[2017] UKFTT 379 (TC)

TC05845

Appeal number: TC/2016/06980

VAT – default surcharge –whether insufficiency of funds was a reasonable excuse – found, no – appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

MORGUN LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE ABIGAIL MCGREGOR
CHARLES BAKER FCA

Sitting in public at Fox Court, London on 24 February 2017

Vitalii Morgun, director, for the Appellant

Ms Donnelly, presenting officer, for the Respondents

DECISION

The appeal

1. The appellant, Morgun Limited ("**MGN**") appealed against the imposition of a VAT default surcharge of £3430.23 for the VAT period 05/16 (being the 3 month period ending 31 May 2016).

Evidence

2. MGN submitted:

(1) bank account statements for the period 1 March 2016 to 11 July 2016;

(2) a statement purporting to show the invoices outstanding at 11 July 2016;

(3) the oral evidence of Mr Vitalii Morgun, director of MGN, given at the hearing.

Law

3. Under Regulation 25(1) of the VAT Regulations 1995 (SI 1995/2518) a person who is registered for VAT must submit a VAT return to HMRC no later than the last day of the month next following the end of the VAT accounting period to which it relates. There is a seven day extension for persons who submit returns electronically. Under Regulation 40(2), any person required to make a return must pay any VAT shown as payable on the return to HMRC not later than the last day on which that return is due.

4. Liability to default surcharge is governed by section 59 of Value Added Tax Act 1994 ("VATA 1994"), the material parts of which are set out here:

> (1) Subject to subsection (1A) below, if, by the last day on which a taxable person is required in accordance with regulations under this Act to furnish a return for a prescribed accounting period—
>
> (a) the Commissioners have not received that return, or
>
> (b) the Commissioners have received that return but have not received the amount of VAT shown on the return as payable by him in respect of that period,
>
> then that person shall be regarded for the purposes of this section as being in default in respect of that period.
>
> …
>
> (2) Subject to subsections (9) and (10) below, subsection (4) below applies in any case where—
>
> (a) a taxable person is in default in respect of a prescribed accounting period; and
>
> (b) the Commissioners serve notice on the taxable person (a "surcharge liability notice") specifying as a surcharge period for the purposes of this section a period ending on the first anniversary of the last day of the period referred to in paragraph (a) above and beginning, subject to subsection (3) below, on the date of the notice.
>
> (3) If a surcharge liability notice is served by reason of a default in respect of a prescribed accounting period and that period ends at or before the expiry of an existing surcharge period already notified to the taxable person concerned, the surcharge period specified in that notice shall be expressed as a

continuation of the existing surcharge period and, accordingly, for the purposes of this section, that existing period and its extension shall be regarded as a single surcharge period.

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

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

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

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

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

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

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

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

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

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

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

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

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

he shall not be liable to the surcharge and for the purposes of the preceding provisions of this section he shall be treated as not having been in default in respect of the prescribed accounting period in question (and, accordingly, any surcharge liability notice the service of which depended upon that default shall be deemed not to have been served).

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

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

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

…

(11) For the purposes of this section references to a thing's being done by any day include references to its being done on that day.

5. The interpretation of reasonable excuse is found in section 71 of VATA 1994:

(1) For the purpose 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; and

(b) where reliance is placed on any other person to perform any task, neither the fact of that reliance nor any dilatoriness or inaccuracy on the part of the person relied upon is a reasonable excuse.

6. HMRC have the burden of proving that MGN failed to pay the VAT on time and is liable to pay the default surcharge. The onus then passes to MGN to prove that it had a reasonable excuse for the failure to pay on time.

Facts

7. The following facts were not in dispute:

(1) MGN is a company operating in the construction trade, undertaking extensions and loft conversions for domestic customers;

(2) MGN was correctly registered for VAT for the relevant period;

(3) MGN paid its VAT electronically and was therefore entitled to an extension of 7 days from the normal due date;

(4) the surcharge period relevant to this appeal commenced in the period 11/13 and this was the first default (with a penalty rate of 0%);

(5) the second default arose in the period 02/14 (with a penalty rate of 2%, but no penalty was issued because it was under the de minimis threshold);

(6) the third default arose in the period 05/14 (with a penalty rate of 5%, but again no penalty was issued because it was under the de minimis threshold);

(7) the fourth default arose in the period 08/14 (with a penalty rate of 10% giving rise to a penalty of £395.10);

(8) three further default surcharge notices were issued for the periods 11/14, 02/15 and 05/15 but were subsequently withdrawn by HMRC following a request for review by MGN;

