TC02550

Appeal number: TC/2011/06612

INCOME TAX – PAYE – Penalty – Late Payment – Special Reduction – Reasonable Excuse – Unforeseen withdrawal of invoice discounting facilities - Effect on otherwise predictable insufficiencies of funds

FIRST-TIER TRIBUNAL
TAX CHAMBER

CUCO **Appellant**

- and -

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

TRIBUNAL: SIR STEPHEN OLIVER QC
MR NICHOLAS DEE

Sitting in public in London on 22 October 2012

H.H. Shah, MBA ACA FCCA CTA, of McCormack & Associates, for the Appellant

P. Reeve, for the Respondents

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DECISION

1. The Appellant appeals against a penalty imposed for late payment of NIC and PAYE for the year ended 5 April 2011. The disputed penalty, reduced from £29,759.50, is now charged as £23,759.50.

2. There is no dispute that the relevant monthly PAYE/NIC payments were made late as claimed by HMRC. Nor is there any dispute as to the calculation of the penalty.

3. Following receipt of a late penalty notice, McCormack & Associates, the accountants acting for the Appellant, wrote to HMRC (on 7 October 2011) advancing a "reasonable excuse" defence for all the late payments as well as challenging the fairness and proportionality of the penalty. In the same letter a request was made for a "special reduction" in the penalty. HMRC's review decision, given in a letter of 21 October 2011, was that the circumstances described in the letter of 7 October did not amount to a reasonable excuse and did not qualify for the special reduction.

4. Evidence was given by the director and sole shareholder of the Appellant. We refer to him as "the Director".

Facts relating to the Appellant's cash-flow during the relevant period.

5. The business of the Appellant is that of haulier, tipping contractor and waste recycling. Throughout the relevant period it had some 100 employees. It has calendar year accounting periods.

6. As well as owning the Appellant company, the Director owns directly all the shares in a company referred to as "Holdings"). Holdings owns plant and machinery and properties which it leases out to, among others, the Appellant.

7. The Appellant's turnover for the years 2008, 2009, 2010 and 2011 was some £18.8m, £14m, £14m and £18 m respectively. Its profitability, as a percentage of turnover, declined from 3.18% in 2009 to 1.70% for 2010.

8. The Appellant had, for many years and until early in 2010, met its cash-flow requirements by means of an "invoice discounting facility" obtained from A Ltd. A Ltd undertook to discount £3.5m of invoices subject to a limit of 85% of amounts outstanding. There was to be no discounting of invoices of any debtor whose liability exceeded 19% of total amounts owed to the Appellant. (That is referred to as the "debt concentration limit".)

9. At the start of 2010 A Ltd transferred its factoring and invoice discounting relationships to B Ltd. The Appellant received a letter from B Ltd explaining that it "would experience little change on a day to day basis". Within three months, however, B Ltd terms changed and by stages thereafter the facility was reduced to £3m subject to a limit of 75% of amounts outstanding and subject to a debt concentration limit of 10%. A further consequence of the change to B Ltd was that

invoices relating to sales by the Appellant of plant and machinery were no longer discountable.

10. An analysis of trade debtors over the three years 2008, 2009 and 2010 showed that the average "debtor days" had increased from 71 to 95 to 105.

11. In the year 2010 the Appellant wrote off some £217,000 of bad debts. The largest bad debt that year had been some £105,000. The bad debts written off in 2009 had been some £85,000 and £98,000 for 2011. The significance of that was that the write-off had happened in a year when gross profit (i.e. turnover minus trade purchases and cost of sales) had been at around 17%. Thus some £1.3m of turnover will, in consequence, have produced no profit.

12. Until 2010, the Appellant held no fixed assets. The use of these had, we understand, been made available by Holdings in return for charges. In 2010, the Appellant is shown as having acquired fixed assets of some £1.18m. Those assets were what remained of a larger purchase during the year. The consideration provided for all the fixed assets purchased had, we were told, consisted of an undertaking to pay some £1.9m.; of that amount, rather more than a quarter had been met out of the proceeds of sale of some of the fixed assets that had previously been purchased. The purpose of those transactions was, we were told, to provide the Appellant with assets that could be charged as security for financing cash requirements.

13. The Appellant's bankers had been "X Bank" and "Y Bank". The Director had borrowed a substantial amount on mortgage from X Bank; to repay that he had sold the charged property at a loss. X Bank had ceased to make loans or give credit to the Appellant by 2010. Y Bank declined to provide further funding for the Appellant.

14. In the year to 31 March 2011, the Director increased his personal borrowing from friends and relations by some £600,000. That amount was used to cover the Appellant's cash requirements.

15. From late 2007 onwards, the Director told us, supplies of diesel, cement and "air space" (for tipping waste) had ceased to be available on credit. Those commodities were required daily by the Appellant to keep its business going.

16. Holdings, as a possible source of cash for the Appellant, had been severely depleted of funds as the result of a badly advised interest rate swap agreement entered into with a major bank. Legal proceedings against the bank were continuing. In the meantime, Holdings was committed to pay out £100,000 a year to the bank

The Appellant's awareness of the obligation to pay on time and of the implications of the new penalty regime.

