WHEN IS A PENALTY DISPROPORTIONATE?

Introduction

My previous article 'it's unfair' touched on the question of proportionality in the context of general fairness within the tax system. This article looks more closely at the question of whether taxpayers can argue that a VAT penalty is disproportionately high and the circumstances in which such a claim might be successful. This involves looking primarily at the recent case law in relation to VAT, where it seems that there is the greatest likelihood of success.

Recent Case Law

Enersys Holdings UK Ltd (2010 UKFTT 20)

This company was part of a worldwide group with an annual turnover of around $2bn. It therefore had adequate resources to make sure that its VAT compliance was exemplary.
The company was already within the default surcharge regime and had had four previous defaults as the default surcharge was initially charged at 10% (one default was a repayment). After the company appealed against an earlier penalty, the rate of surcharge on this appeal was reduced to 5%. The amount of the surcharge was still £131,881 and the company appealed to the tribunal.
The reason for the late payment for the VAT quarter was because the person responsible for the return got confused with the filing deadline for another group company.
The Tribunal firstly decided that the company did not have a reasonable excuse for the late payment.
At this stage, you may be forgiven if your sympathy for the taxpayer has not yet been fully engaged. Anyway, read on. The tribunal then went on to consider proportionality. After a great deal of discussion of relevant legal authorities the Tribunal effectively adopted the thinking in International Transport Roth GmbH v Home Secretary [2003] QB 728 where the test was set out as follows:

"is 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?"

The Tribunal decided on the facts that the penalty was plainly unfair and allowed the appeal. Incidentally, although this was a First Tier Tribunal decision, the case was heard by the President of the First Tier Tax Chamber and therefore can reasonably be regarded as having similar authority to an Upper Tribunal decision.

Total Technology (Engineering) Ltd (2012 UKUT 418)

This case was at the other end of the spectrum size-wise from Enersys. The company was a relatively small independently-owned company which was small enough to be allowed to file abbreviated accounts at companies house. Its net assets according to companies house 2010 accounts were £193k. Its quarterly

VAT liabilities were around £80-126k. According to the tribunal the company (unlike Enersys) had an excellent compliance record and the surcharge only arose because the company had installed a new computer system and the VAT liabilities for the two previous periods had been slightly underpaid by a few hundred pounds. It looks as though the company only submitted one return for those earlier quarters (showing the correct figure) but ended up paying a slightly smaller figure. As this happened for two successive quarters, by the time the quarter under appeal arrived the company was on the 5% default surcharge rate. Eagle-eyed readers may already spot some startling differences between this company's position and that of Enersys. In fact the only similarity between the two cases was that the Total Technology VAT payment in the relevant quarter was also one day late. The First Tier Tribunal had commented, not unreasonably:

"Taking these considerations together, while being mindful of the 'high degree of deference' which courts and tribunals must properly give to statutory regimes put in place by parliament, we found that on the particular facts of this case, the penalty was 'not only harsh but plainly unfair. In coming to our conclusion we noted in particular the lack of correlation between the single day of delay and the quantum of the penalty; the relationship between that quantum and the Company's profits; the sudden jump in surcharge from zero to over £4,000 and the Company's generally good compliance record both before and since this default period. We also considered it relevant that, in the first two default periods, over 99.5% of the amounts due had been paid on time."

Unfortunately, this apparently reasonable decision did not find favour with the Upper Tribunal who, after an even more lengthy discourse on the UK and European jurisprudence, decided that the penalty was not disproportionate. It is difficult to discern exactly why this was but they seem to have simply taken the view that, on the facts, the penalty was not disproportionate. They even seem to have gone out of their way to highlight the differences between this case and Enersys "the amount of the penalty does not approach the sort of level which Judge Bishopp described as unimaginable in Enersys".

There was no discussion in this case of the extent to which the penalty should be compared to the relative sizes of the organisations concerned. In fact, in Enersys, it seemed to be the actual size of the penalty which seemed objectionable, even though that company was a huge multinational for which a penalty of that size would be a drop in the ocean. By contrast, the profitability of the company in this case was apparently around £50,000p.a. The penalty was therefore 8% of the profits for the year. On the facts given in each judgement, it is difficult to see how Enersys was a more deserving case.

Trinity Mirror plc (2015 UKUT 421)

This Upper Tribunal case was decided by different judges to the Total Technology judges but ended up as a further rowing back from the previous bold decision in Enersys.

The default surcharge in this case was £70k because of a one-day failure to file the VAT return and pay the amount due. The surcharge was that the 2% level and again

the first-tier Tribunal discharged the surcharge on the basis that it was disproportionate. HMRC appealed.

Counsel for Trinity Mirror raised an interesting point to the effect that the First Tier Tribunal's decision that the penalty was disproportionate was effectively a finding of fact and is therefore not appealable. The upper tribunal dismissed this and proceeded to displace the First Tier Tribunal's findings, without of course having had access to any of the detailed factual circumstances which one would have to consider in arriving at such a decision. They effectively decided that the Tribunal erred in law, even though they clearly adopted the primary test of whether the penalty was not just harsh but plainly unfair.

The Upper Tribunal's first major point was that "It is thus clear on authority, as well as according with common sense, that it is legitimate to adopt a scheme which takes into account the amount of tax related to the penalty in assessing the gravity of a default in payment of that tax." In other words, one does not just look at the penalty but one also looks at the actual amount of VAT underpaid. This seems reasonable on the face of it but it is not clear how it would work if a company received a penalty equivalent to its annual profits of £10,000 but (say) the penalty had been charged at the rate of 0.1%. The underpaid VAT would be £10m, which is clearly significant. Does this mean that, because the amount of VAT unpaid (even for a day) was very large, the fact that the company's profits have been obliterated would not make the penalty disproportionate?

The actual decision of the Upper Tribunal was actually very short after the usual long discourse on the UK and European jurisprudence. The main factors seem to have been:

- The fact that the payment is only one day late does not render it disproportionate automatically;
- ensuring prompt payment is a legitimate aim of the legislation;
- there were no exceptional circumstances in this case;
- it was a second default;
- the amount of VAT involved was large;
- it was harsh but not plainly unfair.

<u>Conclusion</u>

I would welcome any views on why Trinity Mirror and particularly Total Technology were less deserving cases than Enersys. After a great deal of reading and re-reading I'm unable to discern any real guiding principles which would help one to predict with any accuracy the likely result of an appeal based on proportionality. The following table might be of some interest:

	ENERSYS	**TOTAL**	**TRINITY MIRROR**
Global sales	$2bn	<£6m	£636m
Profit	$144m	£50k	£70m
Penalty	£131k	£4k	£71k

Penalty as % of profit	0.15%	8%	0.1%
Previous defaults	4	2 or 0*	1
Surcharge rate	5%	5%	2%

The rationale seems to be that, even if you are a serial defaulter, once a penalty gets over £100,000 you are in with a chance. Conversely, a small company, even one with a more or less perfect compliance record may as well not bother appealing unless the penalty is a very significant proportion of annual profit.