Appeal number: TC/2014/06345

VAT – default surcharge – VAT payment of £2,291,283.00 received by HMRC two days late – inadvertent delay by agent – single unusually large property transaction in default quarter – reasonable excuse not argued by Appellant – whether in the circumstances a 5% penalty amounting to £114,564.19 was disproportionate and unfair – no – Appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

FRASERS (ST GILES STREET, EDINBURGH) LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE MICHAEL CONNELL
MEMBER JANE SHILLAKER

Sitting in public at the Royal Courts of Justice, The Strand, London on 4 October 2016

Mr Michael Thomas of Counsel for the Appellant

Mr Barry Robinson, Officer of HM Revenue and Customs, for the Respondents

DECISION

The Appeal

1. Frasers (St Giles Street, Edinburgh) Limited ("the Appellant") appeals against a VAT default surcharge of £114,564.19, for its failure to submit, in respect of its VAT period 07/14, by the due date, payment of the VAT due.

2. The penalty was calculated at 5% of the VAT payable on the return of £2,291,283.00. The payment was two days late.

3. The relevant facts and background law were common ground. Whether there was a reasonable excuse was not argued. The sole issue in dispute and to be determined by the Tribunal is whether or not the present case is one where the default surcharge is disproportionate, and contrary to European Union law.

Background

4. The Appellant Company registered for VAT effective from 1 August 2007. The Company is a registered private company, having been incorporated in the UK in March 2007. Its registered office is in St Helier, Jersey.

5. The Appellant's business is holding properties as investments which are let out to tenants. It accounts for VAT on income in respect of the UK properties it owns, all of which it has opted to tax. However, in the period December 2011 to December 2015 the vast majority of the Company's property related VAT outputs (i.e. rental income together with receipts from sales) derived from a property at 12-22 St. Giles Street, Edinburgh.

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

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

8. Section 59 VATA sets out the provisions in relation to the default surcharge regime. Under s 59(1) a taxable person is regarded as being in default if he fails to make his return for a VAT quarterly period by the due date or if he makes his return by that due date, but does not pay by that due date, the amount of VAT shown on the return. The Commissioners may then serve a surcharge liability notice on the defaulting taxable person, which brings him within the default surcharge regime so that any subsequent defaults within a specified period result in assessment to default surcharges at the prescribed percentage rates.

9. The specified percentage rates are determined by reference to the number of periods in respect of which the taxable person is in default during the surcharge liability period. In relation to the first default after the issue of a VAT Surcharge Liability Notice, the specified percentage is 2% and the percentage ascends to 5%, 10% and 15% for the second, third and fourth defaults

10. The Appellant entered the Default Surcharge regime from period 10/12, the history being as follows:

Period 10/12

- The Return was received by HMRC on the due date of 7 December 2012.
- The VAT due of £81,449.50 was received 27 days late by CHAPS on 3 January 2013.
- A Surcharge Liability Notice was issued on 14 December 2012.
- This was the first default.

Period 07/13

- The Return, due by 7 September 2013, was received in time on 2 September 2013.
- The VAT due of £1,672.41 was received 11 days late by CHAPS on 18 September 2013.
- A Surcharge Liability Extension Notice was issued on 13 September 2013. This was the second default, with liability to surcharge being 2% of the tax paid.
- The penalty of £33.44 was not collected as HMRC do not collect surcharges imposed at the rates of 2% or 5% if the amount is £400 or less.

Period 07/14 (The Default Surcharge under appeal)

- The Return, due by 7 September 2014, was received in time on 29 August 2014.
- The VAT due of £2,291,283.83 was due on 7 September 2014 but was received 2 days late by CHAPS on 9 September 2014. 7 September 2014 was a Sunday and therefore payment should have been made by Friday 5 September 2014.
- A Notice of assessment of surcharge and surcharge liability extension notice was issued on 12 September 2014. This was the third default.
- The amount of the surcharge was £114,564.19, being 5% of the tax paid.

11. The Appellant wrote to HMRC on 26 September 2014, followed up by a further letter on 9 October 2014, appealing the penalty. The Appellant's grounds of appeal were that the surcharge was excessive and disproportionate. The letter was treated as a request for a Statutory Review.

12. A review was carried out, the conclusion being that the decision should stand. The review decision was confirmed by letter dated 28 October 2014.

13. The Appellant notified an appeal to the Tribunal through its representative BDO LLP on 27 November 2014.

Evidence

14. We were provided with an agreed bundle of documents which included the VAT notice of assessment, copy correspondence, a schedule of defaults, copy VAT returns for default periods, copy financial statements for the Appellant Company for the years 2012 to 2015, schedules showing the Company's rental income and profitability for those years, relevant legislation and authorities, a witness statement from Ms Linda Nicol the managing director of STM Fiduciaire Limited, also based in St Helier Jersey. Ms Nicol also gave oral evidence to the Tribunal.

The Law

Legislation

15. The relevant legislation is contained in:

VATA 1994

Section 59 - The default surcharge.

(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.

(1A) A person shall not be regarded for the purposes of this section as being in default in respect of any prescribed accounting period if that period is one in respect of which he is required by virtue of any order under section 28 to make any payment on account of VAT.

(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.

(9) In any case where -

(a) the conduct by virtue of which a person is in default in respect of a prescribed accounting period is also conduct falling within section 69(1), and

(b) by reason of that conduct, the person concerned is assessed to a penalty under that section,

the default shall be left out of account for the purposes of subsections (2) to (5) above.

(10) If the Commissioners, after consultation with the Treasury, so direct, a default in respect of a prescribed accounting period specified in the direction shall be left out of account for the purposes of subsections (2) to (5) above.

(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.

Section 71 - Construction of sections 59 to 70.

For the purposes of any provision of section 59 ... which refers to a reasonable excuse for any conduct:

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

Proportionality - Case Law

16. The sole issue to be determined by the Tribunal, is whether the default surcharge under appeal is proportionate to the breach of the VAT default surcharge provisions which has occurred. A surcharge penalty of £114,564.19 has been levied because VAT due for period 07/12 was paid two days late because of inadvertence on the part of an employee of the agent acting for taxpayer. Save for the initial breach in 10/12, and another in 07/13 of relative de minimis proportions, where no surcharge was imposed, the taxpayer has otherwise been entirely compliant with the VAT regulations.

