[2014] UKFTT 491 (TC)

TC03617

Appeals numbers: TC/2012/08608 & TC/2012/08609

INCOME TAX & NIC – liability of directors for unpaid PAYE liabilities of liquidated company - reg 72 Income Tax (PAYE) Regs 2003 – Reg 86 Social Security (Contributions) Regs 2001 – whether conditions met – appeals allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

MR JAN PROWSE **MRS LOUISE ANNE PROWSE**	**Appellants**
- and -	
THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS	**Respondents**

TRIBUNAL: JUDGE PETER KEMPSTER
MRS SHAMEEM AKHTAR

Sitting in public at Priory Courts, Birmingham on 15 May 2013

Mr Gary Rooney (Rooney Tax Services) for the Appellants

Mr Russell Kirk (HMRC Appeals Unit) for the Respondents

DECISION

1. Mr Prowse and Mrs Prowse were directors of Supablast Nationwide Limited ("the Company"). The Company was liquidated in October 2010 leaving unpaid PAYE (income tax and NIC) liabilities, part of which related to amounts paid to Mr & Mrs Prowse. HMRC made determinations effectively shifting those liabilities from the Company to Mr & Mrs Prowse (the relevant legislation enabling that is detailed below). Those determinations were upheld by a formal internal review. Mr & Mrs Prowse appealed against the determinations and the matter comes before this Tribunal.

2. The disputed determinations in relation to income tax were amendments to the self-assessment tax returns of Mr & Mrs Prowse for the two tax years2009-10 and 2010-11, and the formal appeals were against those adjustments. With HMRC's agreement, the Tribunal determined that it would, to the extent necessary to dispose of the dispute, treat the appeals as also being against HMRC's direction notice under reg 72 (details below), and also admit any late appeals.

Law

3. Regulation 72 Income Tax (PAYE) Regulations 2003 (SI 2003/2682) provides:

> **"Recovery from employee of tax not deducted by employer**
>
> (1) This regulation applies if—
>
> (a) it appears to the Inland Revenue that the deductible amount exceeds the amount actually deducted, and
>
> (b) condition A or B is met.
>
> (2) In this regulation and regulations 72A and 72B—
>
> "the deductible amount" is the amount which an employer was liable to deduct from relevant payments made to an employee in a tax period;
>
> "the amount actually deducted" is the amount actually deducted by the employer from relevant payments made to that employee during that tax period;
>
> "the excess" means the amount by which the deductible amount exceeds the amount actually deducted.
>
> (3) Condition A is that the employer satisfies the Inland Revenue—
>
> (a) that the employer took reasonable care to comply with these Regulations, and
>
> (b) that the failure to deduct the excess was due to an error made in good faith.
>
> (4) Condition B is that the Inland Revenue are of the opinion that the employee has received relevant payments knowing that the employer

wilfully failed to deduct the amount of tax which should have been deducted from those payments.

(5) The Inland Revenue may direct that the employer is not liable to pay the excess to the Inland Revenue.

(5A) Any direction under paragraph (5) must be made by notice ("the direction notice"), stating the date the notice was issued, to—

(a) the employer and the employee if condition A is met;

(b) the employee if condition B is met.

(5B) A notice need not be issued to the employee under paragraph (5A)(a) if neither the Inland Revenue nor the employer are aware of the employee's address or last known address.

(6) If a direction is made, the excess must not be added under regulation 185(5) or 188(3)(a) (adjustments to total net tax deducted for self-assessments and other assessments) in relation to the employee.

(7) If condition B is met, tax payable by an employee as a result of a direction carries interest, as if it were unpaid tax due from an employer, in accordance with regulation 82 (interest on tax overdue).

(8) The tax payable carries interest from the reckonable date until whichever is the earlier of—

(a) the date on which payment is made, or

(b) the date (if any) immediately before the date on which it begins to carry interest under section 86 of TMA."

4. Regulation 72C provides:

"**Employee's appeal against a direction notice where condition B is met**

(1) An employee may appeal against a direction notice under regulation 72(5A)(b)—

(a) by notice to the Inland Revenue,

(b) within 30 days of the issue of the direction notice,

(c) specifying the grounds of the appeal.

(2) For the purpose of paragraph (1) the grounds of appeal are that—

(a) the employee did not receive the payments knowing that the employer wilfully failed to deduct the amount of tax which should have been deducted from those payments, or

(b) the excess is incorrect.

(3) On an appeal under paragraph (1) that is notified to the tribunal, the tribunal may—

(a) if it appears that the direction notice should not have been made, set aside the direction notice; or

(b) if it appears that the excess specified in the direction notice is incorrect, increase or reduce the excess specified in the notice accordingly."

5. Regulation 86 Social Security (Contributions) Regulations 2001 (SI 2001/1004) provides (so far as relevant):

"**Special provisions relating to culpable employed earners …**

(1) As respects any employed earner's employment—

(a) where there has been a failure to pay any primary contribution which a secondary contributor is, or but for the provisions of this regulation would be, liable to pay on behalf of the earner and

(i) the failure was due to an act or default of the earner and not to any negligence on the part of the secondary contributor , or

(ii) it is shown to the satisfaction of an officer of the Board that the earner knows that the secondary contributor has wilfully failed to pay the primary contribution which the secondary contributor was liable to pay on behalf of the earner and has not recovered that primary contribution from the earner; …

the provisions of paragraph 3(1) of Schedule 1 to the Act (method of paying Class 1 contributions) shall not apply in relation to that contribution.

…"

Evidence

6. As well as bundles of documents prepared in accordance with case management directions the Tribunal heard oral testimony from (a) for the Appellants, Mr Prowse and Mr John Baldwin of Baldwins (Walsall) Limited (accountants to Mr & Mrs Prowse and the Company); and (b) for HMRC, Miss Mandy Morton (HMRC officer who made the disputed determinations). We found all the witnesses credible and reliable.

