaw

22. As set out above, sub-s 71(1)(a) VATA provides that an insufficiency of funds cannot provide a reasonable excuse as regards late payment of the default surcharge. However, it was established by the Court of Appeal in the case of *Customs & Excise Commissioners v Steptoe* [1992] STC 757 that this provision does not necessarily preclude the underlying cause of an insufficiency of funds from being a reasonable excuse.

23. In that case, the taxpayer's excuse for late payment of VAT was that a customer (the council), which accounted for 95% of the taxpayer's business, never paid its bills until six to eight weeks after the money was due which in turn meant the taxpayer was not able to meet his VAT liabilities. The majority, Nolan LJ and Lord Donaldson, decided in favour of the taxpayer that this constituted a reasonable excuse, with Scott LJ dissenting.

24. All of the judges were agreed that the correct construction of the relevant provision (being the predecessor to sub-s 71(1)(a) VATA) was that it does not prevent the reason for an insufficiency of funds being put forward as a reasonable excuse. However, there was disagreement as to precisely how to determine what reasons for an insufficiency of funds could constitute a reasonable excuse.

Dissenting judgement in Steptoe

25. Scott LJ summarised the test as follows (at page 765 c to d):

> "the reason must in my judgement amount to something more than that the business of the taxpayer has been carried on unprofitably or that conditions of trade produce cash flow problems.
>
> It is the statutory duty of traders to make value added tax return and pay value added tax in due time. They are not relieved of that duty by the unprofitable or barely profitable nature of their businesses. If the conditions of business produce cash flow problems it is their duty none the less to make financial arrangements that will enable their value added tax to be paid on time. Absent some "unforeseeable or inescapable" event cash flow problems are, in my opinion, barred by section [71(1)(a)] from constituting a reasonable excuse".

Majority decision in Steptoe

26. Nolan LJ referred to his earlier decision in the case of *Customs and Excise Commissioners v Salevon Ltd* [1989] STC 907. In that case the excuse for late payment of VAT put forward by the taxpayer included that it had a shortage of funds for the relevant periods due to dishonest acts of a former secretary of the company. The secretary had drawn cheques for the VAT and shown them in the company's records as paid but had not in fact posted them. The case was decided in favour of the taxpayer.

27. Nolan LJ referred (at page 767 d to f) to passages in his judgement in *Salevon* (at page 911*)* where he had drawn a distinction between a case where a trader's

excuse was merely that he was "temporarily bereft of funds and unable to borrow what was needed" and a trader "whose explanation for non-payment or late payment was not simply a temporary cash shortage but the fact that the wrongful act of another had deprived him of the means to pay". He had concluded (at 911 of the *Salevon* case) that in the first case the trader was precluded from having a reasonable excuse, but that was not necessarily so as regards the second case:

> "to say of such a trader that his excuse for non payment was insufficiency of funds would appear to be an incomplete and misleading description of the situation…….....It fails to distinguish between the reason, in the sense of the direct cause for the non-payment, and the excuse for non payment …. The commissioners and the members of the tribunal are well qualified to distinguish between the trader who lacks the money to pay his tax by reason of culpable default and the trader who lacks the money by reason of unforeseeable and inescapable misfortune".

28. He went on to say (at 768 d to e) that he still remained of the view, as in *Salevon*, that it was not correct that if the direct cause of the trader failure to pay is an insufficiency of funds then he can never have a reasonable excuse for non payment, whatever the circumstances. In rejecting HMRC's concern that if one is allowed to look to the reason for the insufficiency then the provisions of [sub-s 71(1)(a)] are rendered ineffectual, he went on to further explain what he had meant in *Salevon*:

> "I remain of the view which I expressed in *Salevon* that as a general rule one can trust the commissioners and the tribunal to determine whether in any given case, and having regard to the scheme of the legislation including [section 77(1)(a)], a reasonable excuse for non payment exists. I would not accept that the reasonable excuse must necessarily involve the wrongful act of another person. My references in *Salevon* to the wrongful act of another and to the distinction between the trader who lacks the money to pay his tax by reason of culpable default and the trader who lacks the money by reason of unforeseeable and inescapable misfortune were directed to the facts of that case. They cannot be regarded as an all purpose test of what constitutes reasonable excuse. The test is to be found in the words of [*the relevant sections*] read in the context of the statutory scheme for the collection of value added tax. As a general rule this scheme has a highly beneficial effect on the cash flow of traders."