(9) the fifth default arose in the period 08/15 (with a penalty rate of 15% giving rise to a penalty of £469.98);

(10) two further default surcharges at the 15% rate arose in respect of periods 11/15 and 02/16;

(11) the default under appeal arose in the period 05/16;

(12) the VAT due in respect of period 05/16 was £22,868.24;

(13) the due date for payment for that period was 30 June 2016, but this was extended by 7 days for electronic payment, ie to 7 July 2016;

(14) the VAT due was not paid until 11 July 2016; and

(15) HMRC issued a surcharge liability notice dated 15 July 2016 for a surcharge of £3430.22 (being 15% of the £22,868.24 due);

(16) MGN responded with a letter disagreeing with the surcharge on 1 August 2016, which was treated by HMRC as a request for a review;

(17) HMRC conducted a review and set out its decision not to cancel the default surcharge in a letter dated 17 October 2016;

(18) MGN asked for a reconsideration of this position in an email dated 28 October;

(19) HMRC responded on 2 November 2016 with a letter requesting further information, sub-divided into 8 categories of information;

(20) MGN replied on 16 November 2016 providing 2 of the categories, namely summaries of the cash in and cash out in the months May to July 2015 and a list of bad debts;

(21) HMRC considered the additional information and found it did not provide sufficient grounds to remove the surcharge, which it set out in a letter dated 23 November 2016;

(22) MGN appealed to the Tribunal on 29 November 2016.

8. Further findings of fact are set out in the discussion below.

Parties arguments

Validity of the penalty

9. HMRC submitted that the VAT default surcharge had validly arisen because:

(1) the VAT due had not been received by the due date, in accordance with VATA 1994, s 59(1); and

(2) HMRC had issued the surcharge liability notice in accordance with VATA 1994, s 59(2) on 15 July 2016.

10. HMRC submitted that the correct rate of surcharge was 15% because MGN had been in a single surcharge period, extended under VATA 1994, s 59(2), since VAT period 11/13 and it had had more than 4 defaults in that surcharge period.

11. Mr Morgun did not raise any arguments on behalf of MGN in relation to the validity of the penalty.

Reasonable excuse

12. Mr Morgun submitted, on behalf of MGN, that it had a reasonable excuse for the late payment of the VAT due for the period 05/16 and that therefore MGN should not be liable to the surcharge and should be treated as not having been in default in respect of the period 05/16.

13. The submissions made to support the reasonable excuse were that:

(1) MGN operates in the construction industry where it has to pay out a significant amount of expenses before it recovers any funds from its customers and is therefore always in position that it is behind in funds;

(2) it would have been able to pay the VAT liability if a customer (Mr P – all customer names in this decision have been anonymised as there is no need to identify them) had paid his bill when expected, but he had not paid the bill until 11 July 2016;

(3) it had been reasonable to expect Mr P to pay the bill before 7 July 2016 because:

(a) the invoice had been issued on 29 June 2016 by email;

(b) MGN usually expected bills to be paid within 1 to 2 working days; and

(c) Mr P had made the payments on his previous 5 progress bills on time;

(4) In addition to the amount due from Mr P (which was a little over £20,000), a further £33,000 was outstanding from other customers at 11 July 2016 – if those payments had been made, then the VAT payment could have been made on time;

(5) Mr Morgun had not considered that he could either pay part of the VAT bill or contact HMRC to discuss a time to pay arrangement.

14. Mr Morgun also submitted that it would be an exceptional hardship on his business to have to pay this surcharge and would result in the closing down of his company and therefore the loss of jobs.

15. HMRC submitted that MGN did not have a reasonable excuse because:

(1) The circumstances described by Mr Morgun are simply the normal perils of the construction trade that MGN carries on and are insufficient to support a reasonable excuse, in particular:

(a) Issuing an invoice on 29 June, expecting to be able to rely on its payment in order to make a VAT payment on 7 July is cutting it a bit fine;

(b) MGN's circumstances do not follow those in *Customs and Excise v Steptoe* [1992] STC 757 ('Steptoe') (where a reasonable excuse was found) because Steptoe had a reliance on one client, whereas MGN had 6 or 7 jobs going at once, with a number providing a similar flow of funds to Mr P; and

(c) The insufficiency of funds was reasonably avoidable in the sense set out in *ETB (2014) Limited v HMRC* [2016] UKUT 424 (TCC) and MGN did not exercise the diligence and foresight necessary to avoid it; and

(d) MGN did receive sufficient funds over the period to meet its VAT obligations, but it chose to treat its VAT receipts as an interest free loan until the VAT became payable, which was a risk it took upon itself and cannot represent a reasonable excuse. HMRC relied on the following statement to support this position: "It should be remembered that VAT is never the property of the company, the money belongs to the Crown at all times and must be paid over as the law requires". HMRC asserted that this

statement was made by Judge Connell in *CG Steel Structures v HMRC* [2014] UKFTT 504 (TC).