Mr Prowse's evidence

7. Mr Prowse had been a director of the Company from 1992 until its liquidation in October 2010. The main business of the Company was shot blasting and industrial painting, mainly for the rail sector. The Company held industry accreditations and was a preferred contractor to major corporations, winning prestigious contracts. The North Seaton contract was a £1.5 million contract for Balfour Beatty. The bid for the North Seaton contract was in October/November 2009 and was a very large job for the Company. One third of that contract related to scaffolding work, which the Company subcontracted. The scaffolding subcontractor, who had been used before and had proved reliable, insisted on being paid before the Company received funds from the contractor. The subcontractor did not have the cash to resource the project and so the Company helped by funding in advance amounts to cover wages and plant hire. The scaffolder failed financially and there was nowhere to go, even with a counterclaim. The Company simply ran out of money. There was profit in the job

and the client was happy with the proposals; the project was fully viable until the subcontractor got into difficulties. The contract was taken over by the contractor who made large retentions and recharged large completion costs to the Company. Until the issue with the scaffolder surfaced in June 2010 no problems were foreseen for the Company; it had been enjoying its best years ever; there were lots of new contracts and the Company was expanding and optimistic, taking on new staff, including a qualified quantity surveyor. When the problems became apparent there were 30 staff on the payroll. The liquidator was still trying to retrieve £280,000 from Balfour Beatty; there were also retentions due for release from other major rail contractors, and those recoveries were ongoing.

8. In the past the directors had been remunerated by small salaries and large dividends but there were problems with large lump sum tax bills. When the year-end tax bills arrived, although he did have the money to pay them, it always came as a big shock. He felt it was better to go onto PAYE. There was also a need to top up the directors’ pension funding. The change of salary was discussed in January 2009 in a conversation with Mr Baldwin at the accountants’ offices which covered several topics. It was in Mr Prowse’s mind because his financial adviser had recently mentioned the topic. He met with Mr Baldwin several times each year and was in email correspondence whenever he needed advice. He did not keep a note of the meetings, although Mr Baldwin might have done so. Mr Baldwin explained the tax and NIC implications, but the advantage was that there would not be a problem of large tax payments due at the year-end. Although there was slightly more tax payable overall by taking salaries he was prepared to do this because the overall difference was not great, and with no great impact on the business he preferred the certainty of knowing the tax payments. Having a higher salary put him in a better position if he wanted to apply for a loan – for example on remortgaging his house, or in adding to his property investment portfolio. He did not understand the detailed pension position and relied on his financial adviser; in fact, pension contributions had not been increased but that was because of the recession.

9. DMW Payrolls (“DMW”) undertook all the payroll tasks. DMW had been used for many years without any problems. Mr Prowse knew the net amount he and his wife needed each month and DMW were asked to compute gross figures from those net figures. The total amount was higher than before because he needed to pay household bills and his mortgage. Everything went through the normal payroll and he received monthly payslips. Some staff were paid weekly and some monthly. He received the payslips at the correct time. His payments were on three standing orders plus one for his wife. They were paid at different times of the month. Both received payslips which were sent by DMW to the company's accounts clerk, who would hand the payslips to him or put them in a desk drawer. Similarly for his wife. He was not an accountant but he understood that his net pay was credited to a director’s loan account and sums drawn, with the difference settled at the end of the year by dividend.

10. Mrs Prowse had been a director since 2006. Her responsibilities were mainly marketing and looking after the website. She worked partly from home, and partly from the Company's offices. She always knew about her payslips.

11. The Company had an accounts department, which paid the wages, but the PAYE SAGE accounting system was run by DMW. Employees were paid by cheque or by BACS. An accounts clerk kept a diary of hours worked by staff and sent those to DMW. DMW prepared the payroll and did all the calculations. Mr Prowse would authorise the BACS & the cheques.

12. He did not take funds without PAYE; PAYE was being correctly operated by DMW. DMW entered everything into the SAGE accounting package.

13. The reason the PAYE was not paid to HMRC was simply company cash flow. There had been payroll compliance visits from HMRC a couple of times in the past, but they raised no concerns.

14. Asked by Mr Kirk for HMRC why the cash payments and standing orders bore no relation to the payslips, Mr Prowse replied that the standing orders were staggered through the month and the difference was only a small difference from the net pay on the joint accounts – perhaps £400 per month. He was busy running the business and did not want to worry about these matters from month to month. The standing orders in earlier years were probably roughly the same amounts.

Mr Baldwin's evidence

15. Historically Mr Prowse had a low salary from the Company. It was more cautious to take dividends rather than salaries from the Company and so protect the Company's profits. In January 2009 there had been a discussion concerning the mix of salaries and dividends. Every year it was a challenge concerning the amount of personal tax to pay. The Company year-end was 30 April, which also gave rise to 31 January tax payments. This was always a major problem. Using a higher salary would produce regular PAYE deductions rather than large lump sum tax payments. There was also discussion concerning pensions and mortgages, but these were secondary to the stress created by large tax payments. Looking at all tax and NIC liabilities together, overall there was not a big difference between extracting money through dividends or salaries. There was a small net amount extra to pay and more NIC, but there was the reduced stress of not having to find large payments every January. At the advice meeting the difference between salaries and dividends was not precisely quantified but it was known that there would be slightly more cost – probably a couple of thousand pounds. Mr Baldwin did not have a record of the discussion or his advice.

16. Mr Baldwin met with Mr Prowse three times a year and there were six or seven phone calls. That was the typical involvement expected for a company of this size. The Company's accounts staff were not sufficient to produce monthly management accounts. Payroll information was prepared by DMW. DMW was not connected with Baldwins. The company accounts were prepared from records on the SAGE computer system. Various people had input into the SAGE system. DMW would have done some of this. After the year-end Baldwins would analyse some accounts, including the director loan accounts and propose some adjustments. This was a very common practice in small companies. The net pay figure came from DMW at the end

of the year. It differed from the P35 data because the accounting year-end was 30 April, compared to the 5 April tax year-end. The net pay was credited to the director's loan account; Mr & Mrs Prowse would then draw funds from the Company, which would not necessarily match the net pay credited to the loan account; any differences at year-end were reviewed and covered by the voting of a dividend to them as shareholders; this was common practice in smaller companies and accepted as permissible by HMRC. When salary was credited to the loan account, or otherwise entered in the records of the business and made available to the directors, then it should be subjected to PAYE – that is what happened in this case when DMW computed the payslips and entered all the figures in the SAGE records.