29. Nolan LJ confirmed (at page 768 f to h) that he remained of the view expressed in *Salevon* (at 911) that the circumstances when a trader would be found to have a reasonable excuse where there is an insufficiency of funds would be rare:

> "I would add however that in my view the cases in which a trader with insufficient funds to pay the tax can successfully invoke the defence of reasonable excuse must be rare. That is because the scheme of collection which I have outlined involves at the outset the trader receiving (or at least being entitled to receive) from his customers the amount of tax which he must subsequently pay over to the commissioners. There is

> nothing in law to prevent him from mixing this money with the rest of the funds of his business and using it for normal business expenses ….. and no doubt he had every commercial incentive to do so. The tax which he has collected represents, in substance, an interest free loan from the commissioners. But by using it in his business he puts it at risk. If by doing so he loses it, and so cannot hand it over to the commissioners when the date of payment arrives, he will normally be hard put to it to invoke [sub-s 59(7) VATA]. In other words he will be hard put to persuade the commissioners or the tribunal that he had a reasonable excuse for venturing and thus losing money destined for the Exchequer of which he was the temporary custodian."

30. Nolan LJ concluded (at page 769) that he felt bound to uphold the earlier decision in favour of the taxpayer in the light of the findings of fact by the tribunal that as a result of the conduct by the council the taxpayer found himself without sufficient funds to pay the tax due as at the relevant due dates and that "if the taxpayer had brought pressure to bear on the council he would probably have received no further orders and the bulk of his livelihood would have disappeared".

31. He noted, however, (at 769 b to c) that in his view the tribunal's findings of fact in this regard were surprising. He noted, in particular, that the taxpayer appeared to have been well aware of his obligations and of the dilatory habits of the council, he appeared to have been able to cope with the problem when making a return for a different period (as there was no surcharge for that period) and there was no apparent reason why the 6 to 8 weeks delay in the payment of his bills should necessarily have resulted in the taxpayer being unable to account for the tax element in them as regards the relevant periods.

32. Lord Donaldson interpreted Nolan LJ's judgement as follows (and noted that in any event this represented his own view) (at 770 d):

> "Nolan LJ, as I read his judgement explaining and expanding on his judgement in [*Salevon*] is saying that if the exercise of reasonable foresight and of due diligence and a proper regard for the fact that tax would become due on a particular date would not have avoided the insufficiency of funds which led to the default, then the taxpayer may well have a reasonable excuse for non-payment, but that excuse will be exhausted by the date on which such foresight, diligence and regard would have overcome the insufficiency of funds.

33. Lord Donaldson continued to expressly reject the view of Scott LJ (at 770 e to f):

> "Scott LJ on the other hand is of the opinion that the underlying cause of the insufficiency of funds must be an unforeseeable or inescapable event. I have come to the conclusion that this is too narrow in that (a) it gives insufficient weight to the concept of reasonableness and (b) it treats foreseeability as relevant in its own right, whereas I think that

> "foreseeability" or as I would say "reasonable foreseeability" is only relevant in the context of whether the cash flow problem was "inescapable" or , as I would say, "reasonably avoidable". It is more difficult to escape from the unforeseeable than from the foreseeable".

Decision on reasonable excuse

34. On the authority of *Steptoe*, therefore, the tribunal can consider whether the reasons put forward by the appellant for the lack of funds to pay the VAT on time constitute a reasonable excuse. In considering this we are bound by the comments of the majority of the Court of Appeal in Steptoe as to how to apply this test. The test, as conveniently summarised by Lord Donaldson, is that a taxpayer may have a reasonable excuse if the exercise of reasonable foresight and due diligence and a proper regard for the fact that tax would become due on a particular date would not have avoided the taxpayer lacking the funds to pay VAT by the due date (assuming the excuse is not exhausted (see 32)). We see this as essentially applying the reasonable excuse test, as it has been generally interpreted by the courts (see 20), in the particular context of a case where the immediate cause of the default is an insufficiency of funds.

35. Lord Donaldson noted that he thought his summary reflected Nolan LJ's views (although if it did not he noted that his comments reflected his own views). In our view, it is clear that Lord Donaldson's summary reflects what Nolan LJ intended. Nolan LJ emphasised that the question for the tribunal is to determine whether in the circumstances, having regard to the scheme of the legislation, the cause of the lack of funds is a reasonable excuse. No restriction should be put upon this general test. He clarified that he had not intended to do so in his earlier decision in *Salevon.* Whilst he had commented in that case that the wrongful actions of the company secretary were unforeseeable and inescapable events, he did not mean that there could be a reasonable excuse only in such circumstances (albeit that the circumstances sufficient to constitute a reasonable excuse in this context may be relatively rare).

36. In this case, the break in to the appellant's premises which lead to an unexpected loss of around £8,000 and disruption to the appellant's business happened on 8 March 2015, just under one month prior to the due date for the VAT payment. The loss of funds due to the break in lead to the appellant using cash reserves set aside to make the VAT payment for the period 02/15 to meet other business costs.

