[2016] UKFTT 220 (TC)

TC04996

Appeal number: TC/2015/00003

PAYE – late payment penalty – tax year 2012-13 – Schedule 56 to Finance Act 2009 – whether economic downturn and bad debts amount to reasonable excuse; no – unspecific cash flow difficulties cannot be reasonable excuse – specific causes for shortage of funds – (a) withdrawal of pupils three fold the normal attrition rate – (b) charity without standing to raise finance on open market – whether reasonable excuse; yes – appeal allowed in part

FIRST-TIER TRIBUNAL
TAX CHAMBER

FERNHILL PRIMARY SCHOOL LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE DR HEIDI POON
EILEEN SUMPTER

Sitting in public at George House, 126 George Street, Edinburgh on 21 May 2015

Mr William Hamilton, Director, for the Appellant

Ms Shari McMullen, presenting officer of HM Revenue and Customs, for the Respondents

DECISION

Introduction

1. The appeal is against the penalty determination issued on 30 January 2014 in relation to PAYE late penalty imposed under Schedule 56 to Finance Act 2009 ('FA2009') in the amount of £11,650.32 at the rate of 4% for the tax year 2012-13.

2. Notwithstanding the designation of 'PAYE (Pay as You Earn) late payment penalty', the penalty is applied with reference to the aggregate of income tax deducted under PAYE, as well as the associated National Insurance Contributions for each 'PAYE' tax period that ends on the fifth of each calendar month (Regulation 67A of the Social Security (Contributions) Regulations 2001 SI 2001/1004).

3. The principal issue for the Tribunal to determine is whether there was a reasonable excuse for the late payment of PAYE in any or all of the periods. In the absence of a reasonable excuse, then the Tribunal needs to consider whether special circumstances obtain to merit special reduction.

Grounds of appeal

4. The Notice of Appeal was submitted on 29 December 2014 by Mr William Hamilton in his capacity as a director *cum* trustee of the School.

5. The grounds of appeal relate key facts regarding the School's financial position, which the Tribunal summarises as follows:

(a) In June 2014, the School's deficit stood at £1,284,626 [sic £1,284,656], which was cumulative over 3 years: £186,860 from 2011, £494,198 from 2012, and £603,598 from 2013.

(b) The financial year to 31 July 2014 showed further deficit of around £200,000.

(c) A new board of governors appointed in June/July 2014 were alerted to the PAYE arrears of £69,000 for 2014-15 and the penalty determination of £11,650.32 for 2012-13.

(d) Teachers agreed to a pay-cut of 8% in 2013-14 to help with the School's finances; 5% of their pay was only restored in 2014-15.

(e) The School has no access to any short-term bank overdraft facilities.

(f) The School was put into the care of the Royal Bank of Scotland Global Restructuring Team due to its serious financial problems, which only become known to parents in June 2014.

(g) The School continues to provide bursaries and scholarships to pupils as a charitable organisation.

(h) PAYE payments in 2012-13, though late, were late by no more than a few weeks each month; the dates of payment were tied to the timing of funds becoming available from the school fees paid monthly.

(i) Since the appointment of the new Board, all monthly PAYE liabilities have been paid on time.

HMRC's case

6. HMRC's review conclusion letter dated 2 December 2014 upheld the penalty determination, states at the outset in respect of special reduction in the following terms:

> 'HMRC have considered special reduction based on the information we hold, but there are no special circumstances which would allow us to reduce the penalty.'

Reasons specific to the appellant given in the review are:

> 'At no time during the penalty year were HMRC contacted before the due date to say there were problems with paying on time or to request a deferment, each time HMRC instigated contact.
>
> Our records also show that on 4 occasions calls were not returned and twice, once to your agent … and also to [name of School's employee] verbal warnings of late payment penalties were given.'

Generic reasons in the review conclusion given are:

> 'Most businesses experience cash flow problems as part of their normal cycle of business. They manage those difficulties as part of their day-to-day operations. A shortage of funds that is normal and can be anticipated, and is something we expect a business to be able to manage, perhaps by arranging short-term finance.'

7. On 10 April 2014, Mrs Baxter wrote to the Debt Management Appeals and Review Team to supply additional information in relation to the effect of bad debts and debtor arrears. The review officer of Debt Management replied on 15 April stating the following:

> '… I acknowledge that the school has had ongoing financial difficulties. I also accept that during 2012-13 the school had payment shortfalls throughout the year. However as these difficulties have been ongoig since 2010 these were not unforeseen or unexpected. There is no evidence that the school contacted HMRC to discuss these difficulties until July 2014, which was fifteen months after the end of the tax year for which penalties have been charged.'

Findings of fact

The business of the appellant

8. The appellant, Fernhill School Limited of Burnside in Glasgow, was incorporated in June 1972 as a charitable company limited by guarantee. The members of the Board of Governors are also the 'directors' of the company, and the charity trustees for the purposes of the law governing charities.

9. We note the School is registered for PAYE purposes under the employer name of 'Fernhill Primary School Ltd', even though the School provides education beyond the primary school years. The School is otherwise known as Fernhill School Limited.

10. The School follows the Catholic ethos in delivering educational services for children aged 2 to 18, from nursery through to senior school. The primary school is co-educational; the secondary school was for girls only, and plans were underway to turn the senior school co-educational from the academic session 2015-16 onwards.

11. According to the Notice of Appeal dated 29 December 2014, the School's then 'current roll excluding the nursery [was] 175 pupils which before the summer meetings stood at just over 200'.