17. The last set of accounts prepared was the 2008 accounts. There were shareholder funds of £262,000 in April 2008. That was an increase from the opening balance and showed a successful company on an upward trajectory. No substantial work was undertaken in relation to the preparation of the 2009 accounts, only preliminary work. The accounts clerk had undergone major surgery and did not produce much information for Baldwins. Baldwins never received the SAGE disks. In January 2010 the accounting period was extended (from 30 April to 31 October 2009) and then in the summer the financial problems manifested. He did not know if DMW still had any records – they may have been passed to the liquidator. Had the Company not gone into liquidation then the same method of accounting would have been used for future years. Work had started on the 2009 accounts but was not completed because of the liquidation. Baldwins would have put forward adjustments for net salaries, derived from DMW's SAGE payroll records, and other corrections. When the Company went into liquidation both the Company and Baldwins handed over relevant records to the liquidator. One of the roles of the liquidator was to consider the conduct of the directors; the liquidator had confirmed there was no evidence of wilful non-deduction of PAYE.

18. The company had deducted PAYE. DMW had been instructed to give a gross pay figure sufficient to provide a net amount of around £11,000 per month, and that was done. The amounts paid into the bank accounts do bear comparison with the payslips. It was not correct – as suggested by HMRC – that the payroll details and payslips were produced retrospectively.

19. The Company had had a number of PAYE compliance visits over the years. There was a full investigation around 2005, which looked at everything, including directors loan accounts. There were a number of private payments which clear through the directors loan account. The main focus of the investigation had been personal expenses being put through the Company and there was a problem concerning some motorsport expenses in the accounts. All those matters been settled and there were no PAYE issues. The Company held a CIS gross payment certificate.

Miss Morton's evidence

20. Miss Morton had not been satisfied by the payslips that had been produced. The PAYE Regulations were clear that a Form P11 deductions working sheet (or equivalent) must be maintained (reg 22) and a Form P14/P35 year end return be made

(reg 73). From her scrutiny of the bank statements it was clear that the payments to the directors did not match the payslips. It was usual for a PAYE calculation to produce amounts of deductions (and thus of net pay) that differed by pence from month to month; that had not happened here. She had concluded that a regular gross amount had been extracted each month, without any deduction of tax. The PAYE Regulations required contemporaneous deduction of the relevant amounts from every payment, and she was not satisfied by the explanation given concerning adjustments to the directors' loan accounts at the end of the year. Having heard Mr Baldwin's fuller explanation at the hearing of the workings of the directors' loan accounts, she was still of the opinion that the conditions in reg 72 were satisfied.

21. It appeared that Forms P45 had been produced by the liquidator of the Company (and HMRC did hold on file those details) but not a Form P35. Her calculation of the true gross pay was the aggregate monthly receipts in the relevant tax years.

22. Her conclusions had been confirmed by a superior officer before issue of the determinations, and had been subsequently upheld on a formal internal review.

The letter from DMW

23. No representative of DWW attended the hearing but in evidence was a letter dated 11 February 2013 from DMW which stated:

> "I started working for Mr and Mrs Prowse approximately 10 years ago.
>
> During the time that I worked for Mr and Mrs Prowse, I was responsible for assisting in the preparation of Companies accounts records. These duties included operating a full payroll service on behalf of the Company.
>
> The salary figures which I required to run the payroll were supplied to me on a regular weekly basis by Mr J M Prowse. I can confirm that at the start of the 2009/2010 tax year, I was informed by Mr Prowse that there was to be a significant increase in the annual wages figures for both Mr and Mrs Prowse. Mr J M Prowse annual salary increased from £5,720 for the year ended 5 April 2009, to a figure of £156,000 for the year ended 5 April 2010. Mrs L A Prowse annual salary increased from £39,520 for the year ended 5 April 2009, to £78,000 for the year ended 5 April 2010. I can also confirm that these instructions were given to me in April 2009.
>
> With the exception of the occasional monthly paid employees (not Mr J M Prowse or Mrs L A Prowse) I can confirm that the wages were prepared by DMW Payrolls on a weekly basis. The payroll was prepared weekly using a SAGE Payroll Package and covered all employees including Mr J M Prowse and Mrs L A Prowse. The relevant payslips were produced at the time of running the payroll and P35's prepared at the relevant year end. Copies of the Companies P35's for year ended 5 April 2009 and 5 April 2010 are enclosed herewith.

> I can confirm DMW Payrolls continued to operate the payroll in the aforementioned manner on behalf of the Company until it ceased trading and went into liquidation during October 2010.
>
> I am content for this letter to be produced before a Tax Tribunal and I accordingly certify that the details given herein are true."

The letter from the liquidator

24. In evidence was a letter dated 23 May 2012 the Company's liquidator (Mr Moore) wrote to Baldwins, which stated:

> "I am surprised to hear that you have received correspondence suggesting that they [ie Mr & Mrs Prowse] have wilfully failed to deduct tax and national insurance contributions properly from the earnings that they have received from the Company.
>
> In my investigations, whilst the Company had considerable arrears of payments to [HMRC] caused I believe by cashflow difficulties resulting from non-payment of contract debts by employers under those contracts, I have not found any evidence of any wilful withholding of payments in respect of their remuneration."

Respondents' Case

25. Mr Kirk for HMRC submitted as follows.

26. The basis for HMRC's determination was that Condition B in reg 72(4) was met. There were three elements to that test:

(1) The employee received relevant payments (not in dispute);

(2) The employer wilfully failed to deduct the right amount of tax from such payments; and

(3) The employee knew of such failure.

27. In applying those tests HMRC had considered the Company's tax compliance history; how the tax debt arose; and representations from the relevant employees.

28. The method of payment for Mr & Mrs Prowse in tax years 2009-10 and 2010-11 was different from that adopted in earlier years. Past practice had been for there to be some earnings (subject to PAYE) and then an additional larger amount of dividend voted annually, based upon the profitability of the Company. The figures drawn from the Appellants' self-assessment returns were as follows.