17. The principle of proportionality and in particular the question whether a power conferred by statute has been exercised in proportion to the purpose for which it has been conferred has been considered by the courts on a number of occasions. We were referred to the following cases:

Marleasing SA v La Comercial Internacional de Alimentacion SA: C-106/89
Profile Security Services Ltd v HMRC [1996] STC 808
Equoland Soc. Coop. art v Agenzia delle Dogane (Case C-272/13) [2014]

Sony Ericsson Mobile Communications AB v HMRC (2007) VAT Decision 205133
Dyrektor Izby Skarbowej w Biaymstoku v Profaktor Kulesza, Frankowski, Jowiak, Orowski (Case C-188/09)
Enersys Holdings UK Ltd v Revenue and Customs Commissioners [2010] UKFTT 20 (TC)
Total Technology (Engineering) Ltd v HMRC [2012] UKUT 418 (TCC)
R (on the application of Lumsdon and others) v Legal Services Board [2015] UKSC 41
Trinity Mirror PLC v HMRC [2015] UKUT 0421
Blue Ocean Associates Limited v HMRC [2016] UKFTT 042
Kingsdale Group Limited v HMRC [2016] UKFTT 236 (TC)
Sun Hill Racing Limited v HMRC [2016] UKFTT 0490 (TC)
Susanna Claire Posnett v HMRC [2016] UKFTT 0557 (TC)

18. The law is now relatively settled and, in stating the law, we can do no better than set out the summary of the Upper-tier Tribunal in the case of *Revenue and Customs Commissioners v Trinity Mirror Plc* [2016] STC 352 as contained in paragraphs 16 to 32 and 56 to 72.

> "16. There are two tribunal decisions that were referred to extensively by the FTT in its decision and which are key to our approach to this appeal; the decision of the First-tier Tribunal in *Enersys Holdings UK Ltd v Revenue and Customs Commissioners* [2010] UKFTT 20 (TC), [2010] SFTD 387 ('*Enersys*') and the decision of the Upper Tribunal (Warren J (P) and Judge Bishopp) in *Revenue and Customs Commissioners v Total Technology (Engineering) Ltd* [2012] UKUT 418 (TCC), [2013] STC 681 ("*Total Technology*"). It is convenient to describe them here.
>
> **Enersys**
>
> 17. *Enersys* was referred to by the Upper Tribunal in *Total Technology* as "the most significant of the first instance decisions in the Tax Chamber". In *Enersys*, the taxpayer company was the representative member of its VAT group. It was, like Trinity Mirror, within the payments on account regime. Its return and payment, due on 30 January 2008, were submitted one day late. As the default was the third default (or, strictly, the third VAT period of default) within the surcharge period, a 10% surcharge was applied to the amount of VAT paid late. That surcharge amounted to £263,763. However, subsequently it was accepted that Enersys had a reasonableexcuse for an earlier default, and as a result the surcharge for the January 2008 default was reduced to 5%, or £131,881.
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> 18. The tribunal judge (Judge Bishopp) held, first of all, that there was no reasonable excuse for Enersys' relevant default. He then turned to the question of proportionality. He considered first the competing arguments whether the focus should be on whether the default surcharge regime as a whole is disproportionate, or whether proportionality could be considered by reference to

the individual penalty. On that point the judge concluded, at [55], that it was open to him to consider the individual penalty without first having concluded that the system as a whole was disproportionate.

19. Judge Bishopp then examined the default surcharge regime. He concluded, at [60], that there were three features of it which had the potential to undermine its proportionality: the absence of a power to mitigate, the fact that the penalty is the same whatever the period of delay, and the absence of any upper limit. In relation to these features, the judge concluded, at [70], agreeing in this respect with the VAT & Duties Tribunal in *Greengate Furniture Ltd v Customs and Excise Commissioners* [2003] V&DR 178, that the absence of a power to mitigate arguably meant that the regime went further than was necessary in order to attain its objective, adopting the phrase used by the ECJ in *Garage Molenheide BVBA v Belgium* (Joined cases C286/94, C-340/95, C-401/95 and C-47/96) [1998] STC 126, at [48]. The judge made a similar observation in relation to the lack of any relation between the period of delay and the magnitude of the penalty.

20. As regards the absence of an upper limit on the amount of a surcharge, Judge Bishopp expressed the view that this might be justifiable on the basis that it is a necessary consequence of a tax-geared penalty, but that there must come a time, even in the case of a large company, when this justification would break down.

21. At [61], Judge Bishopp described as a pertinent question to be asked, whether a court or tribunal, if it had the power to set any monetary penalty it chose without statutory constraint, would exercise its ordinary judicial discretion to impose a penalty of as much as £130,000 for an error of the kind that had arisen in *Enersys*. He regarded it as unimaginable that it would. He arrived at the "inescapable" conclusion that, even taking into account the public interest in the prompt payment of taxes, the surcharge imposed on *Enersys* was disproportionate.

22. The judge cited in support, at [62], the 2007 judgment of the European Court of Human Rights in *Mamidakis v Greece* (Application 35533/04), in which a penalty of up to 10 times the tax sought to be evaded was found to be disproportionate to the legitimate objective of preventing tax evasion. The judge referred to the Court's observation in that case, at para 71, that an essentially fixed (but high) penalty "is compatible with the principle of proportionality only in so far as it is made necessary by overriding requirements of enforcement and prevention, when the gravity of the offence is taken into account".

Total Technology

23. In *Total Technology* the surcharge in question was of a different order of magnitude from that in *Enersys*. The relevant default was the second in the surchargeperiod and the surcharge at the rate of 5% amounted to £4,260.26. The

First-tier Tribunal in that case had decided that the penalty was disproportionate as it was "not merely harsh but plainly unfair", applying the judgment of Simon Brown LJ in *International Transport Roth GmbH v Secretary of State for the Home Dept.*[2003] QB 728 ('*Roth*') at [26].

24. The Upper Tribunal overturned this decision, holding that the surcharge was not disproportionate. It described at [104] the factors relied upon by the First-tier Tribunal, namely (a) the number of days of the default; (b) the absolute amount of the penalty; (c) the inexact correlation of turnover and penalty; and (d) the absence of any power to mitigate. The tribunal concluded at [105] that none of those factors led to the conclusion that the default surcharge regime as a whole infringes the principle of proportionality or to the conclusion that the actual penalty imposed on the company did so.

25. The tribunal in *Total Technology* undertook a thorough examination of the jurisprudence on the principle of proportionality, both from the perspective of EU law 40 and of the European Convention on Human Rights ("the Convention"). It concluded at [72], relying in particular on the judgments of the ECJ in *Louloudakis* and in *Márton Urbán v Vám-és Pénzügyőrség Észak-alföldi Regionális Parancsnoksága* (Case C-210/10) (9 February 2012, unreported), first, that penalties must not go beyond what is strictly necessary for the objectives pursued, and secondly, that a penalty must not be so disproportionate to the gravity of the infringement that it becomes an obstacle to the underlying aims of the VAT directive. In that regard, and in connection with the issue whether proportionality is to be tested by reference to the scheme as a whole or in an individual case, the tribunal stated that an excessive penalty would impose a disproportionate burden on a defaulting trader and distort the VAT system as it applies to him.