Schedule of defaults 2012-13

12. From the calculation accompanying the penalty notice issued on 30 January 2014 and HMRC's 'Electronic Payment Advice', the appellant's PAYE payment details for 2012-13 are summarised as follows:

A	*B*	*C*	*D*	*E*	*F*	*G*
Mth	**Tax period ended**	**PAYE due**	**Default**	**Date paid**	**PAYE paid late**	**Days late**
1	5 May 2012	£26,576.12	**no**	8 June 2012	£26,576.12	17
2	5 June 2012	£27,403.35	**yes**	4 July 2012	£27,403.35	12
3	5 July 2012	£28,846.08	**yes**	14 Aug 2012	£28,846.08	23
4	5 Aug 2012	£28,991.81	**yes**	7 Sept 2012	£28,991.81	16
5	5 Sept 2012	£28,849.68	**yes**	28 Sept 2012	£28,849.68	6
6	5 Oct 2012	£28,600.18	**yes**	13 Nov 2012	£28,600.18	22
7	5 Nov 2012	£29,212.11	**yes**	No payment		
8	5 Dec 2012	£29,270.00	**yes**	5 Dec 2012	£51,735.80	On time
9	5 Jan 2013	£30,050.66	**yes**	8 Jan 2013	£29,270.00	On time
				5 Feb 2013	£30,050.66	14
10	5 Feb 2013	£29,074.78	**yes**	4 Mar 2013	£29,074.78	10
11	5 Mar 2013	£30,959.50	**yes**	3 Apr 2013	£30,959.50	12
12	5 Apr 2013	£31,293.77	**no**	2 May 2013	£31,293.77	10
	Total	**£349,128.40**			**£371,651.73**	

13. Columns *B*, *C* and *D* are extracted from HMRC's schedule on 'PAYE Late Payment Penalties Calculator' ('PLPP Calculator'). Month 1 is excluded as a default by statutory provision. Month 12 is excluded in the penalty calculation in consequence of the decision in *Agar Ltd v HMRC* [2011] UKFTT 773 (TC) ('*Agar*').

14. There are 10 defaults by this reckoning, giving rise to a 4% penalty rate, which is imposed on the amounts paid late for Months 2 to 11, which total at £291,258.15, to arrive at the penalty charge of £11,650.32.

15. Columns *E*, *F* and *G* are extracted from the 'Electronic Payment Advice' produced by HMRC (p101 of documents bundle). The schedule was not referred to at the hearing. We note however the unusual payment of £51,735.80 in December, which would appear to be for discharging the £29,212.11 due for November 2012, leaving an unknown balance of £22,523.69.

16. The Tribunal cannot readily infer the purpose of the payment of £22,523.69, or of its eventual allocation by HMRC. The balance also features in the supporting schedule to the PLPP Calculator, but no indication of its allocation.

17. The statutory due date for PAYE payment is 14 days after the end of the tax period. Each PAYE month period ends on the fifth of the month; the due date for payment is therefore the nineteenth of the month. However, when considering if payment is made late, HMRC allow an extra three calendar days for electronic payments. The appellant had made electronic payments throughout 2012-13, and payments were reckoned as late if made after the twenty-second day of the month.

Circumstances leading to Mrs Baxter's involvement with the School's management

18. Mrs Morag Baxter, chartered accountant, gave evidence for the appellant in her capacity as Bursar of Fernhill School. She is not and has not been a member of the governing Board. We found Mrs Baxter a credible and reliable witness who gave her evidence in a measured and factual manner. From the questions we asked and HMRC's cross-examination, we found the following facts.

19. Mrs Baxter's expertise is in general practice, and specialises in small to medium sized companies. She works on a sub-contractor basis for the family-owned business of the principal benefactor of the School.

20. This principal benefactor had pledged funding to provide the School with the shortfall in working capital requirement for the financial year 2012-13, having already advanced loans for the previous two financial years to assist with the School.

21. As a charitable company limited by guarantee, the School has no capacity to raise short-term finance with a bank. The principal benefactor advanced a personal loan of just over £500,000 in 2011, and the family company controlled by the benefactor advanced a loan of around £450,000 in 2012.

22. When it came to the financial year beginning 1 August 2012, the benefactor had again pledged funding from the family-owned company; the pledge was based on the budget prepared in June 2012 for the financial year ending 31 July 2013.

23. By September 2012, the benefactor became concerned with the accuracy of the budget deficit projected for the year as at £200,000. The budget for 2012-13 was prepared by the former bursar, who left employment with the School in August 2012.

24. To ascertain the true extent of the year's deficit, the benefactor requested Mrs Baxter to lend her expertise by examining the budget forecast against the actual finances of the School to obtain a fair view of the extent of the School's deficit. As a result of the request, Mrs Baxter became involved with the School's financial management in September/October of 2012.

25. Mrs Baxter's involvement was initially a temporary arrangement, working two days a week on the School's finances 'off-site' from the benefactor's business premises (ie: not from the School). This temporary arrangement lasted from September 2012 to June 2013, when the main focus of Mrs Baxter's work was on the financial accounting and budgetary control; she did not deal directly with the payroll.

26. From July 2013, Mrs Baxter's role was formalised as the Bursar of the School; her commitment remains part-time only, but she has been based from the School premises since the formal appointment.

Payroll functions

27. Mrs Baxter related that the book-keeping and payroll functions used to be dealt with by the firm of accountants along with the auditing services it provides. These functions were brought in-house as a cost-saving measure from 2012-13. The in-house book-keeper, who previously worked in a book-keeping capacity for the local government, started her employment with the School in February/March 2011, which was around the same time as the former bursar started her employment. (As related earlier, the bursar left in August 2012, and the book-keeper left in May 2014.)

28. The change in personnel dealing with the payroll explained why the communications from HMRC referred to in the review conclusion letter were not effectively acted upon, as the auditing firm that HMRC contacted no longer dealt with the School's payroll. The new book-keeper who looked after the payroll records did not have enough awareness to grasp the significance of the communications to respond or to arrange any time-to-pay agreements.