	Tax year	Employment income £	Dividends £
Mr Prowse	2006-07	5,200	120,429
	2007-08	5,830	124,108
	2008-09	5,720	155,861
	2009-10	156,000	0

	2010-11	83,400	0
Mrs Prowse	2006-07	39,520	120,429
	2007-08	40,280	124,108
	2008-09	39,520	155,861
	2009-10	78,000	0
	2010-11	42,250	0

29. Miss Morton had compared the cash payments made by the Company to the directors (as shown on the bank statements) with the payslips for the same period, and had identified inconsistencies. The accountants had stated that the directors drew their money from the Company in instalments. HMRC's considered view was that the method of cash extraction had remained the same throughout, in that monthly withdrawals were made on the basis that at the end of the accounting year a reconciliation could be made. When the likelihood of insolvency had been realised, and thus that no dividend could be paid, there was then a retrospective reconsideration as to how to treat the monies extracted, and they were treated as sums net of PAYE (thus giving a deduction-at-source credit to the directors). In reality the sums paid to the directors' bank accounts were gross amounts because no consideration had been given at that time that the amounts would not be covered by voting a year end dividend. HMRC had also concluded that, in response to Miss Morton's enquiries, a decision had been made to produce retrospective payslips to present to HMRC the false picture that the Company had properly and timeously deducted PAYE tax and NIC correctly.

30. The payslips presented were insufficient evidence that the Company had deducted the right amount of tax. A similar conclusion had been reached by the Special Commissioner in *Moran v RCC* [2008] STC (SCD) 787:

> "22. I find as fact that no PAYE tax in respect of deductions from the appellant's employment income had been sent to the respondents by J Moran Construction Ltd, Vector Construction Ltd or Vector Builders Ltd between 6 April 1996 and 5 April 1999. In the light of that finding the onus was on the appellant to demonstrate on the balance of probabilities that the said amounts of income tax as declared in his self-assessment returns for the years in dispute were deducted from his earnings. The appellant chose not to attend the hearing to give oral evidence. Further he did not comply with Miss Winn's request of 18 March 2002 for company payroll records and personal bank statements for each of the years in question. The only documents produced by the appellant to support his contention that tax was deducted from his earnings were copies of payslips from Vector Construction Ltd for the period from 1 April 1997 to 31 March 1998. I place no weight on the information contained in the payslips because the information on its own did not demonstrate that tax had been deducted from his earnings. I, therefore, find that the appellant has failed to satisfy me on the balance of probabilities that he should be given credit for the tax he

> alleged was deducted from his employment earnings with the three companies for the years in question."

31. The circumstances of the current case mirror those of the Tribunal case of *Michael Owen Williams v HMRC* [2012] UKFTT 302 (TC). There the Tribunal stated:

> "12. In the tax year 2004/05, Mr Williams received a salary from Instafix of £4,680 and a dividend of £58,000. In the following year, he received a salary of £4800 and a dividend of £110,000. The Commissioners accepted that Instafix might structure its payments to directors and shareholders in that way, so that they were satisfied that the company had no liability to account for tax on the salaries paid to Mr Williams, each being below his personal allowance for the years in question. Instafix was however required to prepare and maintain a deductions working sheet for PAYE purposes (see reg 66 of the 2003 Regulations). We find that it did not do so. We infer that Instafix was provided with a PAYE code for Mr Williams.
>
> 13. From the accounts produced to us, it would appear, and we find, that in the tax year 2006/07 Instafix moved into a loss making situation. Consequently, in November 2006 it was not in a position to pay a dividend for 2006/07 out of income, or for that matter out of reserves. Nevertheless, from April 2006 onwards Mr Milligan and Mr Williams both continued a practice of withdrawing round sums from the company's bank account on a weekly basis. Such monies were initially shown in the company's nominal activity ledger as "dividends" (E8 and 9). The sums in question were not insignificant, in Mr Williams' case being of the order of £2000 per week. He continued withdrawing similar sums until 4 April 2007, but claimed that from April 2006 onwards they represented salary net of tax and NIC. On 10 July 2009 (C36), CCW, Instafix's accountants, wrote to Mrs Elston saying,
>
> > "We were later advised, prior to the liquidation, that the November 2006 dividend was not declared as there was concern as to whether it was legal (i.e. a possible lack of distributable funds) – so we therefore presume the loan account was cleared by way of a bonus, but as we have not seen the payroll records as they were submitted to Campbell, Crossley & Davis [the firm in which the liquidator was a partner], we are unable to comment further."
>
> (The reference to the clearing of Mr Williams' loan account must be read against a background of the account having been overdrawn at 31 March 2006 to the extent of £102,163). In our judgment, the accountants' letter speaks for itself as indicating that Mr Williams was advised, and thus was well aware, of Instafix's precarious financial position at the end of 2006 and in the early part of 2007.
>
> 14. Mr Williams claimed to have severed all connection with Instafix in January 2007, and to have transferred his shareholding to Mr Milligan on 3 January of that year (Statement of Company's Affairs filed by the liquidator pursuant to section 95/99 of the Insolvency Act 1986 at B99 et seq). Yet on 24 February 2007 Mr Williams signed "[an

authorisation] in accordance with the [RBS] Bank Account Mandate" (E1) sending a CHAPS payment of £4526.10 from Instafix's account to Clear View Windows. He continued to withdraw sums of approximately £2000 per week from Instafix's bank account through to April 2007 (D9-D14). We find that he did not sever his connection with the company in January 2007: he remained the controlling party of Instafix until the company went into liquidation, was closely connected with the daily operation of its financial affairs and dealt with its finances.