26. The tribunal went onto conclude, [at 78] in common with what judge Bishopp had decided in *Enersys*, that it is open for a tribunal to find that a penalty system as a whole is disproportionate, in which case a flaw which offends against the principle of proportionality may be relied upon by any affected person, and as well to consider an individual penalty without having first concluded that the system as a whole is disproportionate.

27. The tribunal noted that the aim of the default surcharge regime was twofold - from a general perspective it aimed to ensure compliance with a taxpayer's obligations to file returns and to pay tax, and more specifically it aimed to ensure submission of returns and the payment of tax on the due date. The tribunal went on to examine possible areas of criticism about the general architecture of the statutory scheme at issue here. At [83], the tribunal identified the main such areas as follows:

> (a) The regime does not distinguish between a trader who has made a trivial slip and a trader who deliberately fails to file a return and to pay on the due date. Nor does it cater for degrees of culpability between those two extremes.

(b) A trader who is late but has a reasonable excuse is not subject to a penalty. Nor, however long he then delays in payment, is he subjected to a penalty.

(c) In contrast, a trader who is late is subject to a penalty which cannotbe reduced even though his payment is only a single day late.

(d) The regime does not distinguish between traders who are a day late, a week late or even a month late, in contrast with some other regimes to be found in the United Kingdom tax system.

(e) The potential hardship to a trader is not a factor to be taken intoaccount. In particular, the amount of the penalty is not related to profitability.

(f) The previous compliance record of the trader is not taken into account save in the negative sense that previous defaults within the preceding 12 months affect the amount of the penalty (as a percentage ofthe tax overdue).

(g) The correlation between the turnover of the trader and the size of the penalty is far from exact even where there is a failure to pay any of the tax due.

(h) There is no maximum penalty.

(i) There is no discretion to reduce or waive a penalty once imposed. Although the 'reasonable excuse' exception provides some relief from the harshness of the regime, there are meritorious cases where a penalty, it is suggested, should not be paid that cannot be brought within that exception.

28. For the reasons explained by the tribunal at [86] – [98], the tribunal concluded, at [99], in relation to the default surcharge regime itself that "there is nothing in the VAT default surcharge which leads us to its conclusion that its architecture is fatally flawed". However, there were some aspects of it which might lead to the conclusion that on the facts of a particular case the penalty is disproportionate. But the tribunal urged caution in the assessment of whether an individual penalty is disproportionate, saying:

> "... the tribunal must be astute not to substitute its own view of what is fair for the penalty which Parliament has imposed. It is right that the tribunal should show the greatest deference to the will of Parliament when considering a penalty regime just as it does in relation to legislation in the fields of social and economic policy which impact upon an individual's convention rights. The freedom which Parliament has in establishing the appropriate penalties is not, we think, necessarily exactly the same as thefreedom which it has in accordance with its margin of appreciation in relation to convention rights (and even there, as we have explained, the margin of appreciation will vary depending on the right engaged)."

29. The tribunal summarised the position as follows (at [100]):

> Our conclusion, therefore, is that with the possible omission of an upperlimit 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."

30. As it is central to this case, we should also set out in full the tribunal's discussion, at [93], of the lack of a maximum penalty under the regime:

> "*There is no maximum penalty*. This, we think, is a real flaw at both the level of the regime viewed as a whole and potentially at the individual level of a taxpayer with a very large payment obligation. In *Enersys*, JudgeBishopp considered it unimaginable that a tribunal imposing a penalty would do so in an amount as much as £130,000 for the sort of error in that case. We have adopted a slightly different analysis of the purpose of the legislation from that set out in *Enersys*, and have taken a slightly different view of the requirements of the principle of proportionality, as a reflection of the changed focus of the arguments presented to us. But any approach to the analysis must pay due regard to the principle that the absolute amount of the penalty must be proportionate in the context of the aim pursued and in the context of the objectives of the directive. We agree therefore that there must be some upper limit, although it is not sensible for us in the present case to suggest where that might be. That is because the penalty imposed on the Company here, of £4,260, is clearly of a wholly different character from the £130,000 in issue in *Enersys*. If one accepts, as our conclusions above show must be the case, that a substantial, rather than purely nominal, penalty may legitimately be imposed it is in our judgment plain that the penalty imposed on the Company cannot properly be described as 'devoid of reasonable foundation' (*Gasus Dosier*) or 'not merely harsh but plainly unfair' (*Roth*) and that it correspondingly falls and, we would say, comfortably so, below any possible upper limit."

31. Having reached its conclusion as regards the regime as a whole, the tribunal turned to the factors put forward in support of the company's complaint of unfairness on its particular facts. Those factors, described by the tribunal at [101], were: (a) the payment was only one day late; (b) previous defaults had been innocent, even if no reasonable excuse could be established; (c) the company's excellent compliance record; and (d) the amount of the penalty represented an unreasonable proportion ofthe company's profits.

32. The tribunal held that at the individual level of the company, the amount of the penalty, even if looked at in isolation, could not be regarded as disproportionate. Furthermore, at [103], the tribunal held that the company's

Convention rights had not been infringed, as although the surcharge might be considered harsh, it could not be regarded as plainly unfair.

Our decision on proportionality

56. In respect of penalties the principle of proportionality, according to EU law, is concerned with two objectives. One is the objective of the penalty itself; the other the underlying aims of the directive. But more broadly, the objective of the penalty in enforcing collection of tax is itself a natural consequence of the essential aim of the directive to ensure the neutrality of taxation of economic activities.

57. In *Total Technology* the Upper Tribunal rightly focused not only on the general aim of the default surcharge regime to ensure compliance with a taxpayer's obligations to file returns and to pay tax, but on the specifics of that regime. It did so because questions of proportionality can only be judged against the aim of the legislation (*Total Technology*, at [79]). But the tribunal did not examine in detail the other relevant objective, namely the underlying aim of the directive, which we consider to be the more fundamental question.

58. That question is in our view fundamental because the way the principle of proportionality has been expressed in the case law is not confined to an examination of the penalty simply by reference to the gravity of the infringement. It is not enough for a penalty simply to be found to be disproportionate to the gravity of the default; it must be "so disproportionate to the gravity of the infringement that it becomes an obstacle to [the underlying aims of the directive"] (*Louloudakis*, at [70], referred to above).