29. Mrs Baxter explained that most of the school fees are paid by monthly direct debit at the start of each month, and the School cannot apply for the money until the first working day of the month. While noting that the due date of the monthly PAYE payments was the twenty-second of every month, in the course of the tax year 2012-13, the book-keeper generally had to wait until the beginning of the following month when there was sufficient funds accrued to settle the monthly PAYE due for the preceding month *in full*.

30. The Tribunal notes that there were no part-payments made for any of the PAYE months (see table at §12).

Variants between budget and actual deficit for 2012-13

31. It was not until September 2012 that the budget drawn up in June 2012 for the financial year ending 31 July 2013 was re-examined at the request of the benefactor. Mrs Baxter identified that the income for the year had been overstated and the expenses, understated. The budget was based on a projected pupil number of 240, while the actual number for the academic year 2012-13 was down to 225, which meant a shortfall of projected income by about £120,000.

32. For the size of the School, Mrs Baxter put the natural attrition rate at around 5 pupils a year. The loss of 15 pupils (being three times of the expected loss) represented an unusually high number in a single year.

33. Mrs Baxter explained that the School was co-educational for primary years, and was 'girls only' for the senior school years. Instead of continuing to P7, in 2012-13 some boys left earlier at P4/P5 to join the designated schools for their senior school years. In some instances, the withdrawal of a boy in a family could mean losing up to 3 pupils in total, when siblings moved with the boy to a new school.

34. The withdrawal of pupils at P4/P5 posed special difficulty for these places to be filled with new pupils, who tend to be joining at P1 or lower primary, not at upper primary. The Board has made the decision to convert senior school to co-educational from 2015-16 onwards.

35. The impact from the shortfall in projected income for 2012-13 could not be alleviated by any corresponding reduction in costs. The shortfall in pupil number did not allow any material reduction in overheads, especially in respect of staff costs. The number of teachers was fixed at the start of an academic year and the commitment to employ a teacher for a whole year could not be altered mid-way through the session.

36. Coupled with the income shortfall, staff costs went over the budget in 2012-13 when supply teaching cover was required due to one teacher being on maternity leave, and three others being on sick leave for long periods. The School employed 46 teachers, though not all of them were full-time.

37. Mrs Baxter explained that the combined effect of the overstatement in income and the understatement of expenditure from the budget prepared in June 2012 meant that the projected deficit of £200,000 was in reality over £600,000 for 2012-13.

The effect of bad debts on the School's finances

38. The shortfall in projected income was only one factor causing the considerable cash flow problems faced by the School in 2012-13. In her reply during cross-examination, Mrs Baxter referred to the bad debts provided for on the School's balance sheet, and of the considerable difficulties in collecting the school fees arrears from families who had fallen into financial difficulty; in some instances, parents were faced with bankruptcy from business failure.

39. Mrs Baxter recalled that in 2012-13, the School was still dealing with school fees being in arrears dating back from 2010-11.

40. To quantify the extent of bad debts, the Tribunal has been provided with the submissions Mrs Baxter made to HMRC's Debt Management Team by letter dated 10 April 2015. The supporting schedules include a list of fees arrears from May 2012 to July 2013.

41. The schedules of debts list the arrears (with the pupils' names blocked out leaving only the account numbers), the balance of outstanding fees at the end of July 2012 was £142,891. By the end of July 2013, the balance dropped slightly to £138,437 with the very limited recovery from the debtors.

42. The stages in debt recovery involve the normal credit control methods in the first instance, followed by referral to an external debt collection agency by the time the debt is more than one term in arrears, culminating in legal action to obtain inhibitions for recovery.

43. Every stage of the debt recovery process involves resources, both in terms of time and costs, such as legal fees, and the expenses could yet result in a net loss when the action did not lead to any recovery.

44. By the end of July 2014, £100,123 of the cumulative debtor balance was written off as irrecoverable, after two years of debt recovery action. A further £79,175 was provided as doubtful.

Responses from teachers and parents

45. In response to the School's continuing financial difficulties, the teachers had agreed to a pay-cut of 8% from 2013-14 and a stop of pension contributions by the School. The teachers' pay was restored by 5% in 2014-15 against the sector pay award of 2% in April 2014.

46. As for the parents, Mrs Baxter informed the Tribunal that in June 2014, when the governing Board took the view that the School was not viable and was under the threat of administration, the School's financial position was made known to the parents. The Parents' Association responded with a fund-raising campaign in July 2014, which brought in £170,000 to help reducing the School's cumulative deficit.

The charitable work in the School's engagements

47. In the Report of the Trustees to the financial year ended 31 July 2013, it is stated that:

> 'The current economic environment is clearly challenging for the whole Independent Education sector, and the School faces ongoing financial pressures and a school roll below its target levels.'

48. Against these ongoing financial pressures, the School nevertheless had increased its bursaries granted from a total of £139,615 in the year ended July 2012 to £169,777 for the year to July 2013.

49. These bursaries were given to provide new and continuing assisted places. The School has the commitment to continue with the assistance for the duration of the pupil being educated by the School once a pupil is accepted with an assisted place.

The effect of the School's charitable status on cash flow

50. The School is a charitable company limited by guarantee, and has no capacity to raise finances in the open market.

51. The working capital deficit cumulative over the years has been met by the principal benefactor, who advanced an unsecured personal loan of just over £500,000 for 2010-11. For the year ended 31 July 2012, the benefactor's family company advanced a loan of £452,730, and £548,086 in the year to 31 July 2013. The combined personal and company loans to the School in the sum of £1,599,258 were eventually secured against the school buildings in the financial year to July 2013.