(2) MGN should have contacted HMRC to arrange time to pay or pay part of the bill on time. This would have been reasonable behaviour given that:

(a) MGN had been receiving surcharge liability notices from HMRC for a long period and these notices always refer to the ability to contact HMRC to discuss time to pay and the option to pay part of the bill on time in order to reduce; and

(b) MGN had requested reviews of earlier default surcharges and in the letters sent back to MGN, these options were reiterated again, including providing the telephone number of the team to contact at HMRC;

Discussion

Validity of the penalty

16. It was agreed between the parties that the VAT was paid late and it is evident from the letter sent by MGN on 1 August 2016 that the appellant had received the surcharge liability notice issued by HMRC. Therefore we find that the penalty validly arose.

Findings of fact

17. Based on the oral evidence given by Mr Morgun and the bank statements and other documentation submitted, we find the following facts:

(1) An invoice was issued to Mr P by email on 29 June 2016 for £20,622.60;

(2) Payments of £7,500 were received into MGN's bank account from Mr P on both 8 July 2016 (given reference 61) and 11 July 2016 (given reference 62);

(3) Previous payments received from Mr P over the preceding months were as follows:

(a) £9,462 on 18 March 2016, given a reference of 2 in the bank statement

(b) £5,000 on 12 April, given a reference of 3A

(c) £5795.80 on 14 April, given a reference of 3B

(d) £7170 on 5 May 2016, given a reference of PLNG

(e) £7,791 on 13 May 2016, given a reference of 4

(f) £5,000 on 6 June 2016, given a reference of 51

(g) £10,000 on 7 June 2016, given a reference of 52

(h) £5,451 on 8 June 2016, given a reference of 53

(4) At the relevant time MGN was carrying out at least 7 jobs. The size of receipts from those other jobs were comparable to those coming from Mr P, looking at the month of June only:

(a) AS paid £8000 on each of 3, 17, and 28 June 2016;

(b) JB paid £19,416.46 on 6 June 2016;

(c) CJL paid £10,000 on 10 June and £916.80 on 15 June 2016;

(d) GA paid £7,500 on 22 June 2016;

(e) S&D paid £10,000 on 29 June 2016; and

(f) DM paid £3,500 on 13 June, £2,500 on 27 June and £7,163 on 29 June 2016.

Reasonable excuse

18. The meaning of reasonable excuse in the context of the VAT default surcharge regime and insufficiency of funds in particular has been considered by the Court of Appeal in *Customs and Excise v Steptoe* [1992] STC 757 in which the following principle was set out:

> Insufficiency of funds can never of itself constitute a reasonable excuse, but that the cause of that insufficiency, ie the underlying cause of the default, might do so.

19. The Upper Tribunal in *ETB (2014) Limited v HMRC* (para 15) provided a helpful summary of how this should be approached:

> In summary, the question to be asked when considering whether someone has a reasonable excuse for failing to pay an amount of tax on time because of a cash flow problem is whether the insufficiency of funds was reasonably avoidable. A cash flow problem would usually be regarded as reasonably avoidable if the person, having a proper regard for the fact that the tax was due on a particular date, could have avoided the insufficiency of funds by the exercise of reasonable foresight and due diligence. If the cash flow problem was reasonably avoidable then the mere fact that the taxpayer could not afford to pay the VAT at the proper time would not, without more, be a reasonable excuse. On the other hand, if such foresight, diligence and regard would not have avoided the insufficiency of funds then the taxpayer will usually be regarded as having a reasonable excuse for the VAT having been paid late until it would be reasonable to expect the taxpayer to have found alternative funding or taken other action to counteract the insufficiency.

20. These are therefore the principles we must apply when considering the arguments put forward by Mr Morgun on behalf of MGN.

21. While we accept that the way that MGN's business operates, with customers paying in stages as work is being completed, puts MGN in a position that it has to spend money to do the work before it receives money; this is, as Mr Morgun

submitted himself, just the way it works, rather than a set of circumstances surrounding this particular payment date. A businessman exercising reasonable foresight could see that this structure of business means that funds for paying over VAT to HMRC must be set aside from earlier flows of funds in order to avoid being late.