59. The underlying aim of the directive that is relevant for this purpose was considered in *Profaktor*. It is the principle of fiscal neutrality in its sense of ensuring a neutral tax burden which protects the taxable person, since the common system of VAT is intended to tax only the final consumer. This is reflected, for example, in the system of deductions, in the UK of input tax, designed to ensure that the taxable person is not improperly charged to VAT. This analysis is derived from *Elida Gibbs Ltd v Customs and Excise Commissioners* (Case C-317/94) [1996] ECR I-5339, [1996] STC 1387, in which the ECJ also said (at [22]):

> "It is not, in fact, the taxable persons who themselves bear the burden of VAT. The sole requirement imposed on them, when they take part in the production and distribution process prior to the stage of final taxation, regardless of the number of transactions involved, is that, at each stage of the process, they collect the tax on behalf of the tax authorities and account for it to them."

60. It is a necessary concomitant of a system that provides for a system of deduction and collection of tax at each stage in the process, that tax should be accounted for, and paid, on a timely basis. That essential neutrality can itself be undermined by a failure of a taxable person to comply with its obligations. It is in that context that the legislative measures adopted by member states to ensure

collection and to deter default, and the question whether those penalties, either generally or in an individualcase, are so disproportionate as to constitute an obstacle to fiscal neutrality, must be viewed.

61. The Upper Tribunal in *Total Technology* determined, at [99], that the default surcharge system was not fatally flawed so as to give rise to disproportionate penalties generally, although at [100] it entertained some residual doubt about the absence from the regime of an upper limit on the penalty which might be imposed. It regarded certain aspects of the regime, however, as capable of leading to the conclusion, in an individual case, that the penalty is disproportionate. Chief amongst these was the question of the absence of a maximum penalty which the tribunal addressed at [93] in a passage we have set out above.

62. In our judgment, it is not appropriate for the courts or tribunals to seek to set any maximum penalty, or range of maximum penalties. That would in effect be to legislate. The task of the tribunal is to consider the relevant tests in the context of the individual case before it. It must not seek to establish a maximum and then compare the actual penalty to that benchmark. That was what the FTT attempted to do in this case, and it was wrong in law to have done so.

63. The correct approach is to determine whether the penalty goes beyond what is strictly necessary for the objectives pursued by the default surcharge regime, as discussed in detail in *Total Technology* and whether the penalty is so disproportionate to the gravity of the infringement that it becomes an obstacle to the achievement of the underlying aim of the directive which, in this context, we have identified as that of fiscal neutrality. To those tests we would add that derived from *Roth* in the context of a challenge under the Convention to certain penalties, namely "is the scheme not merely harsh but plainly unfair, so that, however effectively that unfairness may assistin achieving the social goal, it simply cannot be permitted?"

64. In *Total Technology* the Upper Tribunal identified, at [84], features of the regime which supported an argument that the scheme was fair. The tribunal said:

> "However, from HMRC's point of view, the regime has a lot to commend it. It is mechanistic and therefore comparatively easy to administer. There is no need for hard-pressed officers of HMRC to spend scarce time and resources in dealing with a vague and amorphous power to mitigate a penalty. The following factors can be prayed in aid in response to the unfairness alleged by the Company:
>
> (a) The simplicity of the system makes it easily understood, as well asbeing relatively easy to operate.
> (b) The surcharge is only imposed on a second or subsequent default, and after the taxpayer has been sent a surcharge liability notice warning him that he will be liable to surcharge

if defaults again within a year. Taxpayers thus know their positions and should be able conduct their affairs so as to avoid any default.

(c) The penalty is not a fixed sum but is geared to the amount of outstanding VAT. Although a somewhat blunt instrument, it does bring about a broad correlation between the size of the business and the amount of the penalty. It does not suffer from the objections which could be madeto the fixed penalty in *Urbán.*

(d) The percentage applicable to the calculation of the penalty increases with successive defaults if they occur within 12 months of each other. This is a rational and reasonable response to successive defaults by a taxpayer.

(e) The 'reasonable excuse' exception strikes a fair balance. The gravityof the infringement is reflected in the absence of 'reasonable excuse' andthe amount of the penalty reflects the extent of the default, that is to say the amount of tax not paid by the due date."

65. We agree with the tribunal in *Total Technology* that the default surcharge regime, viewed as a whole, is a rational scheme. The penalties are financial penalties, calculated by reference to the amount of tax unpaid at the due date. Although penalties may vary with the liability of the taxable person for the relevant VAT period, and increase commensurately with an increase in such liability (and, consequently, such default), the penalties are not entirely open-ended. The maximum liability for a fifth or subsequent period of default is 15% of the amount unpaid. In common with the Upper Tribunal in *Total Technology*, we consider that the use of the amount unpaid as the objective factor by which the amount of the surcharge varies is not a flaw in the system; to the contrary, the achievement of the aim of fiscal neutrality depends on the timely payment of the amount due, and that criterion is therefore an appropriate, if not the most appropriate, factor.

66. However, we accept that, applying the tests we have described, the absence of any financial limit on the level of surcharge may result in an individual case in a penalty that might be considered disproportionate. In our judgment, 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 characteristics of a case where such a challenge to a default surcharge would be likely to succeed.

67. We should, in particular, not be taken to have endorsed the suggestion put forward by Mr. Mantle that the exceptional circumstances that might give rise to a disproportionate penalty could include cases, such as *Enersys*, where there had been what was described as a "spike" in profits, such that for a particular VAT period the liability to account for and pay VAT was of a different order

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

68. With these observations in mind, we turn to the particular facts of Trinity Mirror's case. Viewed simply in absolute terms, the surcharge of £70,906.44 is large. Its size was dictated by the substantial sum of VAT, £3,545,324 that Trinity Mirror paid late, the surcharge being levied at the rate of 2% for a first default within the surcharge period. Although payment was delayed by only one day, we accept that the scheme of the default surcharge regime is to impose a penalty for failing to pay VAT on time, and not to penalise further for any subsequent delay in payment. That, as we have described, is entirely consistent with the fiscal neutrality aim of the directive. It would not be possible, therefore, in our view, for the fact that the payment was only one day late to render an otherwise proportionate penalty disproportionate.

69. In our judgment, there are no exceptional circumstances in Trinity Mirror's case that could render this surcharge disproportionate. A financial penalty of this nature, based on a modest percentage of the amount of VAT unpaid by the due date, cannot be regarded as going beyond the objectives of the default surcharge regime.

70. 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.

71. 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.

72. 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 characterised as devoid of all reasonable foundation. The penalty might be considered harsh, but in our view it cannot be regarded as plainly unfair."

The Appellant's case

19. The Appellant does not dispute that its VAT payment for period 07/14 was due on 30 September 2014 or by 07 September 2014 if paid electronically, nor that HMRC received the payment on 09 September 2014.