52. While interest charge on the loan capital has been provided in the loan agreements at a rate of 5.83%, the interest charge was waived for a period of 5 years from 11 June 2014.

53. These loans by the benefactor or the company to assist with the School's working capital requirements were not advanced upfront as a lump sum, but was contingent upon the company's own cash flow being in place and in surplus.

54. For the PAYE periods under appeal, the first 'draw down' of the benefactor's loan funds for 2012-13 took place in October/ November of 2012.

Communications with HMRC

55. The log of communications between the appellant and HMRC in respect of the late payments of PAYE and NICs is produced in the documents bundle (at page 126). It is true that in 2012-13, HMRC contacted the appellant by phone nine out of the twelve months around 27th or 28th of the month, and the various persons HMRC spoke to include Ms Findley (an accountant at the firm of auditors as the appellant's agent), a Mrs Waugh, a 'third party named Kerry', and unnamed 'authorised person' who returned the November 2012 call to promise payment by a certain date.

56. As Mrs Baxter explained, the firm of accountants no longer acted for the School in relation to the payroll, and Mrs Waugh would seem to be the 'book-keeper' as referred to in evidence, and who had the responsibility for the payroll in 2012-13.

57. We note from the log that the messages between HMRC and the appellant were dominated by when the late payments would be made. There was no mention in the message log that HMRC had offered to discuss the appellant's difficulties in making payments on time, or to arrange 'time to pay' agreements.

The applicable legislation

Paragraph 6 of Schedule 56 to FA 2009

58. Schedule 56 to FA 2009 introduced the penalty regime for failure to make payments on time, which came into effect on 6 April 2010. A host of taxes are brought under Schedule 56, and the in-month PAYE penalty regime is under paragraph 6, which has been revised more than once since its inception. The version in force from 25 January 2011 to 16 July 2013 is the one applicable to the tax year 2012-13 and relevant to this appeal.

59. Even though the penalty regime is often referred to as the in-month PAYE penalty, for the purpose of paragraph 6, an employer makes a default if the monthly payment under PAYE and NIC regulations (not just PAYE) is not made in full by the due date. For the avoidance of doubt, where PAYE payments are referred to in this decision, it should be taken as to include any NICs payable (primary and secondary) on the gross earnings from which PAYE is deductible.

60. Each PAYE tax month can potentially trigger a default, and the method of calculating the penalties is on a sliding scale, with the main features as:

(1) The first failure in any year is disregarded altogether;

(2) The second failure triggers the first default, and for the first to third defaults, the penalty is at 1% of the total paid late; that is '*the amount of the tax comprised in the total of those defaults*';

(3) For the fourth to sixth defaults, the penalty is at 2% of the total paid late;

(4) For the seventh to ninth defaults, the penalty is at 3% of the total paid late;

(5) For the tenth default, the penalty is at 4% of the total paid late; (the maximum number of defaults is ten following the decision of *Agar* as a Month 12 default is not counted as a default 'during the year').

61. The version of paragraph 6 to Schedule 56 applicable to 2012-13 means that the penalties in this appeal are calculated on the cumulative total of PAYE and NICs paid late, as detailed at §14. In other words, the overall percentage is set according to the number of defaults in the tax year, and that percentage would then be applied to the aggregate total of the amounts paid late.

62. The subsequent version of paragraph 6 to Schedule 56 (in force from 17 July 2013) amended the charging provisions whereby:

(a) The penalties are calculated according to the amount paid late on each default, instead of being on the cumulative total. The material change in the wording for sub-para 6(1) is rendered as: 'P is liable to a penalty under this paragraph, in relation to *each tax, each time* that P makes a default *in relation to* a tax year'. (emphasis added)

(b) That each default is to be separately calculated is reinforced by the change in wording whereby, for example, the first three defaults are to be

charged to penalty at 1% 'of the amount of tax *comprised in the default*'. (emphasis added)

(c) The pre-17 July 2013 version used the phrase 'defaults *during* the tax year' whereas the post-17 July 2013 version amended the phrase to 'a default *in relation to* a tax year'. The effect of this amendment is to *include* Month 12 default into the relevant year, rendering the ruling of *Agar* obsolete, which also means that there can be an eleventh default in in a tax year.

On appeal to the Tribunal

63. The Tribunal's jurisdiction in respect of a Schedule 56 penalty is provided under paragraphs 13 to 15.

64. The Tribunal's powers in relation to an appeal are to confirm or cancel a penalty, or to substitute for HMRC's decision another decision that HMRC had the power to make. As regards special reduction, the Tribunal can rely on the provision under paragraph 9 to a different extent than that applied by HMRC if it considers HMRC's decisions was 'flawed' in the judicial review sense.

Reasonable excuse under paragraph 16 of Schedule 56

65. Under paragraph 16(1), it is provided that where the employer has a 'reasonable excuse' for a failure to make any one or more of its PAYE payments by the due date, that failure will not count as a default; liability to a penalty does not arise therefore in relation to such a failure or failures.

66. Paragraph 16(2) precludes the following from being a reasonable excuse:

> '(2) For the purposes of sub-paragraph (1) –
>
> (a) an insufficiency of funds is not a reasonable excuse unless attributable to events outside P's control,
>
> (b) where P relies on any other person to do anything, that is not a reasonable excuse unless P took reasonable care to avoid the failure, and
>
> (c) where P had a reasonable excuse for the failure but the excuse has ceased, P is to be treated as having continued to have the excuse if the failure is remedied without unreasonable delay after the excuse ceased.'

Relevant case law

The test for reasonable excuse

67. The term 'reasonable excuse' has no statutory definition, and the test set out by Judge Medd QC in *The Clean Car Co Ltd v Customs & Excise Commissioners* [1991] VATTR 234 ('*The Clean Car*') is a helpful starting point in considering the facts in any particular case.