17. Over the four years until 31 March 2011 the Appellant has been consistently late in paying its PAYE/NIC liability.

18. The Appellant, through its management, was well aware of the obligation to pay on time. It was fully aware of the introduction of the penalty regime and the

implications of late payment. It had received HMRC's publications and all letters concerned with its late payment. HMRC's records of its "action history" in 2010/2011 show a constant dialogue between HMRC and the Appellant about the state of payments of PAYE/NIC due to HMRC and warnings of remedial action.

The case for the Appellant

19. The late payments of the PAYE/NIC occurred during a time of deep recession. The recession had been a cause for the late payments by customers and for the bad debts. The change in the discounting facilities had had a major effect on the Appellant's cash flow position, as had the drop in turnover and the refusal of banks to provide funds and suppliers to give credit. The Appellant had taken every step reasonably available to it to provide itself with cash to enable payment to be made to HMRC. The underlying reasons for the Appellant's inability to pay were matters that were unforeseen and beyond its control.

20. The penalty equated to an annual interest rate varying from 15% and 183% depending on the facts of the particular month. On that basis it was disproportionate and should not, therefore, be imposed.

The case for HMRC

21. In the decision letter of 21 October 2011, HMRC recognise that the Appellant was trading in difficult conditions but, given the current economic climate, the circumstances could not be considered as either special or unusual. There was therefore no reasonable excuse for late payment nor did the circumstances qualify the Appellant for a special reduction. The 2010 turnover had remained much the same as that of 2009. There was nothing exceptional about the level of bad debts in 2010/11; nor was delay in payment of debts significantly longer in that period. The recession had started in 2007: that should have given the Appellant more than sufficient time to adapt and manage its business differently. What was more, the level of shareholders' funds shown in the Appellant's Balance Sheet had increased in recent years to some £2.5m. The reality was that the Appellant had been a habitual late payer. All the events of 2010 did was to make it an even later payer.

Conclusions

22. The Appellant had become aware of the new penalty regime and its officers knew full well what the implications of late payment were. We are satisfied that it everything that could reasonably be done to pay on time was done throughout the relevant period. The Appellant and its staff were unable to achieve this on account of their failure to generate a sufficient level of cash flow. The situation is, in principle, one of insufficiency of funds. In addressing the reasonable excuse defence, we have to determine whether, to use the words in paragraph 16(2)(a) of Schedule 56 to FA 2009, the insufficiency was attributable to events outside the Appellant's control.

23. Of the several factors causing the Appellant's cash flow difficulties, some were ordinary incidences of trading that affected businesses generally; others were more particular problems of the Appellant.

24. By 2010/11 the recession was well under way and its impact was understood, if not manageable. "Debtor days" were lengthening. Bad debts were on the increase. Banks were restricting their loan and credit facilities. Businesses, like that of the Appellant which depended on day to day supplies of commodities such as diesel and air space for tipping, were compelled to pay cash, or else give up. Those factors were, as noted, industry-wide causes of insufficiencies of funds. The makers of the late payment penalty regime were unsympathetic so far as those causes were concerned.

25. What happened here was more complex. The adverse impact of the predictable causes of cash flow difficulties was, we consider, made significantly worse by the unpredicted change of ownership of the Appellant's supplier of invoice discounting facilities. This had occurred at the start of 2010 when B Ltd "acquired" A Ltd's customers, assuring them that it would be "business as usual". Then, by stages, the restrictions on the discounting facilities ratcheted up. Neither side provided us with an analysis showing their precise effect on the Appellant's cash flow and profitability. But, in our view, the adverse changes summarised in paragraphs 8 and 9 above were not just unforeseen, they had the effect of transforming an insufficiency of funds that went with the recession (as explained above) into a cash crisis that could not be contained by a reasonable exercise of good management.

26. We are, in that connection, satisfied that everything was done, within the bounds of reasonableness, to manage the Appellant's cash position during the relevant period (2010/11). We observe that the Appellant took steps to increase the value of its fixed assets available as security for borrowings. HMRC made the point that, during the relevant period there had been a £3.5 million increase in shareholders' funds in the Appellant and in Holdings. As we understand the position, these had resulted from revaluations, rather than from acquisitions and savings. Moreover, the Director had, by relying on his friends and family, increased the Appellant's dependence on their cash resources by some £600,000 during the relevant period.

27. Our conclusion is that the unforeseeable change in the invoice discounting facilities that occurred over the relevant period should be treated as a reasonable excuse.

28. The decision letter of 21 October 2011 addressed the Appellant's request for a special reduction in the penalty under paragraph 9 of Schedule 56 to Finance Act 2009. The request was refused on the grounds that the circumstances could not be considered either special or unusual. We do not need to address this; indeed it was not pursued in argument at the hearing before us.

29. Nor do we need to address the question whether the penalty was so disproportionate as to justify its reduction.

Decision

30. The Appellant's appeal is allowed. It has been anonymised by Direction of the Tribunal for reasons given in the Direction.

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.

SIR STEPHEN OLIVER QC
TRIBUNAL JUDGE

RELEASE DATE: 19 February 2013