20. The Appellant's grounds of appeal as set out in its Notice of Appeal (amended here to exclude reference to the First-tier Tribunal decision in *Total Technology (Engineering) Limited*, which since the Appellant's Notice of Appeal was lodged with the Tribunal has been overturned by the Upper-tier Tribunal), can be summarised as follows:

i. The penalty of £114,516.19 is 'plainly disproportionate, harsh and unfair'. The Appellant referred, in support of its contentions, to the Tribunal decision in *Enersys.*

ii. The Appellant maintains that there were wholly exceptional circumstances that led to the Surcharge. These were that in the default period 07/14, it disposed of an interest in its main asset that resulted in VAT due of approximately £2.3 million. This compared with the Company's usual position of submitting repayment returns, or on the few occasions where VAT was due, for small amounts of approximately £2,000.

21. STM Fiduciaire Limited ("STM"), an asset management company based in Jersey, undertakes administrative and directorship services for the Appellant. As a part of STM's engagement, it is responsible for submitting VAT returns and paying VAT on behalf of the Appellant.

22. Ms Linda Nicol, the managing director of STM, in a witness statement on behalf of the Appellant, said that the Appellant was established as a property leasing company and had owned various properties which were let to tenants. She explained that it is no longer letting any property having sold its main asset, 12-22 St. Giles Street, Edinburgh, (the "Property") by way of a grant of a 75 year lease in the quarter 07/14.

23. As a result of the sale of the Property, the Company's liability for payment to HMRC for that quarter was in the region of £2.2m, which Ms Nicol said was approximately 20 times more than the maximum amount of VAT the Appellant had previously ever had to pay.

24. Ms Nicol provided a spreadsheet which detailed the Appellant's VAT payment history for the period between 1 August 2011 and 31 December 2015. These are shown at the Table below.

25. In terms of size of the Appellant's operations, the vast majority of the Appellant's turnover was derived from the Property which had now been sold. Its turnover reported in the financial statements for the years 2012, 2013, 2014 and 2015 (copies provided) had been as follows:

For year ended September 2015 - £0
For year ended September 2014 - £603,000
For year ended September 2013 - £559,000
For year ended September 2012 - £1,916,000

26. Ms Nicol said that the 07/14 VAT payment was late because the relevant staff member at STM, failed to make the payment on time. STM accepted responsibility for this delay.

27. The surcharge was nearly 20% of the Appellant's turnover for the year ended September 2014 and was nearly 25% of the operating profit earned by the Appellant for the same year.

	Output VAT	Input VAT	Net
Oct-11	£0.00	£0.00	£0.00
Nov-11	£0.00	£700.00	(€700.00)
Dec-11	£0.00	£0.00	£0.00
Jan-12	£0.00	£0.00	£0.00
Feb-12	£0.00	£0.00	£0.00
Mar-12	£0.00	£0.00	£0.00
Apr-12	£0.00	£0.00	£0.00
Jul-12	£0.00	£0.00	£0.00
Oct-12	*£84,000.00*	*£2,550.50*	*£81,449.50*
Jan-13	£0.00	£3,862.47	(£3,682.47)
Apr-13	£112,000.00	£763.60	£11,236.40
Jul-13	*£2,279.71*	*£607.30*	*£1,672.41*
Oct-13	£0.00	£2,298.79	(£2298.79)
Jan-14	£0.00	£11,963.70	(£11,963.70)
Apr-14	£0.00	£386.23	(£386.23)
Jul-14	*£2,297,066.32*	*£5,782.49*	*£2,291,283.83*
Oct-14	£37,658.33	£4,343.18	£33,315.15
Jan-15	£0.00	£946.60	(£284.12)
Mar-15	£0.00	£0.00	£0.00
Apr-15	£0.00	£0.00	£0.00
May-15	£0.00	£0.00	£0.00
Jun-15	£0.00	£0.00	£0.00
Jul-15	£0.00	£0.00	£0.00
Aug-15	£0.00	£0.00	£0.00
Sep-15	£0.00	£0.00	£0.00
Oct-15	£0.00	£268.20	(£268.20)
Nov-15	£0.00	£0.00	£0.00
	£0.00	£400.00	(£400.00)

[The default period under appeal and previous default periods are identified in italics in the Table]

28. Mr Thomas appearing for the Appellant said that the financial penalty issued to the Appellant in this case is a clear paradigm of a situation where the strict application of the VAT default surcharge regime produces an unintended and disproportionate result. The breach, modest if all circumstances are taken into account, coincided with a "spike" in the amount of VAT payable by the taxpayer. He said that HMRC themselves suggested that this scenario was the obvious occasion when a surcharge might be disproportionate: *Trinity Mirror* at [67]. During the period in respect of which the Surcharge was levied, the Appellant sold its major capital asset in a transaction which attracted VAT, and so the Surcharge was levied on an amount of VAT that was much higher and out of all proportion to the VAT that the Company would normally have paid. The surcharge is very clearly disproportionate to the breach.

29. Mr Thomas said that the Appellant's VAT payment pattern is unusual. In the majority of the VAT periods between October 2011 and December 2015, as shown in the Table, the Appellant had for VAT purposes, been either in a nil payment or a refund position. Of the 28 returns submitted over that four year period, only 5 returns required a net payment due to HMRC. The remaining 23 returns show a nil return or a refund due from HMRC. Further, except for the quarter ended July 2014, the Appellant had never had to make a payment of VAT to HMRC in excess of £115,000.

30. He conceded that in that there had been a "spike" in taxable income some 18 months previously, when VAT of £81,450 was due, but to use that as an analogy for suggesting that spikes in the Appellant's income was not unusual would be ridiculous. The liability of £81,450 is of an entirely different order to £2,291,284. There had been a massive "spike" in the VAT liability for the period in respect of which the Surcharge was issued because the Appellant sold its main capital asset and by unfortunate coincidence the VAT fell due over a weekend which contributed to the agent paying the VAT two days late.

31. Mr Thomas submitted that if one goes further and considers relevant EU law in more detail, then it is clear that the surcharge is entirely disproportionate to the gravity of the default. UK law, including sections 59 and 84 Value Added Tax Act 1994 ("VATA 1994"), must of course be interpreted so as to give effect to the overriding requirements of EU Law: *Marleasing SA v La Comercial Internacional del Alimentacion SA* (Case C-106/89) [1990] ECR I-4135, ECJ.

32. Here, the tax was paid two days late (following two similar failures over an extended period) with the return having been submitted on time. Not only is this a minor failure as a matter of common sense, under EU Law it is characterised as a *"merely formal infringement that cannot call into question the taxable person's right to deduct"*: *Equoland Soc. Coop. arl v Agenzia delle Dogane (CaseC-272/13) [2014] ("Equoland")* at [39].