> '… the test of whether or not there is a reasonable excuse is an objective one. One must ask oneself: was what the taxpayer did a

> reasonable thing for a responsible trader conscious of and intending to comply with his obligations regarding tax, but having the experience and other relevant attributes of the taxpayer and placed in the situation that the taxpayer found himself at the relevant time, a reasonable thing to do?'

68. In *Bluu Solutions Ltd v HMRC* [2015] UKFTT 0095 (TC) ('*Bluu*'), a case concerning the late payment of in-month PAYE penalties as in the instant appeal, Judge Redston at [82] adopts the same approach for the purpose of 'reasonable excuse' as in *The Clean* Car, which is a VAT case in respect of a serious misdeclaration penalty.

69. The Tribunal agrees, that the authorities on 'reasonable excuse' in respect of VAT establish principles that are equally applicable for Schedule 56 penalties in relation to direct taxes. From the test set out in *The Clean Car*, the centrality of the behaviour of the appellant in determining whether a reasonable excuse obtains is in line with other authorities that consider reasonable excuse in connection with the issue of insufficiency of funds.

Insufficiency of funds

70. As with VAT default surcharge, Schedule 56 specifically precludes an insufficiency of funds from being a reasonable excuse. In *Customs & Excise Commissioners v Steptoe* [1992] STC 757 ('*Steptoe*'), the Court of Appeal decided by a majority (Nolan LJ and Lord Donaldson MR; Scott LJ dissenting) that the insufficiency of funds was the immediate cause of the trader's default in *Steptoe*, but the underlying cause for the shortage of funds may amount to a reasonable excuse. The case establishes the principle that there is a distinction between the *direct or proximate* cause from the *underlying* cause for the shortage of funds.

71. In the words of Lord Donaldson, 'the legislative intention is that 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.' That said, Lord Donaldson states that 'there must be limits to what *could* be regarded as a reasonable excuse' (emphasis original). In his reasoning of what those limits could be, Lord Donaldson expresses his agreement with Nolan LJ's judgment, which as Lord Donaldson understands:

> '… is saying that if the exercise of reasonable foresight and of due diligence and a proper regard for the fact that the tax would become due on a particular date would not have avoided the insufficiency of funds which led to the default, then the taxpayer may well have a reasonable excuse for non-payment, but that excuse will have exhausted by the date on which such foresight, diligence and regard would have overcome the insufficiency of funds.'

72. In contrast, Scott LJ's opinion that the underlying cause of the insufficiency of funds must be an 'unforeseeable or inescapable event' is considered to be 'too narrow' by Lord Donaldson for the following reasons:

> '(a) it gives insufficient weight to the concept of reasonableness and (b) it treats foreseeability as relevant in its own right, whereas I think that "foreseeability" or as I would say "reasonable foreseeability" is only relevant in the context of whether the cash flow problem was "inescapable", or as I would say, "reasonably avoidable". It is more difficult to escape from the unforeseeable than from the foreseeable.'

73. According to Lord Donaldson therefore, it would appear that the appropriate test concerning whether an insufficiency of funds amounts to a reasonable excuse is to examine if the underlying cause of the insufficiency is 'reasonably foreseeable' or 'reasonably avoidable'. In rejecting the limits set by Scott LJ for reasonable excuse with reference to '*the yardstick of "unforeseeable and inescapable misfortune"*', Lord Donaldson is emphasising that the factors concerning what is 'foreseeable' or 'escapable' should both be accorded reasonableness.

74. It is worth highlighting that HMRC's published view that a 'reasonable excuse' is 'an unexpected or unusual event that is either unforeseeable or beyond the taxpayer's control' would seem to accord with Scott LJ's dissenting judgment in *Steptoe*. The inappropriateness of this formulation has been highlighted in *Barret v Revenue and Customs Commissioners* [2015] UKFTT 329 (TC) ('*Barret*'), and the Tribunal can find no better words than to quote from Judge Berner at [153]:

> ' … the view of HMRC that a reasonable excuse must be some circumstance which is both "unforeseen and beyond the control of the taxpayer". That reflects HRMC's own published guidance which is, as this tribunal has pointed out in a number of cases, notably in *Electrical Installation Solutions Ltd v Revenue and Customs Commissioners* [2013] UKFTT 419 (TC), wrongly places reliance on the dissenting judgment of Scott LJ in *Steptoe* … It is inappropriate for HMRC to seek to rely on that formulation as representing the state of the law on reasonable excuse.'

75. The dissenting judgment in *Steptoe*, in one sense, represents Scott LJ's development of the judgment in *Customs & Excise Commissioners v Salevon Ltd* [1989] DTC 907 ('*Salevon*'). Scott LJ applies the 'yardstick of unforeseeable and inescapable misfortune' as the test of reasonable excuse in *Steptoe*, but *Salevon* is the origin of the 'unforeseeable' and 'inescapable' criteria.

76. *Salevon* was decided by Nolan LJ, sitting at first instance, and was one of the judges in *Steptoe* in majority with Lord Donaldson against Scott LJ in dissent. The cross-over of Nolan LJ's judgment in *Salevon* into *Steptoe*, and with *Salevon* being developed into the dissenting judgment of Scott LJ, has to some extent, contributed to the confusion as regards which formulation of 'reasonable excuse' is the majority and the binding judgment in *Steptoe*.

Bad debts and insufficiency of funds

77. In *Salevon*, two grounds of reasonable excuse were advanced. First, the taxpayer took a controlling interest in a company, whose former secretary had misappropriated the funds designated for VAT payments, and the VAT liabilities totalling £24,000 for three accounting periods supposed to have been settled were

eventually paid, but late, and the company was left in serious cash flow difficulty as a consequence. Secondly, the company lost a further £20,000 through bad debts, which led to further defaults.