37. Clearly, in planning for meeting his VAT obligations for the period 02/15 the appellant could not reasonably be expected to have anticipated the break in and consequent losses. The question for the tribunal is whether, in the period from the time when the break in occurred with its consequent losses and disruption to the business, the exercise of reasonable foresight and due diligence and a regard for the timely payment of VAT would have avoided the appellant being unable to meet its VAT obligations for the 02/15 period by the due date.

38. When the break in happened the appellant should have been aware that the substantial loss of £8,000 would potentially adversely impact upon its cash flow

position in the short term thereby affecting its ability to meet its next VAT payment on time. It appears that an insurance claim was promptly made but it would be reasonable to expect that settling the insurance claim would take a period of time and indeed funds were not received from the insurers until after the due date. From the evidence given Mr McLennan considered these difficulties when the break in happened and he noted that he had had to resort to using funds set aside to meet the VAT payment to keep the business running. However, at that time he estimated that the appellant should receive sufficient takings from the business to compensate for the lost funds so that the appellant could nevertheless make the VAT payment by the due date. It was only a few days before the due date that the sharp drop in takings occurred which meant that Mr McLennan's initial projections were not met. This meant that in fact the lack of funds caused by the break in was not fully compensated for by the expected takings of the business. It was the combination of the cash flow problems caused by the break in compounded by this unexpected drop in takings which lead to the insufficiency of funds.

39. This raises the further question as to whether it was reasonable for the appellant to rely on the expected turnover from the business as sufficient to make up the deficit in funds arising from the break in given that Mr McLennan was aware that the precise level of takings from the business was highly weather dependent. We have found this aspect of the case difficult.

40. We would expect the exercise of reasonable diligence and foresight by a business which, as here, has been carrying on a weather dependent business for some time to lead the business to make some allowance in its cash flow projections and its expected funding requirements for such "ups and downs" to ensure that generally it has sufficient funds to meet it VAT obligations. On that basis we would not usually expect on-going fluctuations in business takings caused by weather conditions of itself to be a reasonable excuse. However, in this case, it is not simply on-going fluctuations in weather conditions which has lead to the lack of funds. It is the combination of the prior effects of the break in, occurring just one month before the due date, exacerbated by the effects of a particularly unseasonable and unexpected rise in temperatures occurring in that following month just a few days before the due date.

41. Our view is that a small business in the appellant's circumstances, exercising due diligence and reasonable foresight, could not reasonably have been expected, when faced with this particular combination of difficulties occurring so shortly before the due date, to be able to have avoided the lack of funds to pay the VAT by the due date.

42. We note that HMRC have submitted that the appellant should have approached them to agree an extended time to make the VAT payment and that, if it had, an extended time would have been agreed. However, the granting of additional time to pay is not automatic and it is a matter of speculation as to whether the relevant HMRC officer would have agreed to this or not. The fact that Mr McLennan did not approach HMRC on this basis does not affect our conclusion.

43. Nor is our conclusion affected by HMRC's submissions that the appellant's cashflow deficit represented only 10 per cent of the appellant's VAT outputs for the period. The appellant may well have been operating according to tight margins but we do not see that of itself as preventing the appellant from having a reasonable excuse under the applicable test.

44. Finally we note that HMRC assert that "by not paying the VAT due by the due date in effect the business was treating the VAT as an interest free loan and had taken the risk that it would not have sufficient funds to pay the VAT should circumstances change". This appears to be taken from the comments of Nolan LJ in *Steptoe* (see 29 above). However, these comments cannot mean, as HMRC seem to say, that of necessity by having used the funds in the business the taxpayer can never have a reasonable excuse. That would simply negate the conclusion that the cause of an insufficiency of funds can be a reasonable excuse. Nolan LJ was emphasising that the occasions when a taxpayer is likely to have a reasonable excuse will be rare but, as set out in the rest of his judgement, this will depend on the precise reason giving rise to the deficit and all the circumstances of the case.

45. For all the reasons set out above we have decided that the appellant has a reasonable excuse for failing to pay the VAT due for the period 02/15 on time.

Disproportionate

46. Whilst we have decided this case on the basis that the appellant had a reasonable excuse, we have also considered whether the surcharge was disproportionate in case we are wrong on the reasonable excuse position.

47. The question of whether the default surcharge regime or a particular surcharge can be defeated on the basis it is disproportionate, both from the perspective of EU law and of the European Convention on Human Rights, has been considered in detail by the Upper Tribunal in *HMRC Revenue and Customs Commissioners v Total Technology (Engineering) Ltd* [2010] UKUT 418 (TCC) and most recently in *The Commissioners for Her Majesty's Revenue and Customs v Trinity Mirror Plc* [2015] UKUT 0421.