22. We also accept that if Mr P had paid the invoice dated 29 June 2016 before 7 July 2016, MGN would have had sufficient funds in its bank account to pay the VAT on time. However, we do not find that it was the action of taxpayer taking reasonable foresight and diligence to expect that invoice to have been paid in one lump sum by 7 July 2016. By Mr Morgun's own admission, he had been struggling to get hold of Mr P and he lived abroad. Mr Morgun submitted that Mr P had always paid 'on time' before and that he generally expects his customers to pay within 1 or 2 days of receiving an invoice. We were not presented with any evidence of the previous invoices sent to Mr P and therefore cannot be certain about the timeframe for payments made in relation to previous invoices. However, based on the flows of funds from Mr P in the months from March to June and the references given by Mr P to the payments made, we note that Mr P had never made a single payment in excess of £10,000 and we infer that on previous invoices the payments had been split into more than one payment spread over several days, eg the payments with references 51, 52 and 53 all related to progress payment 5, which was split into three payments. This would be corroborated by Mr Morgun's evidence that the invoice that was dated 29 June 2016 was progress payment 6 (and those payments, when they did come into the bank, had references 61 and 62). Therefore it was not reasonable for MGN to have assumed, without any evidence to support it, that the invoice of over £20,000 would be paid in full by 7 July 2016.

23. Although the particular invoice issued on 29 June 2016 to Mr P was a substantial sum that would have covered the VAT liability, Mr P was only one of a number of customers who were paying sums to MGN during the months of June and July and those other customers were paying invoices of a similar size. Therefore we find that MGN was not reliant on Mr P, in a manner that might be aligned with the facts in ***Steptoe.***

24. Turning to the argument that there was, in addition to Mr P's invoice, an amount of £33,000 of outstanding invoices from other customers as at 11 July 2016. MGN provided a rather unsatisfactory document to support this argument. The document was unsatisfactory because it was rendered in such a way that the columns were too narrow, so that it did not show any invoice dates or due dates. As noted above, the burden of proof in relation to the reasonable excuse is on MGN. We find that MGN has not satisfied that burden in relation to the assertion that other outstanding invoices had prevented the payment of VAT on time. Mr Morgun also explained in his submissions that three of the invoices contained in it, which added up to £19,169.67 concerned three related jobs (where work was being done to three adjacent houses at the same time), on which there had been a disagreement about windows and he therefore knew that these would not be paid before the VAT due date. Therefore even if we were satisfied that the remaining outstanding invoices on this schedule of bad debts showed a true picture of what a taxpayer exercising

reasonable foresight could have expected to receive before the due date, it would not have been sufficient to pay the VAT amount that was due.

25. Standing back from the detail, we find that the shortage of funds was caused by the ordinary ebb and flow of commercial life and was not attributable to any abnormal cause that could be said to have not been reasonably avoidable.

26. Turning to HMRC's argument that a company does not own that VAT it has received from its customers, HMRC relied on a statement that Ms Donnelly asserted that this was a statement of Judge Connell in the case of *CG Steel Structures v HMRC* [2014] UKFTT 504 (TC). This was incorrect. It was contained in the decision in *Temps Limited v HMRC* [2014] UKFTT 262 (TC). This decision was given by Judge Connell, but the statement was set out in a part of the decision entitled 'HMRC's case'. It therefore cannot be treated as a principle outlined by the judge. However that case also refers back to the principle on which HMRC were relying in *Steptoe,* in which Nolan LJ refers back to his earlier decision in *Salevon* [1989] STC 907:

> "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 persuade the commissioners or the tribunal that he had a reasonable excuse."

27. Nolan LJ was not identifying a separate principle to be applied in considering reasonable excuse, he was simply describing the way that VAT collection works under the statutory framework and that it is difficult to find a reasonable excuse based on an insufficiency of funds. Therefore I do not believe these statements take us any further in this case.

28. We also note that MGN was in a position to pay a part of the VAT bill earlier than 11 July 2016 and that, if it had, it might have reduced the surcharge issued. It also did not contact HMRC to discuss time to pay. Mr Morgun said that he did not know that part payment was an option and did not consider contacting HMRC. These are not the actions of a taxpayer taking reasonable diligence, not least because the company had been in the default surcharge regime for some time and received a number of letters that contained information encouraging both part payment and seeking time to pay.

29. For the reasons set out above, we therefore find that MGN did not have a reasonable excuse for late payment of VAT in relation to period 05/16. This means that the default surcharge of £3430.23 stands.

30. 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.

ABIGAIL MCGREGOR
TRIBUNAL JUDGE

RELEASE DATE: 2 MAY 2017