78. The two grounds of reasonable excuse are distinguished in *Salevon* (at 912):

> 'The initial shortfall of £24,000 was no doubt totally unforeseen and unforeseeable, and thus potentially acceptable without too much difficulty as affording a reasonable excuse for the non-payment of the tax. The further £20,000 lost by way of bad debts would seem to me, on the face of it, to stand in a different category. The risk of bad debts is an incident of most, if not all, types of business activity, and I would not, as a general rule at least, think that bad debts (apart from the part thereof which represent output tax) could form the basis of a reasonable excuse for failure to account on the due date for money belonging to the commissioners.

79. In *Steptoe*, Nolan LJ refers to his earlier decision in *Salevon* as follows:

> 'My references in *Salevon* to "the wrongful act of another" and to the distinction between "the trader who lacks the money to pay his tax by reason of culpable default and the trader who lacks the money by reason of unforeseeable and inescapable misfortune" were directed to the facts of that case. They cannot be regarded as an all-purpose test of what constitutes a reasonable excuse. The test is to be found in the words of [the relevant provisions] read in the context of the statutory scheme for the collection of valued added tax. As a general rule this scheme has a highly beneficial effect on the cash flow of traders.'

80. As a general rule therefore, the risk of bad debts is an incident of most types of business activity, and cannot be considered as a reasonable excuse.

81. In both *Salevon* and *Steptoe*, Nolan LJ gives special regard to the 'highly beneficial effect on the cash flow of traders' when considering whether an insufficiency of funds resulting in a failure for making a VAT payment on time amounts to a reasonable excuse. He describes value added tax as 'money destined for the Exchequer of which [the trader] was the temporary custodian' (at 911 in *Salevon*), because the scheme of collection for VAT 'involves at the outset the trader receiving (or at least being entitled to receive) from his customers the amount of tax which he must subsequently pay over to the commissioners'.

82. It is for this reason that in *Salevon* Nolan LJ distinguishes 'bad debts' in general, where the principal sums have become irrecoverable, from the output VAT related to the principal sums. The non-payment of the output VAT on the bad debts could have a reasonable excuse, but the non-payment of other output VAT collected from other customers or debtors could not have been a reasonable excuse.

83. Nolan LJ's view on bad debts in *Salevon* is applied in cases such as *Beechill Building Services v C & E Comrs* (BEL/90/20, unreported) and *Fleet Car Hirings v C & E Comrs* (LON/90/1499, unreported), where bad debts are regarded as 'a normal

hazard of trade'. On reviewing these cases in *Steptoe*, Scott LJ in his dissenting judgment refines the issue, and states that:

> 'The relevant question is not what are the normal hazards of commerce in general, but what are the normal hazards of the taxpayer's particular business.'

When considering whether bad debts can be a reasonable excuse, Scott LJ is emphasising the *particularity* of each case. This concurs with what Nolan LJ observes in *Steptoe* (quoted at §79) that there is *no all-purpose test* of what constitutes a reasonable excuse.

Economic downturn and reasonable excuse

84. Whether an economic recession is an underlying cause for an insufficiency of funds that can constitute a reasonable excuse was considered in the Court of Appeal decision, *Dollar Land (Feltham) Ltd & Another v Customs & Excise Commissioners* [1995] STC 414 (CA) ('*Dollar*'). The tribunal of first instance, after considering *Steptoe*, expressed the following view:

> 'We see no reason in principle why the length and depth of the recession should be incapable of giving rise to a reasonable excuse provided it is clearly shown that the recession is the real cause of the shortage of funds and that the resultant lack of funds is unavoidable.'

85. While a recession is capable of giving rise to a reasonable excuse, the critical question to ask in any particular case is formulated in *Dollar* (Gibson LJ, Sir Roger Parker) – *whether, given the exercise of reasonable foresight, due diligence and a proper regard for the fact that the tax is due, the lack of funds is reasonably avoidable*. This formulation follows the precedent set in *Steptoe* in the majority judgment as quoted at §71.

86. On asking this critical question, the court found that there was no reasonable excuse in *Dollars*, as the appellant had committed funds to capital investment at a time when it was already in difficulty with its VAT payments. An examination of the appellant's financial report at the material time led the court to conclude: '[i]n the face of that report it could hardly be said that the earlier defaults could not reasonably have been avoided'; the appellant was expending on capital acquisitions 'to take advantage of exceptional opportunities' – even when cash might have been tight by then.

87. The view expressed in *Dollar* in respect of whether a recession could give rise to a reasonable excuse was considered in *Scrimsign v HMRC* [2014] UKFTT 866 (TC) ('*Scrimsign*'). The particular facts of the case led Judge Reid QC to conclude:

> '[27]… the Appellant's temporary lack of funds which prevented it from meeting its VAT obligations timeously *was caused not through any imprudence of Mr Scrimshire*, who controlled the company, but by the underlying economic recession the effects of which so far as the Appellant was concerned were difficult to predict and could not be reasonably avoided.' (emphasis added)

88. In contrast to *Dollar*, *Scrimsign* was decided in favour of the appellant, and the attitude or conduct of the appellant in *Scrimsign* would seem to be a determining factor. The conscientious efforts of the managing director in *Scrimsign* in meeting the company's VAT liability on time, using personal funds at times and in the face of its customers taking in excess of 60 days to pay, contrast starkly with the speculative investment endeavours of the appellant in *Dollar*, which were made at the expense of the company meeting its obligations to pay its VAT liabilities on time.