15. Further, Mr Williams instructed Instafix's bookkeeper, Mrs Angela Stanworth, to reconstruct the company's nominal activity account on its Sage system, and we find that she did so on 22 February 2007. In an email of 9 February 2007 (E6) Mrs Stanworth had informed Mr Williams that she had "finished calculating the amended wages for the current year", adding "This will increase the company PAYE liability by £63,400". She asked that he "confirm that this is ok so that I can amend the sage account accordingly". We are satisfied that he did so confirm for, in a note endorsed on the print out of that account, in handwriting we find on the balance of probabilities to have been that of Mrs Stanworth, she recorded (E11):

> "Reallocation of dividends posted in error for MOW [Mr Williams] per MOW 9/2/07 all amounts for him in 06/07 related to net wages, shares were reallocated but forgot to advise. Have reworked wages to take this into account and advised of additional [tax] liability."

16. We do not accept that dividends were posted 'in error' to Mr Williams or that he 'forgot to advise' Mrs Stanworth of the 'reallocation' of his shares; indeed we find to the contrary. All the evidence, and particularly that of the company not having declared a dividend in November 2006, points to his having been advised, or realised, that the company was not in a position to pay a dividend in 2006-07. We further find that he deliberately instructed Mrs Stanworth to reconstruct Instafix's records in such a way as hopefully to ensure that he had no personal tax or NIC liability on the drawings he had made from the company in that year.

17. On 15 May 2007 Instafix submitted its annual return of the PAYE tax and NIC for which it had to account (reg. 73 of the 2003 Regulations) showing tax due of £174,465.20 and NIC of £75,892.01. The majority of the tax returned related to payments made to Mr Milligan and Mr Williams, and has never been paid.

18. Mr Williams included a salary of £249,400 from Instafix in his self-assessment return for 2006/07, and claimed that tax of £91,706 had been deducted therefrom, so that he was entitled to a tax refund of £1,265.36. His net salary on the declared basis would have been £157,694, which closely compares with the figure of £156,700 showed as paid to him in the company's bank statements and BACS payment sheets (D3 et seq). No explanation has ever been provided for the discrepancy between the amount returned and Mr Williams' actual receipts.

> 19. We might add that Mr Williams was asked by the Commissioners to provide evidence of deduction of tax and NIC from his salary but, apart from his producing payslips which the Commissioners rejected as having being prepared no earlier than February 2007 and being designed to deceive (see the submissions of Mr Kane below), he never did so. Mr Milligan claimed that Mr Williams was responsible for Instafix's financial affairs throughout the events with which we are concerned. Since Mr Williams chose not to attend the hearing, we are unable to test his own claim that he was not so responsible and, on the basis of all the evidence before us, we conclude that Mr Milligan's claim was correct."

32. The basis for reconciling after the end of the accounting period payments made by adjusting a director's loan account had been reviewed by the High Court in *R v Inland Revenue Commissioners, ex parte McVeigh* [1996] STC 91. May J stated (at 98):

> "The evidence relied on by Mr McVeigh is to the effect that he received money which was entered as a debit to his loan account; that the company decided to award bonuses in each of the years in gross amounts of £25,200 and £25,000; that the awarding of these bonuses is evidenced by the accounts and that the amounts for creditors in the accounts includes the tax and national insurance contributions calculated on those bonuses; that the amounts net of tax and national insurance contributions were credited to the loan account and that accordingly, by this process, the company did deduct tax; and, importantly for the submission, what Mr McVeigh received were amounts from which tax had been deducted.
>
> …
>
> In this case, however, there was no payment made at all in the sense of the handing-over of a sum of money. There was, at most, at the relevant time, bookkeeping and accounting. Nor was there a pre-existing entitlement to a gross sum from which calculated tax was deducted upon payment to reach the net sum paid. Rather the reverse happened. There was money already received as drawings on the loan account and no doubt a calculation was made of the amount which needed to be added to this to reach a gross amount which, if tax and national insurance contributions were deducted from it, would produce an amount approximately equivalent to the amount already received. This gross amount was then, it seems, declared to be a bonus and by s 203A of the 1988 Act (as amended) the payment of the bonus is to be treated as having been made on the date it was determined, i e apparently £25,200 is to be treated as having been paid on 22 March 1990 and £25,000 as having been paid on 7 January 1991. …
>
> …
>
> What then would constitute deduction in these abnormal circumstances? Mr Sokol submits that including the tax liability within the creditors in accounts, and entering the amounts net of deductions in the loan account ledger and the deductions in the other ledger, constitute the crediting of Mr McVeigh with amounts net of tax, and

> the setting-aside (in the sense of accounting for) the tax and that this, taken together, constituted deduction.
>
> Those matters would no doubt contribute to a deduction of tax if, additionally, the tax was accounted for and paid. But in this case the employer, to Mr McVeigh's knowledge, has neither accounted for nor paid the tax and these failures were wilful, or so the Revenue have concluded upon a basis which was, in my judgment, not perverse. In these circumstances I consider that it would be a misuse of language to say that the bookkeeping and accounting alone, without actual payment, and without any of the procedures which the 1993 regulations require, constituted a deduction of tax from the gross payment. There was, on the contrary, a wilful failure to do anything relating to tax obligations, beyond making some internal paper entries which the company proceeded to ignore for tax accounting purposes and which Mr McVeigh also ignored when he submitted his own tax returns. That, in substance, is what, according to Mr Shortland's affidavit, the Revenue decided in making their direction. In my judgment there was no deduction of tax by the company, and the direction of 12 September 1994, which is challenged, was a sustainable direction in law and in fact."

33. The Company had got into financial difficulties from 2009-10 onwards but the directors had continued to draw money as before. Payslips had been produced that did not reflect the actual payments made to the directors. When the Company went into liquidation the directors had to decide how to account for the drawings; that was done by adjusting the directors' loan accounts. As in *McVeigh* the amounts of money taken bore no relationship to the payslips produced. The onus of proof was on the Appellants (to the balance of probabilities) and, despite ample opportunity, they had not discharged that burden.

Appellants' Case

34. Mr Rooney for the Appellants submitted as follows.

35. One constituent of the Condition B test in reg 72 was that the Company wilfully failed to deduct the right tax. The payroll was run by an unconnected third party, DMW, who correctly computed the necessary deductions, produced payslips contemporaneously and produced information for Forms P35. The payslips could not have been produced without the necessary computations on the P11 working sheets. In the normal course of events the deductions made would have been paid over to HMRC, but the Company's unexpected cash flow difficulties (and subsequent liquidation) prevented that.