48. In *Total Technology* the issue was whether a surcharge of £4,260.26 imposed at the rate of 5 per cent as a result of the late payment of VAT of £85,205 was disproportionate. It was held at [99] that there was nothing in the VAT default surcharge regime which led to the conclusion that its architecture was fatally flawed in the sense of the entire scheme being unlawfully disproportionate. However, there were some aspects of the default surcharge regime which may lead to the conclusion that on the facts of a particular case a penalty is disproportionate. The tribunal cautioned that in making any such assessment the tribunal must be astute not to substitute its own view of what is fair for the penalty which Parliament has imposed.

49. At [100] the tribunal noted that:

> "Our conclusion, therefore, is that with the possible omission of an upper limit on the penalty which may be imposed, the regime viewed as a whole

> does not suffer from any flaw which renders it non–compliant with the principle of proportionality in the sense that it, or some aspect of it, falls to be struck down."

50. The tribunal went on to suggest at [93] that the fact that there was no maximum penalty was a "real flaw" and that "there must be some upper limit, although it is not sensible for us in the present case to suggest what that might be". This was on the basis that it was plain that the penalty in that case could not be described as "devoid of reasonable foundation" or "not merely harsh but plainly unfair" so that it comfortably fell below the possible upper limit.

51. Having concluded that the regime as a whole was not fatally flawed, the tribunal turned to considering whether the particular surcharge was disproportionate. At [101] the tribunal rejected the taxpayer's submissions that the penalty was unfair on the basis that payment was only one day late, previous defaults were innocent, the taxpayer had an excellent compliance record prior to the first of the defaults leading to it being in the regime and the amount of the penalty represented an unreasonable proportion of the taxpayer's profits.

52. The tribunal noted that even if the penalty was more than would be imposed if it were a matter for the decision of a tribunal, the amount of the penalty did not approach the sort of level which had been held to be disproportionate in an earlier case which was described as "unimaginable". It was noted that the result for the taxpayer may be seen by some as harsh, but that the tribunal did not consider that it could be regarded as "plainly unfair".

53. In the *Trinity Mirror* case the Upper Tribunal upheld a default surcharge of £70,906.44 imposed at the rate of 2 per cent for the failure by one day to file a VAT return and pay the VAT due for the relevant period of £3,545,324. The tribunal agreed with the tribunal in *Total Technology* that the default surcharge regime, viewed as a whole, is a rational scheme (at [65]). The tribunal noted, however, that:

> "applying the tests we have described, the absence of any financial limit on the level of a surcharge may result in an individual case in a penalty that might be considered disproportionate. In our judgement, given the structure of the default surcharge regime, including those features described in *Total Technology*, this is likely to occur only in a wholly exceptional case, dependent upon its own particular circumstances 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 characteristic of a case where such a challenge is likely to succeed."

54. The tribunal concluded at [68] that although payment was only one day late, they accepted that the scheme of the regime is to impose a penalty for failing to pay VAT on time and not penalise further for any subsequent delay in payment. They considered that to be entirely consistent with the fiscal neutrality aim of the directive. They noted at [70] that the gravity of the default must be assessed by reference to the

relevant factors, first that it was a second default, in respect of which Trinity Mirror had been notified by the surcharge liability notice issued following the first default that further default within the surcharge period could result in a surcharge and, secondly that it was in a substantial sum.

55. Finally the tribunal concluded at [70] and [71] that:

> "Having regard to the need, in order to preserve the fiscal neutrality of the VAT system, to enforce prompt payment of VAT collected by a taxable person, a penalty of 2% cannot be regarded as so disproportionate to the gravity of the infringement as to constitute an obstacle to the underlying aim of the directive.
>
> Nor can the surcharge be regarded as disproportionate by reference to the Convention. It has been arrived at by the application of a rational scheme that cannot be characteristics as devoid of all foundation. The penalty might be considered harsh, but in our view it cannot be regarded as plainly unfair."

56. Following the approach in these cases, we have concluded that the surcharge imposed on the appellant in this case is not disproportionate. We note in particular that the appellant had received a number of previous surcharges and had been in default ever since it first registered for VAT until the period in question. The prior notices and surcharges would have alerted the appellant to the fact that a further penalty would be charged at the higher rate of 15 per cent in the event of further default.

57. We also conclude that there is no power to mitigate the surcharge. The default surcharge regime does not include a power to mitigate. In *Total Technology* the Upper Tribunal concluded that the absence of such a power did not render the regime as a whole disproportionate but, if they were wrong on that, then such a power should only be regarded as included in exceptional circumstances. We do not consider that there are any exceptional circumstances in this case.

Conclusion

58. For the above reasons, the appeal is allowed on the basis that the appellant had a reasonable excuse for the late payment of VAT for the 02/15 period.

59. 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.

HARRIET MORGAN

TRIBUNAL JUDGE
RELEASE DATE: 25 NOVEMBER 2015