89. The decision in *Scrimsign* reiterates the centrality of the behaviour of the taxpayer in the test set out by Judge Medd in *The Clean Car* in determining whether a reasonable excuse can obtain. The surcharges for three VAT periods (06/12 to 12/12) that form the subject of the appeal in *Scrimsign* were all discharged, and the underlying causes that gave rise to the insufficiency of funds being a reasonable excuse in *Scrimsign* are informative to the current appeal.

90. Mr Scrimshire's family business (the appellant) had been badly affected by the recession; working capital was depleted and the bank was unwilling to extend overdraft facilities; the working week was reduced. *'Big customers* were throwing their weight about by delaying payment' beyond the stipulated 60 days; Mr Scrimshire's position was that the family company 'would have had to cease trading if the VAT had been paid on time'. Mr Scrimshire's MP had written on his behalf to the Treasury, and a letter from HM Treasury dated 8 April 2013 acknowledging '*this difficult economic period*' is referred to at [14] of the decision. At the material time, the appellant's bank was refusing to extend overdraft facilities.

91. In *PSC Photography Limited v HMRC* [2014] UKFTT 926 (TC), Judge Powell allowed the appeal against Schedule 56 penalty determination for the late payments of PAYE in 2012-13. The taxpayer supplied electronic photographic work for major high street retailers. A major contract with TR Lewin which was expected to start in February 2012 was postponed to May 2012 due to client's own cash flow reasons; the contract was subsequently terminated before completion, with adverse effect on the appellant's short term cash flow.

92. A second event affecting the appellant's cash flow position in *PSC Photography* was the abrupt changes to its banking arrangements, which saw its overdraft facilities being reduced and then totally withdrawn.

93. Prior to these two events, the appellant had suffered a downturn in its business for several years due to the prevailing economic conditions. The Tribunal notes at [7]:

> 'The nature of the appellant's business is such that in a general downturn clients which are themselves suffering financial setbacks will economise by not using, or limiting their use of the appellant's services and during this period a couple of clients went out of business.'

94. In deciding to allow the appeal, the Tribunal in *PSC Photography*'s reasoning is set out at [14]:

> 'We would not have found that unspecified cash flow difficulties would be a reasonable excuse but in this case the cash flow problems

> stemmed from two particular underlying problems stemming from the TR Lewin contract and the Bank's change of attitude about borrowing arrangements. It is evident that the these two factors severely affected a business that was already weakened by the economic downturn.'

Case law on the allocation of PAYE and NICs payments

95. In *AJM Mansell Limited v HMRC* [2012] UKFTT 602(TC) ('*Mansell*'), the application of the common law principle established in *The Mecca* [1897] AC 286 to payments of PAYE and NICs is set out in detail. In summary, the common law principle established by Lord Macnaghten in *The Mecca* at page 293 is:

> 'When a debtor is making a payment to his creditor he may appropriate the money as he pleases, and the creditor must apply it accordingly. If the debtor does not make any appropriation at the time when he makes the payment the right of application devolved on the creditor.'

96. In contrast, when the debtor has a 'running account' with the creditor, the principle established by *Clayton's case* [1816] 1 Mer 573 at 608 is that a payment is allocated to the earliest debt with the creditor.

97. The findings in law made in *Mansell* are that each monthly PAYE is a separate debt with reference to a 'tax period'; that Class 1 NICs are calculated with reference to an 'earnings period' and each earnings period gives rise to a separate debt for NICs; that neither the monthly PAYE nor NICs are in the nature of a 'running account' with HMRC as the creditor; and that the employer as the debtor can specify the allocation of a payment against a certain debt in line with *The Mecca* principle.

Discussion

98. Whether an insufficiency of funds can amount to a reasonable excuse in this case has two aspects that require determination:

(1) whether the appellant had an underlying cause for the insufficiency of funds in the year 2012-13, and

(2) whether the lack of funds was reasonably avoidable given the exercise of reasonable foresight, due diligence and a proper regard for the fact that the tax was due on a particular date (formulated in *Steptoe* and adopted in *Dollar*).

99. The appellant has referred to the ongoing cash flow difficulties that had been prevailing for some years prior to 2012-13. The economic downturn had created bad debts when families who had fallen into financial difficulty could not meet the school fess, and in some instances, parents were faced with bankruptcy from business failure.

100. We note the penalties in *Scrimsign* and *PSC Photography* coincided with the tax year 2012-13 under the current appeal. We note also the reply to Mr Scrimshire's MP by HM Treasury dated 8 April 2013 acknowledging '*this difficult economic period*'. We observe that the economic downturn that started in the later half of 2008 would be in its fifth year in 2012-13 and had a cumulative adverse effect on many businesses. However, can the economic downturn be, without more, a reasonable excuse?

101. It is suggested in *Dollar* that '[the court] see no reason in principle why the length and depth of the recession should be incapable of giving rise to a reasonable excuse', but that opinion comes with the provisos that (a) 'it is clearly shown that the recession is the real cause of the shortage of funds', and (b) 'the resultant lack of funds is unavoidable'.

102. The Tribunal is of the view that the opinion in *Dollar* does not allow an interpretation that an economic downturn can be, without more, a reasonable excuse. Indeed, the two provisos to the opinion set out in the paragraph above require a court to address the issues of (a) the 'real cause' of shortage of funds, and (b) whether the shortage is unavoidable. These are the same two aspects to the principal issue as set out at §98 which the Tribunal considers need to be determined in this case.

103. If the economic downturn cannot be, without more, a reasonable excuse for the insufficiency of funds, was the bad debts faced by the School a reasonable excuse for the shortage of funds?

104. The general rule is that the risk of bad debts is a normal hazard of any business. To allow bad debts as a reasonable excuse, the Tribunal has to be satisfied that there is something *particular* about the appellant's business that should render the risk of bad debts out of the ordinary. The relevant question is not what the normal hazards of commerce are, but what the normal hazards of the taxpayer's particular business are.