36. Good reasons had been put forward for the change from dividends to salaries. The calculation of the new gross salary amounts had been done before the start of the 2009-10 tax year and before the Company's financial difficulties commenced. The payslips showed the new salaries and the correct deductions.

37. An explanation had been provided for the differences between the payslips and the bank statements. There was no requirement under the PAYE Regulations for the employee's net pay to be paid within a certain time frame.

38. There was an important distinction between a failure to deduct and a failure to pay. That distinction was emphasised in *McVeigh.* Here there was a pre-existing obligation to pay the new salaries. The payslips were sufficient evidence of the fact of deduction, and the inability to pay because of the subsequent liquidation did not change the fact of deduction.

The further evidence

39. After the conclusion of the oral evidence and submissions from both parties, we expressed the view that a potentially important piece of evidence had been alluded to but not produced to the Tribunal and we considered it was necessary for the overriding objective (to deal with cases fairly and justly) to give the Appellants the opportunity, unusually, to produce belatedly that evidence. Accordingly the Tribunal adjourned the hearing and formally directed:

> "No later than 28 days after the date of issue of these Directions the Appellants may send or deliver to both the Tribunal and the Respondents:
>
> (1) Copies of the Forms P11 (PAYE deduction working sheets) for each of Mr Prowse and Mrs Prowse for the two tax years 2009-10 and 2010-11 as maintained by DMW Payrolls during those respective tax years; and
>
> (2) A certificate of authenticity of those forms provided by DMW Payrolls."

40. Pursuant to the direction the Appellants provided a letter from DMW dated 18 June 2013 which stated:

> "We certify that the attached documents, as described below, are true copies and representations of the data contained in the SAGE Payroll system operated by us on behalf of Supablast Nationwide Limited and that these print outs have today been produced by us from that retained data.
>
> - Form P11 (Deduction Working Sheet) for Mr. J. Prowse to 5 April 2010
> - Form P11 (Deduction Working Sheet) for Mr. J. Prowse to 5 April 2011
> - Form P11 (Deduction Working Sheet) for Mrs. L. Prowse to 5 April 2010
> - Form P11 (Deduction Working Sheet) for Mrs. L. Prowse to 5 Apri12011

> On behalf of DMW Payrolls I confirm that the above is true and that the attached print outs are authentic copies of the data held within our computer systems."

41. We also gave HMRC the opportunity to make submissions in relation to that additional evidence. HMRC submitted that:

(1) There was no clear statement by DMW that the records had been maintained contemporaneously.

(2) Despite evidence at the hearing that the original payslips had been "put away in a draw" by Mr & Mrs Prowse, those originals had still not been produced.

(3) Even if the payroll records were contemporaneous (which HMRC did not accept) then they were merely cosmetic and the reality was that the directors continued to draw regular round sums from the Company with an intention to reconcile the drawings at the year end, as they had done in earlier years. That was not compatible with the keeping of a contemporaneous PAYE deduction scheme.

42. Having considered both the additional evidence and the submissions, the Tribunal informed the parties that it would be able to determine the matter in dispute without reconvening the adjourned hearing.

Findings, Consideration and Conclusions

43. We do not accept HMRC's contention that the decision to change the method of cash extraction from mainly dividends to mainly salaries was only made when the Company was already in financial difficulties and it was clear that dividends could not be used to reconcile the cash drawings in the year. We find that the decision to change the method of cash extraction was reached in January 2009 for the reasons given by Mr Prowse and Mr Baldwin. At the time of the decision the Company was financially successful, with no indication that there would not be sufficient profits to cover future dividends if the past method of cash extraction had continued.

44. We do not accept HMRC's contention that the payroll records produced by DMW were manufactured after-the-event. We find that the payroll records were maintained contemporaneously, including P11 working sheets for both Mr & Mrs Prowse maintained on a monthly basis. Further, that the payslips, copies of which were presented in evidence, were provided contemporaneously by DMW to Mr & Mrs Prowse.

45. We find that round sum monthly payments were made to Mr & Mrs Prowse by bank standing orders in amounts which were different from the net pay amounts recorded on the PAYE record system. Mr & Mrs Prowse were aware of all this throughout. The position was well summarised by the reviewing officer (Mr Nichols) in his formal review note:

> "(i) Mr Prowse and Mrs Prowse had separate bank accounts, with the Yorkshire Bank and the Allied Irish Bank respectively.

(ii) Mr Prowse received (in most months) three round sums totalling exactly £10,000, while Mrs Prowse received one payment of exactly £1,000 per month.

(iii) According to the payslips Mr Prowse's net pay should have been amounts varying each month between £7,252.90 and £7,253.30 while Mrs Prowse's net pay should have been amounts varying between £4,183.39 and £4,184.32."

46. The intention of the Company's accountants was that at year end the differences between the bank payments and the net pay would be reconciled, apparently through the directors loan account or a "wages suspense account". That was overtaken by the liquidation of the Company, but we accept Mr Baldwin's evidence that it would have been performed had the Company continued.

47. We must determine whether the tax and NIC recorded on the payroll records maintained by DMW (P11 working sheets, payslips and P35 summary schedules) constituted "deductions" for the purposes of reg 72.

48. It is clear that there is a distinction between (a) tax being deducted at source, and (b) tax being paid to HMRC – see for example, *McVeigh* (at page 98). Therefore, the fact that following the liquidation of the Company there were substantial unpaid PAYE (tax and NIC) liabilities (from HMRC's statement of case, in excess of £280,000 for all employees) does not in itself mean that the PAYE was not "deducted".

49. Looking at the caselaw on this point, we do not gain much assistance from the cases of *Moran* and *Williams*, because the facts of those cases were significantly different from the current case.

(1) In *Moran* the employee (who did not appear at the hearing) failed to provide any payroll records other than payslips. In the current case we have found that there were contemporaneous payroll records.