33. Penalties imposed by a Member State must not go further than is necessary to attain the objective of the Principal Directive:

> "In order to assess whether such a penalty is consistent with the principle of proportionality, the nature and degree of seriousness of the infringement which that penalty seeks to sanction must, inter alia, be taken into account, as must also the means of establishing the amount of that penalty": *Equoland* at [34].

34. A penalty which makes a single transaction subject to double imposition of VAT, while only allowing that tax to be deducted once (so as to create "sticking" VAT), leaves the taxable person liable to pay the remaining VAT and amounts in essence to depriving that person of his right to deduct: *Equoland* at [40]:

> "The Court has repeatedly held that, in view of the preponderant position which the right to deduct has in the common system of VAT, which seeks to ensure complete neutrality of taxation in all economic activities, that neutrality presupposes that a taxable person may deduct the VAT paid or payable in the course of all of his economic activities, a penalty consisting of a refusal of the right to deduct is not compatible with the [directive] where no evasion or detriment to the budget of the state is ascertained":

Equoland at [41] and the authorities there cited.

35. For a tribunal to set aside a default surcharge, it has to be shown that the surcharge either "goes beyond what is strictly necessary for the objectives pursued by the default surcharge regime" or is "so disproportionate to the gravity of the infringement as to constitute an obstacle to the underlying aim of the directive", which is fiscal neutrality: *Trinity Mirror* at paragraphs 14, 58, 63 and 71. An excessive penalty imposes a disproportionate burden on a trader and distorts the VAT system as it applies to him: *Total Technology* at [72].

36. The gravity of the default is clearly very relevant because the proportionality test is applied by reference to this: *Trinity Mirror* at [58]. It therefore follows that the gravity of the default must be assessed by all the circumstances and is not dictated simply by reference to the number of times the taxpayer is in default: *Trinity Mirror* at [48]. As a consequence the absence of reasonable excuse is not relevant to the gravity of the default: *Trinity Mirror* at [55].

37. Mr Thomas submitted that the size of the penalty in absolute terms had to be a very relevant factor. The absence of a maximum penalty is the chief factor upon which the Upper Tribunal in *Total Technology* considered that a penalty in an individual case might be disproportionate: *Total Technology* at [93] and also *Trinity Mirror* at [61] and [66].

38. The size of the penalty relative to the taxpayer's business is also relevant. In *Sony Ericsson Mobile Communications AB v Commissioners for HM Revenue and Customs* [2007] VAT Tribunal No. 20513 ("*Sony Ericsson*") a default surcharge penalty of £675,575 was upheld because although large in absolute terms it reflected the value of the taxpayer's supplies and the amount of VAT due. Whereas in *Enersys*

when finding a surcharge disproportionate, Judge Bishopp relied partly on a comparison with the taxpayer's financial circumstances, namely that the surcharge represented almost 16% of its profits for the entire year, was equivalent to two months' of turnover and amounted to 44% of its corporation tax liability for the entire year: see [44], [57] and [61].

39. The Surcharge is totally disproportionate to the size of the Appellant's business. (It is almost 20% of the turnover and nearly 25% of the operating profit earned by the Company for the accounting year in which the default arose). The Surcharge exceeds the highest amount of actual VAT which the Company was required to account for to HMRC in any other period during the time from October 2011 to December 2015. The Surcharge is entirely out of proportion to the value of the taxable supplies typically made by Frasers.

40. Following the approach in *Enersys*, there is no way that a court or tribunal would have considered levying a penalty of anything like the Surcharge had it been given a discretion to decide what level of penalty is appropriate in the present case.

41. The penalty has been calculated mechanically in accordance with s 59 VATA 1994. It has not been tailored to the individual case as this is impossible under the default surcharge regime. A much smaller penalty would have sufficed to achieve the objective of ensuring timely compliance. A penalty of, say, £20,000 would have been a very significant deterrent to the Company and such an amount would itself be disproportionate – even at only a fraction of the Surcharge. The Surcharge therefore goes far beyond what is strictly necessary for ensuring compliance with the VAT payment obligations for a business the size of the Appellant Company.

42. This is the first occasion on which the Company was actually required to pay a Surcharge to HMRC in respect of the relevant defaults. The relevance of this is that a much smaller penalty would have had the appropriate deterrent effect – HMRC cannot say that a smaller fine did not deter the Appellant because they never levied one. Secondly, it indicates that the first two defaults were not serious and therefore taking that into account the overall gravity of the third default was not serious.

43. It is not sufficient for HMRC to argue simply that the Surcharge is justified as it is only 5% of the tax due for the period. A default surcharge is only ever calculated by reference to the tax which is due. Accordingly, although this linkage helps justify the default surcharge regime as a whole it does not prevent a taxpayer from prevailing where it has been demonstrated that the Surcharge would otherwise be disproportionate.

44. Here there was a spike in the Appellant's VAT outputs of an order far beyond what its normal trading activities would have produced. Although the Upper Tribunal expressly refused to endorse a spike in profits as a circumstance that would allow a tribunal to consider a Surcharge as being disproportionate, this was only because any attempt to isolate by reference to particular criteria any such circumstances was inappropriate, as that might confine an exceptional jurisdiction.

45. In *Blue Ocean Associates Limited v Commissioners for HM Revenue and Customs* [2016] UKFTT 042 (TC) ("*Blue Ocean*") it was said at [26] that:

> "if the principle is that it is entirely appropriate to calculate a surcharge by applying the specified percentage to the amount of tax unpaid even in a case where there has been a "spike" in profits, then it is hard to see what circumstances could lead a surcharge so calculated to be regarded as disproportionate"

46. In absolute terms the Surcharge of £114,564.19 is a very large penalty. There had been a massive increase in the VAT for which the Appellant was required to account in the period of default so that the VAT outstanding was of a different order of magnitude than was normal. Moreover, this was not due to any spike in profits but rather because the Appellant sold its main capital asset. As said in *Blue Ocean* if the principle is that it is entirely appropriate to calculate a Surcharge by applying the specified percentage to the amount of tax unpaid even in a case where there has been a "spike" in profits, then it is hard to see what circumstances could lead a Surcharge so calculated to be regarded as disproportionate.

47. Mr Thomas submitted that the Surcharge in this case is contrary to EU Law. It went beyond what is strictly necessary for the objective pursued by the default surcharge regime and is so disproportionate to the gravity of the Appellant's infringement that it is an obstacle to the achievement of fiscal neutrality in accordance with the underlying aim of the Principal VAT Directive.