105. We appreciate that the provision of education is closely connected with the welfare of the pupils who are not the payers, and that the withdrawal or termination of such provision cannot be readily resorted to as a form of sanction for non-payment by the School, given that the welfare of the children would be at stake. Nevertheless, the risk of bad debts is a normal hazard of any providers of private education, and it is a risk that is all the greater in an economic downturn. The increased risk of bad debts with an economic downturn is *reasonably foreseeable* in the appellant's case, and most of the debts mentioned related to the years prior to 2012-13. The Tribunal has no reasons to depart from the general rule. We regard the risk of bad debts as a normal hazard of the appellant's particular business; we conclude therefore that the bad debts cannot amount to a reasonable excuse for its shortage of funds in 2012-13.

106. Whether the cause is the economic downturn itself or bad debts attributable to the economic downturn, unspecified cash flow difficulty cannot, of itself, be a reasonable excuse.

107. In respect of the year 2012-13, however, we find there were two specific underlying causes for the School's lack of funds. First, the loss of 15 pupils (being three times the normal attrition rate) for the financial year beginning on 1 August 2012 was a crucial factor that severely affected the School's finances, which were by then much weakened by the deficits cumulated from the preceding years. The adverse effect stemming from the income shortfall was aggravated by the increased staff costs through prolonged sick leave of three members. Secondly, the School has no capacity to raise any short-term finance in the open market to ease its cash flow difficulty, and

the pledge from the benefactor was *contingent* upon her own business having the surplus to lend the required working capital to the School.

108. The Tribunal further considers whether the lack of funds was reasonably avoidable given the exercise of reasonable foresight, due diligence and a proper regard for the fact that the tax was due.

109. We note from the Mrs Baxter's evidence that the attrition rate of 15 in 2012-13 was unusually high, and that the loss of pupils at P4/P5 meant that these places were difficult to fill with new intake. What was reasonably foreseeable by the School was the loss of 5 pupils, not three fold of five.

110. If the loss of 15 pupils in 2012-13 was not reasonably foreseeable the first time it happened, once it has happened, it can no more be argued that it is not reasonably foreseeable. To quote Oscar Wilde slightly out of turn, 'To lose one parent may be regarded as a misfortune; to lose both looks like carelessness.' In this respect, the Tribunal is satisfied that the School had exercised foresight from the experience in 2012-13 by putting plans in place to turn the senior school to co-educational.

111. We would not have found for the appellant if the cash flow difficulties were of a general unspecific nature. But for the two *specific* reasons (a) in relation to the withdrawal of pupils three fold the normal attrition rate, and (b) the fact that the School has no standing to raise short-term finance on the open market, we find that the School had a reasonable excuse from August 2012 in respect of the underlying causes for the lack of funds to meet its PAYE monthly payments on time. The month of August is referential to the beginning of the academic session 2012-13 to which the loss of 15 pupils related.

112. In determining when the excuse has ceased, we refer to the statutory formulation under sub-paragraph 16(2)(c) of Schedule 56, that 'P is to be treated as having continued to have the excuse *if the failure is remedied without unreasonable delay after the excuse ceased*'.

113. We agree with the findings in *Mansell* that each default for PAYE is with reference to a 'tax period', and for NICs, to an 'earnings period'. The failure for each default is to be examined independently to ascertain if the failure for each is remedied without unreasonable delay. In this regard, the Tribunal has noted that the number of days that the monthly payments were late ranged from 6 to 23 days. We are satisfied that the appellant has proper regard for the fact that the tax was due and made payments as soon as it was able to do so. In other words, the appellant had remedied each failure without unreasonable delay. We also note that since the new board of directors/trustees took management of the School in June 2014, all the monthly payments have been made on time.

114. We have noted the lack of clarity as regards the allocation of £22,523.69 paid in November 2012, and that if the appellant had been more aware of its rights as a debtor to appropriate the monthly payments in line with the principle established in *The*

Mecca, it could have specified allocation of its payments in a manner that could have mitigated the overall penalty assessed.

115. We note that HMRC have submitted that at no time during 2012-13 did the appellant contact HMRC to request deferment, and that each time HMRC instigated contact. From the content of the communications log, there is no evidence that the prospect or possibility of deferment or 'time-to-pay' arrangement was ever intimated to the appellant. It would not be unfair to infer from the messages recorded in the log that the appellant considered the phone calls from HMRC as 'chaser' calls for the overdue payments. In the context of these calls being perceived as 'chaser' calls, the appellant might not have returned calls on the four occasions noted by HMRC if the requisite action of making payment had been put in place.

116. We note also that the in-month PAYE penalty regime was only in its third year of operation in 2012-13, and that it was probably not widely known by employers that there was scope for negotiation for a 'time-to-pay' agreement. Indeed in the appellant's case, had it asked for a deferment for one month, it would have allowed itself to make payments on time in the subsequent months. However, even had the appellant applied for deferment, the grant of which was not automatic, and it is a matter of speculation whether the relevant HRMC officer would have agreed to the application. The fact that the appellant did not approach HMRC to discuss its cash flow difficulties does not affect our conclusion.

Decision

117. For the reasons stated above, the Tribunal concludes that the appellant had a reasonable excuse for its failure to pay the monthly PAYE and NICs on time from 6 August 2012 (Month 5) to the end of the tax year 2012-13.

118. The amount of penalty in respect of the defaults arising in Month 5 to Month 11 is accordingly discharged.

119. The penalty therefore falls to be re-calculated with reference to the defaults arising in Months 2, 3 and 4 only; the appeal is allowed in part.

120. 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.

DR HEIDI POON
TRIBUNAL JUDGE

RELEASE DATE: 31 March 2016