(2) In *Williams* the evidence of the employee (who did not appear at the hearing) was disbelieved (at [14]). The Tribunal found that the employee was aware of the "precarious financial condition" of the company before payments were made (at [13]). The Tribunal did not accept that the SAGE accounting system had been "reconstructed" after the year end to reflect "amended wages" so as to reallocate dividends "posted in error" to net wages: (at [16]):

> "We do not accept that dividends were posted 'in error' to Mr Williams or that he 'forgot to advise' Mrs Stanworth of the 'reallocation' of his shares; indeed we find to the contrary. All the evidence, and particularly that of the company not having declared a dividend in November 2006, points to his having been advised, or realised, that the company was not in a position to pay a dividend in 2006-07. We further find that he deliberately instructed Mrs Stanworth to reconstruct Instafix's records in such a way as hopefully to ensure that he had no personal tax or NIC liability on the drawings he had made from the company in that year."

In the current case there has been no deception or retrospective reconstruction of accounting records.

50. Turning to *McVeigh*, which were judicial review proceedings, the facts were again different from the current case but we have been assisted by the analysis of May J. Dealing first with the facts, in *McVeigh* "bonuses" had been recorded in the company accounts but there had been no no reflection in the PAYE records (or the taxpayer's income tax return) (at page 98 onwards):

> "The evidence relied on by Mr McVeigh is to the effect that he received money which was entered as a debit to his loan account; that the company decided to award bonuses in each of the years in gross amounts of £25,200 and £25,000; that the awarding of these bonuses is evidenced by the accounts and that the amounts for creditors in the accounts includes the tax and national insurance contributions calculated on those bonuses; that the amounts net of tax and national insurance contributions were credited to the loan account and that accordingly, by this process, the company did deduct tax; and, importantly for the submission, what Mr McVeigh received were amounts from which tax had been deducted.
>
> The approach to the evidence which is adopted on behalf of the Revenue is that there was no movement of money at all at any time relevant to the deduction of tax. The material before Mr Shortland, the assistant controller who dealt with the matter, did not constitute positive evidence that deductions in accordance with the 1993 regulations had been made. He was not able to conclude that net credits of amounts whose calculation may or may not have related to tax and national insurance contributions, without more, evidenced a deduction of tax in accordance which the 1993 regulations, and that where forms P14, P35 and P60 and Mr McVeigh's own personal tax returns were all completed and submitted without including amounts referable to the bonuses, the proper conclusion was that the company had failed to deduct tax in accordance with the 1993 regulations and that that was wilful.
>
> …
>
> … In this case, however, there was no payment made at all in the sense of the handing-over of a sum of money. There was, at most, at the relevant time, bookkeeping and accounting. Nor was there a pre-existing entitlement to a gross sum from which calculated tax was deducted upon payment to reach the net sum paid. Rather the reverse happened. There was money already received as drawings on the loan account and no doubt a calculation was made of the amount which needed to be added to this to reach a gross amount which, if tax and national insurance contributions were deducted from it, would produce an amount approximately equivalent to the amount already received. This gross amount was then, it seems, declared to be a bonus and by s 203A of the 1988 Act (as amended) the payment of the bonus is to be treated as having been made on the date it was determined, i e apparently £25,200 is to be treated as having been paid on 22 March 1990 and £25,000 as having been paid on 7 January 1991. I say

> 'apparently' because the evidence does not explicitly say when the bonuses were declared. It is not clear, and was not clear to Mr Shortland, when the bookkeeping entries were actually made. They cannot have been made on the dates actually entered in the ledger."

51. That is different from the current case. The decision to increase the salaries was made in January 2009 and communicated to DMW at the start of the 2009-10 tax year. Thus there was, as Mr Rooney submitted, a "pre-existing entitlement" to the salaries. There was also "the handing over of a sum of money", being the monthly bank payments to Mr & Mrs Prowse; however, those payments were not the same amounts as recorded in the payroll records, as summarised in Mr Nichols' review note, and thus there is the problem that what Mr & Mrs Prowse did does not fall within the description "a pre-existing entitlement to a gross sum from which calculated tax was deducted upon payment to reach the net sum paid" – the sum paid was different from the figure in the payroll records reflecting the gross pay less the calculated tax.

52. Reverting to *McVeigh*, May J set out (*ibid*) what he described as the normal operation of what is now reg 72:

> "It is clear that the usual circumstances where these provisions may apply will be where an employee has received a payment gross and there will have been no deduction of tax because the payment was made gross. If, on the other hand, the employee is paid net, he or she will normally receive a document required by employment legislation, but not by tax legislation, indicating how the net amount is calculated. In the modern world the fact of payment in an amount net of tax will normally constitute deduction, whether or not the employer also effects any money movement of the sum which is deducted, for example by transferring it to a tax reserve. There will be a pre-existing entitlement to gross pay and a deduction from this is effected by paying the net amount due after subtracting the tax. This accords with reg 14, where the employer has to ascertain, among other things, the tax and to deduct it 'on making the payment in question'.
>
> Regulations 49(5) and 42(3) would normally operate where the employer had wilfully paid an employee gross and the employee knew this. Although the employer has to prepare a deductions working sheet under reg 38, the preparation of that sheet does not, in these normal circumstances, constitute or contribute to the making of the deduction. It is, as the regulation makes clear, the making of a record and one of the things that has to be recorded is 'the amount of tax, (if any), deducted or repaid on making the payment' (see reg 38(3)(c), which is one of a number of instances where the point of deduction appears to be on making the payment). Again, although the employer is required to give a P60 certificate to the employee and to provide the Revenue with forms P14 and P35, the giving and providing of those documents does not constitute the deduction of tax. The documents record among other things the deduction of tax."

53. May J decided that the facts in *McVeigh* meant that the normal operation of the provision was not applicable (at page 99):

> "In my judgment in this case the crucial question whether the employer deducted the amount of tax which he was liable to deduct under the 1993 regulations cannot be determined by what I have described as 'normal considerations', for the simple reason that on the date when payment is to be treated as having been made no actual payment was in fact made. There was, accordingly, no deduction in the normal sense of a deduction constituted by the payment of a net sum against a pre-existing entitlement to gross pay."