48. Given the circumstances of the default, a two day delay due to inadvertence on the part of an employee of the agent, the gravity of the default is very minor. As a belated settlement of VAT in the absence of attempted evasion or detriment to the budget of the State, the Appellant's default is categorised as merely formal under EU Law: *Equoland* at [39]. The Appellant delegated its VAT compliance and payment obligations to an appropriate third party; although this cannot provide the Company with a reasonable excuse by virtue of s 71(1)(b) VATA 1994, it certainly affects the gravity of the default. All VAT returns were submitted on time. In the 19 month period from 1 November 2012 to 31 July 2014 there were two periods of default, the payments having been made only two and eleven days late and in neither case was a surcharge levied.

49. The penalty is clearly tax-related rather than in the nature of a fixed sum for a minor breach. It generates additional revenue with no corresponding right to deduct. It is therefore contrary to EU law because it is a restriction on fiscal neutrality which is unjustified in the absence of evasion or financial detriment to the State: *Equoland* at [39] to [41]. EU Law is clear; significant tax-related penalties for merely formal defaults are not permitted.

50. The operation of the scheme in the circumstances of the present case is not merely harsh but plainly unfair, so that it cannot be permitted in accordance with the European Convention on Human Rights: *Trinity Mirror* at [63].

51. Although UK law does not permit a taxpayer to simply appeal and ask for a default surcharge to be mitigated where, as the Appellant submits is the position here, a surcharge should be struck down as disproportionate, it is open to HMRC to argue that s 84(6) VATA 1994 provides a mechanism whereby the tribunal can substitute an appropriate penalty. This would achieve the optimum result from an EU Law perspective by ensuring that all taxpayers are subject to penalties which are appropriate but which do not offend fiscal neutrality. This is not the same as saying that the tribunal has a general power to mitigate default surcharges which are perhaps unduly harsh, because a taxpayer would need to have the default surcharge set aside as contrary to EU Law before this power can be applied. In other words, the result of the Appellant's submissions succeeding is not inevitably that it suffers no penalty as s 84(6) VATA 1994 may enable the tribunal to reach a result which not only complies fully with EU Law but is also fair.

HMRC's case

52. Mr Robinson for HMRC said that the Appellant, by period 07/14, would have been aware of the consequences of paying VAT late, having received Notices for two earlier defaults (10/12 and 07/13) and should have taken the appropriate steps to ensure that payment was made in time.

53. The first default results in a trader being placed in the Default Surcharge regime for a specified surcharge period and being put on notice that he may be liable to a Default Surcharge of 2% if there is a further default in that surcharge period. A second default in the surcharge period, in addition to a penalty of 2% of the VAT paid late (subject to HMRC not collecting an amount up to £400) leads to the trader being informed that the next default may lead to a surcharge of 5% of any VAT paid late.

54. The surcharge has been applied in accordance with legislation and is not disproportionate. The Upper-tier Tribunal found in *Trinity Mirror* that the surcharge of £70,906.44 in that case could not be regarded as disproportionate by reference to EU law. The judgment is binding and HMRC's submissions in the instant appeal are in keeping with that judgment. Although the surcharge may appear harsh it is not, "plainly unfair".

55. In *Sony Ericsson* a penalty of £675,575, calculated at 2% of the tax paid late, was found not to be disproportionate. The Tribunal Chairman noted in that case:

> "On the issue of proportionality, it does not seem to us that the penalty in this case is any more disproportionate than in any other case. The penalty is large in absolute terms but that reflects the value of the Appellant's supplies and the amount of tax that had not been paid by the due date." (paragraph 37)

56. HMRC do not dispute that in period 07/14 the VAT due was a much higher amount than was usual for the Appellant. However, in period 10/12 the VAT due was £81,449.50. The Appellant was therefore not unfamiliar with a larger-than-usual VAT payment being due for a single quarter.

57. The circumstances surrounding the large amount of VAT due and the fact that this was a sale of a capital asset, do not themselves make the Surcharge disproportionate.

58. The Upper-tier Tribunal in *Trinity Mirror* held that it is legitimate to take account of the amount of tax related to the penalty in assessing the gravity of a default:

> "The underlying aim of the directive that is relevant for this purpose was considered in *Profaktor*. It is the principle of fiscal neutrality in its sense of ensuring a neutral tax burden which protects the taxable person, since the common system of VAT is intended to tax only the final consumer." (paragraph 59 of the decision).

59. HMRC submit that in *Trinity Mirror* the Upper Tribunal did not endorse the suggestion that exceptional circumstances that might give rise to a disproportionate penalty could include cases such as *Enersys* where there had been what was described as a "spike" in profits in the VAT period for which the surcharge had been imposed, even if the consequent liability for VAT was of a different order of magnitude than was normal for the trader concerned.

60. The liability of £81,450 in period 10/12 was admittedly, substantially less than the £2,291,284 liability in 07/14 but it still shows that the Appellant does have "spikes" in its trading income. The £81,450 represented an increase of some magnitude compared to the small amounts (£2,000 approximately) due.

61. At paragraph 76 of the Decision in *Total Technology* Mr Justice Warren states:

> "...imagine a flat rate penalty of £50, 000 for a third default which no-one could possibly say was a permissible penalty for ordinary small traders...."

The Appellant is however not within the category of "ordinary small traders". The penalty, at £114,564.19 represents less than 1% of the value of the Appellant's sales of £11,485,331.00.

62. The Company's profitability is not a factor to be taken into account when considering proportionality. This view is supported by the judgment in the UT case of *Total Technology*, and which is also cited in *Blue Ocean* at paragraph 34 of that decision.

> "The potential hardship to a trader is not a factor to be taken into account. In particular, the amount of the penalty is not related to profitability." (*Total Technology* paragraph 90)

63. A modest percentage (which HMRC maintain 5% is) of the VAT which is due as a financial penalty is consistent with the objectives of the Default Surcharge regime according to the UT at [69] of *Trinity Mirror*:

> "A financial penalty of this nature, based on a modest percentage of the amount of VAT unpaid by the due date, cannot be regarded as going beyond the objectives of the default surcharge regime."

64. The surcharge is not contrary to EU law. The *Equoland* decision has little relevance to the instant appeal given that it concerned very different facts and circumstances, for example the penalties under appeal were for a failure to observe the obligation to physically place imported goods in a tax warehouse. In addition, the regime in that case imposed a penalty at a fixed rate of 30% of the VAT concerned, whereas VAT Default Surcharges are imposed on a graduated scale of 2% to 15%.

65. Nor is the penalty in the instant appeal "an obstacle to... the underlying aims of the directive". The Upper-tier Tribunal in *Trinity Mirror* accepted that the absence of any financial limit on the level of surcharge may result in a penalty that might be disproportionate. However, this is likely to occur only in a "wholly exceptional case" and the facts of this case cannot be described as "wholly exceptional".