54. He then went on to consider whether in the abnormal circumstances in *McVeigh* there could be said to be a deduction, and concluded that there could not (*ibid*):

> "What then would constitute deduction in these abnormal circumstances? Mr Sokol submits that including the tax liability within the creditors in accounts, and entering the amounts net of deductions in the loan account ledger and the deductions in the other ledger, constitute the crediting of Mr McVeigh with amounts net of tax, and the setting-aside (in the sense of accounting for) the tax and that this, taken together, constituted deduction.
>
> Those matters would no doubt contribute to a deduction of tax if, additionally, the tax was accounted for and paid. But in this case the employer, to Mr McVeigh's knowledge, has neither accounted for nor paid the tax and these failures were wilful, or so the Revenue have concluded upon a basis which was, in my judgment, not perverse. In these circumstances I consider that it would be a misuse of language to say that the bookkeeping and accounting alone, without actual payment, and without any of the procedures which the 1993 regulations require, constituted a deduction of tax from the gross payment. There was, on the contrary, a wilful failure to do anything relating to tax obligations, beyond making some internal paper entries which the company proceeded to ignore for tax accounting purposes and which Mr McVeigh also ignored when he submitted his own tax returns. That, in substance, is what, according to Mr Shortland's affidavit, the Revenue decided in making their direction. In my judgment there was no deduction of tax by the company, and the direction of 12 September 1994, which is challenged, was a sustainable direction in law and in fact.
>
> Mr Sokol submits that if the direction which is challenged stands there will be an unjust species of double taxation in the sense that Mr McVeigh will have received only the net amounts but will also have to pay the tax. I disagree that this would be unjust on the facts of this case, where there was a wilful failure to deduct tax, where Mr McVeigh knew this, and where the company of which he was a director has not paid the tax. For these reasons the application fails and is dismissed."

55. How should the principles set out by May J in *McVeigh* be applied in the current case? May J acknowledged that the facts in *McVeigh* were "abnormal circumstances" – there had been no mention of the bonuses on any of the PAYE documents or the taxpayer's tax return, but only "bookkeeping and accounting alone, without actual payment, and without any of the procedures which the [PAYE] regulations require".

We have already noted (at [51] above) that the facts in the current case are different from those in *McVeigh*. We have scrutinised May J's comments (quoted at [52] above) on the role and status of the payroll records including those required by the PAYE regulations. We do not take May J to be saying that the PAYE records are irrelevant in determining whether there have been deductions; only that those documents are merely a record and do not themselves constitute deductions, and (we infer) are not conclusive that deductions have been made if in fact there is evidence to the contrary: "… although the employer is required to give a P60 certificate to the employee and to provide the Revenue with forms P14 and P35, the giving and providing of those documents does not constitute the deduction of tax. The documents record among other things the deduction of tax." Thus the payroll records have evidential importance which must be weighed in the normal way in determining what importance should be placed on them and the conclusions to be drawn from them. In *McVeigh* the position was relatively clear: the bonuses had not been recorded in the payroll contemporaneously, nor PAYE procedures applied contemporaneously or after year-end, nor included as employment income on the employee's self-assessment return – thus any payroll/PAYE records would be at best a retrospective exercise to accord with the bookkeeping that took place after the bonuses were declared, and consequently there had been no deductions for the purposes of the PAYE regulations.

56. We understand why HMRC have taken their stance in the current case; all the caselaw cited to us (*McVeigh*, *Williams* and *Moran*) related to cash being drawn during the year and then adjusted later in the employer's accounts (and *McVeigh* specifically concerned the use of a director's loan account). However, as we have already stated, we consider the facts of the current case are materially different. The salaries were set before the start of the relevant tax years (and also before the Company encountered financial difficulties) and thus there was a "pre-existing entitlement" to the salaries. DMW processed those salaries through the SAGE payroll and PAYE system contemporaneously, maintaining P11 working sheets and providing monthly payslips. We are satisfied that the cash drawn by each of Mr & Mrs Prowse was at least in part the net pay - ie their salary less the PAYE deductions recorded on their payslip. We say "at least in part" because of the discrepancies between the net pay shown on the payslips and the cash received by Mr & Mrs Prowse, to which issue we now turn.

57. We consider that the above conclusions are sufficient to determine Mrs Prowse's appeal in her favour. The cash received by Mrs Prowse each month was less than the net pay shown on the P11 and payslip, so we conclude that she did not receive sums from which PAYE was not deducted. Mr Prowse, however, did receive more than the net pay shown on the P11 and payslip. The contention put forward on behalf of the Appellants by their accountant was (again) well summarised by the reviewing officer:

> "[Mr Baldwin denies] failure to operate PAYE etc correctly. His argument was that between them Mr & Mrs Prowse's net pay came to approximately £11,000 per month and this was paid as £10,000 (in 3 instalments per month) to Mr Prowse and £1,000 per month. The net

> pay from the payslips indicate that the directors should have been paid £7,253 and £4,184 (plus or minus odd pence) per month – individually Mr Prowse received £2,747 too much and Mrs Prowse £3,184 too little – a net difference of around £437 per month too little."

58. We have considered whether the position should be viewed taking Mr & Mrs Prowse together - which is in essence what Mr Baldwin was arguing for in his representations to HMRC – or instead viewing Mr Prowse's position as separate. We have found that a difficult decision – for example, as noted by the reviewing officer, Mr Prowse had a separate account with a bank different from that used by Mrs Prowse. However, on balance we have concluded from the evidence (both in the documents and Mr Prowse's oral testimony) that Mr & Mrs Prowse saw their financial affairs as being joint and – although they would not have put it this formally – part of Mrs Prowse's salary was being received by Mr Prowse on her behalf, for pragmatic reasons such as the home mortgage payments being made from Mr Prowse's bank account. Therefore, on balance, we conclude that neither Mr nor Mrs Prowse received sums from which PAYE was not deducted.

59. For those reasons we would allow both appeals.

Decision

60. The appeals are ALLOWED.

61. 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.

PETER KEMPSTER
TRIBUNAL JUDGE

RELEASE DATE: 21 May 2014