66. In *Enersys* the First-tier Tribunal found that the default surcharge was disproportionate, having considered that the penalty was *"not merely harsh but plainly unfair"* for reasons which included the fact that the Appellant had made the mistake of confusing the due dates for two associated companies.

67. In the decision of the UT in *Total Technology* the UT concluded at [99]

> "….in assessing whether the penalty in a particular case is disproportionate, the tribunal must be astute not to substitute its own view of what is fair for the penalty which Parliament has imposed"

The surcharge has been determined in accordance with legislation and the circumstances must be compelling before a surcharge can be regarded as unfair and disproportionate.

Conclusion

68. Mr Robinson referred to the similar case of *Susanna Claire Posnett v HMRC,* which concerned the late submission of the Appellant's VAT return, and as in this case, the late the late payment of VAT, (8 days late). A very substantial amount of net VAT fell due because of a single large land transaction. The penalty of £217,701.52 was calculated at 15% of the net VAT payable on the return.

69. The Appellant's case was that the penalty imposed was disproportionate and "plainly unfair" by reference to the sheer magnitude of the penalty and the fact that it arose from a significant large and one-off exceptional transaction. Furthermore it did not arise from a spike of profits because it was not within the normal pattern of the Appellant's business. It was a one off. The Appellant's compliance record had been poor; she had been required to pay two previous penalties albeit in relatively small sums which exacerbated the rate at which the penalty had to be calculated.

70. For HMRC it was argued that in assessing the gravity of the penalty, the amount of VAT which was unpaid as at the return due date was a factor to be taken into account. The Appellant had failed to pay on a timely basis a very substantial sum in net tax due to HMRC.

71. It is established law that there is nothing in the default surcharge regime as a whole which renders its architecture as fatally flawed. It is however recognised that a default surcharge could be plainly unfair if the regime as it applies to an individual taxpayer operates in a disproportionate manner.

72. In absolute terms a penalty of £114,564.19 for a two day delay in payment would seem very harsh. Whilst on the one hand the courts have identified that the use of the amount unpaid, in this case £22,912,263.00, as the objective factor by which the surcharge is determined to be the most appropriate factor in the calculation of the surcharge, it is also recognised that the regime is flawed insofar as there is no mechanism for determining a maximum penalty. The absence of a financial limit on the level of the default surcharge may therefore result, in the circumstances of an individual case, in a penalty that might be considered disproportionate. The courts have said that this is likely to occur only in a "wholly exceptional case".

73. As the objective of the default surcharge regime is to penalise a failure to pay VAT on time and not to penalise for a further delay in payment, the fact that a late payment is made only two days after its due date is not sufficient to render an otherwise proportionate penalty disproportionate.

74. The underlying aim of the relevant directive is the principle of fiscal neutrality, since the common system of VAT is intended to tax only the final consumer, and again as stated in *Trinity Mirror* it is fundamental to a system that provides for the deduction and collection of tax that, at each stage in the process, tax should be accounted for and paid on a timely basis.

75. As stated in *Trinity Mirror* the correct approach is to determine whether the penalty goes beyond what is strictly necessary for the objective pursued by the default surcharge regime. The principle of proportionality is concerned with two objectives - the objective of the penalty itself and the underlying aims of the relevant directive. Of the two objectives, the latter has been stated by the courts as the more fundamental. It is not enough for a penalty simply to be found to be disproportionate to the gravity of the default. It must be "so disproportionate to the gravity of the infringement that it becomes an obstacle to [the underlying aim of the directive]" *(Louloudakis* at [70]).

76. We also have to ask whether, in the context of the circumstances of the breach, is the application of the scheme "not merely harsh but plainly unfair, so that, however effectively that unfairness may assist in achieving the social goal, it simply cannot be permitted?"; *International Transport Roth GmbH v Secretary of State for the Home Dept.* [2003] QB 728 at [26].

77. The Upper Tribunal in *Trinity Mirror* expressly stated that it should not be taken to have endorsed the suggestion that the exceptional circumstances giving rise to a disproportionate penalty could include cases where there has been a "spike" in profits but that is not to say that a penalty imposed in such circumstances could never be disproportionate, in particular where neglect or culpability was minimal.

78. The question is therefore whether this is an example of the "wholly exceptional case".

79. Section 71(1)(a) VATA - Construction of sections 59 to 70, provides that "For the purposes of any provision of section 59 ... which refers to a reasonable excuse for any conduct where reliance is placed on any other person to perform a task, neither the fact of that reliance nor any deleteriousness or inaccuracy on the part of the person relied upon is a reasonable excuse". The purpose of this legislation, particularly in the overriding context of fiscal neutrality in the administration and collection of VAT is plain. Without such a provision the infrastructure of the VAT system would be open to failure.

80. However, for the purpose of deciding whether a surcharge is disproportionate, and whilst reliance placed on another person to perform a task cannot provide a reasonable excuse in itself, where it is one of a number of circumstances which have combined to cause a delay in payment not involving any direct neglect or culpability on the part of the taxpayer, resulting in a very substantial surcharge in absolute terms, it would be unreasonable for reliance not to be considered when combined with other mitigating features.

81. Where the delay in payment is exacerbated by a "spike" in taxable income arising not from exceptional profits, but as in this case, from the sale of the taxpayer's main asset, even taking into account the fact that the amount of VAT not paid on time is an appropriate objective factor by which the surcharge is calculated, the penalty imposed could be regarded as disproportionate to the gravity of the infringement and in that respect an obstacle to the underlying aim of the directive.

82. We therefore take the above mitigating circumstances into account. However this was a third default over an extended VAT default period of 19 months. The gravity of the default must be assessed by reference to all the relevant factors. The Appellant had been notified by the surcharge liability notice issued following the first default and the notice which followed the second default that any further default within the extended surcharge liability period could result in a surcharge of 5% of the amount due. Knowing this, as the Appellant should, and that a very substantial sum in VAT would be payable, a careful and prudent taxpayer would have ensured that payment was made on time.

83. Taking all these facts into account, a penalty of 5% of delayed VAT which reflects the value of the Appellant's supplies in the default period and which has been imposed as part of a regime designed to encourage prompt payment of VAT collected by a taxable person and thereby preserve the fiscal neutrality of the VAT system, cannot be regarded as so disproportionate to the gravity of the infringement as to

constitute an obstacle to the underlying aim of the directive. It has been arrived at by the application of a rational scheme that cannot be characterised as "devoid of all reasonable foundation". The penalty might be considered harsh, but in our view, particularly given that it relates to a third breach, cannot be regarded as "plainly unfair".

84. For the reasons above the appeal is dismissed and the surcharge upheld.

85. 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.

MICHAEL CONNELL

TRIBUNAL JUDGE
RELEASE DATE: 25 NOVEMBER 2016