TC03053

Appeal number: TC/2012/10958 & TC/2012/10959

VAT – Default Surcharge – Insufficiency of funds – Underlying causes – Economic downturn – Reasonable excuse – No – Appeals dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

EUROPEAN DEVELOPMENT COMPANY (WESTHILL HOTEL) LIMITED **Appellant**

- and -

EUROPEAN DEVELOPMENT COMPANY (HOTELS) LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE ANNE SCOTT, LLB, NP
CHARLOTTE BARBOUR, CA, CTA

Sitting in George House, 126 George Street, Edinburgh on Tuesday 12 November 2013

Having heard Philip Simpson, Counsel, for the Appellant

Mrs Elizabeth McIntyre, Officer of HMRC, for the Respondents

The basis of the appeals

1. Although there was extensive documentation in this appeal the point in issue was short, albeit not straightforward. There was no material dispute about the factual background and the only issue was whether the Appellants had a reasonable excuse for the late submission of a number of VAT returns and the late payment of the associated VAT.

2. HMRC based their arguments on the late payments, not pursuing the point on the late submissions of the VAT returns.

3. There are two appellants, associated companies, and for ease of reference we refer to appeal TC/12/10958 as "Westhill" and TC/12/10959 as "Hotels".

4. The appeal by Westhill is in respect of the periods 09/09 to 03/12 and the total of the surcharges is £137,438.99. The appeal by Hotels is in respect of the periods 06/09 to 03/12 and the total of the surcharges is £302,422.72

5. Apart from the slight difference in the periods under appeal and the amounts of tax and surcharges, the facts are the same for both appellants.

6. There was no dispute that the reason for the defaults was because the cash flow was under severe pressure. The issue was whether the underlying causes of the cash flow difficulties were unforeseen and outwith normal trading circumstances, amounting to a reasonable excuse for the late payments.

7. At paragraph 27 in his witness statement, Mr Wallace articulated three reasons for that pressure. The first was the economic downturn, the second was the interest rate payments to which the companies were committed and the last was the fact that the interest payments were automatically deducted from the bank accounts.

8. Although it does not form part of this appeal, both of the appellants had been in the Default Surcharge regime since period 03/08. The total tax paid late for both appellants in that period alone amounted to in excess of £300,000. That was before the banking crisis in September 2008. We note that in his letter of 23 September 2011 to HMRC, Mr Wallace stated that "The banking crisis started in 2008 and our banking problems started mid 2009….". There were more than one default periods for each of the appellants before that.

Economic Downturn

9. Mr Wallace stated that turnover had dropped because fewer people were staying in the hotels and accommodation made the biggest profit. They had had to reduce the rates charged because of increased competition. He described it as "dog eat dog". When it was put to him that at that time Aberdeen had had an undersupply of hotel rooms, he conceded that the economic recession had not impacted quite so heavily in

Aberdeen but it had not escaped unscathed. He said that the “dip” in Aberdeen had been between 2009 and 2011 and during that period the rates had slid down but then come up again. It had not been as easy as it had been. We are concerned with the longer period from 2009 until April 2012 (“the default period”).

10. The accounts show that the drop in turnover in Westhill between 2008 and 2009 was only £103,892 which is 3.4% and for Hotels £387,933 which is approximately 5%. In the following year the percentages were 2.9% and approximately 4%. In 2011, the turnover for Westhill was described in the accounts as “static”, and in Hotels it increased very marginally.

11. If turnover falls, then in this type of business, so too will the liability for VAT.

12. During the periods with which we are concerned, the VAT liability varied in each quarter. However, as a very rough guide, Westhill, in a quarter, averaged approximately £100,000 and Hotels was approximately £200,000. Accordingly, the drop in turnover was not significant particularly in the context of the general economic downturn.

Interest Rates

13. We do not doubt that the cash flow problems were primarily caused by the high interest rates which had been imposed to fund the abortive Glasgow development project by another related company (“EDC Glasgow”). Whilst we accept that the economic collapse that triggered the interest rate falls was in itself unforeseeable, the golden rule when looking at any financing whatsoever is to bear in mind that interest rates can rise as well as fall. As Mr Wallace pointed out, he and Mr Finnie had been in businesses relating to commercial and domestic property since the 1970s. Accordingly they have lived and worked through periods with both very low and exceptionally high interest rates and indeed inflation.

14. We note that Mr Wallace states at paragraph 12 of his witness statement that they had not fully understood the implications of the interest rate hedging agreement. A prudent businessman looking at hedging agreements, for in excess of £21 million for any period, let alone a four year period, should most certainly have taken professional independent advice as to its implications. The documentation is complicated, technical and less than transparent even to the financially literate layperson. That alone should have alerted them to the need to take appropriate advice. He stated that they did not take advice. The fact that interest rates could subsequently fall but the appellants would be tied into the agreements is certainly a risk that a competent professional advisor would have highlighted. It is one that should have been considered and very carefully weighed in the balance. It appears that it was not. Mr Wallace told the Tribunal that they had not understood that interest rates could fall. That is the whole point of hedging arrangements. Although they can be complex instruments the underlying concept is simple. The borrower enters into the agreement to minimize exposure to interest rate rises and the lender the reverse.

15. Although, at paragraph 10 of his witness statement, Mr Wallace states that the hedging agreements were for five years and the agreements did last for five years, in fact it seems that there was a one year period and a four year period which expired on 1 August 2012. That fits with his oral evidence that at the outset they had intended that the agreements would only have been in place for a couple of years, at most, because they would get development finance to replace it. On that point however, we note that the development funding negotiated with Anglo Irish Bank for the Glasgow project was also subject to a "suitable hedging strategy to be agreed with the borrowers". That fell through after planning permission was not granted at the end of 2007. The four year agreement was negotiated thereafter, admittedly before the banking crisis.

16. In terms of the agreements, the lender, HBOS, had the right to raise the rate of interest and did so shortly after the banking crisis from 1.25% to a 3% margin meaning an overall interest rate of 9.09%. Their right to do so is something that an advisor would have highlighted as a basic point, namely that having entered into an agreement, the actual monies payable thereunder could change for a number of reasons. It is a clearly identifiable risk regardless of the economic downturn.

17. The second point in regard to interest is that, whilst general interest rates were apparently at a record low of 0.5%, the appellants were tied to the rate of 9.09% and were unable to negotiate a lower rate in the market. When they entered into the hedging agreement they knew that they would have to pay at least the swap rate of 6.09% plus the margin of 1.25% over base rate and they had done so since September 2007. At an absolute minimum, their budgeting should have been on that basis.

18. Mr Wallace said that the interest rate that they were paying until the end of 2008 was not much higher than the other available rates and they had been "pretty much OK". However, the increase imposed in early 2009 was an additional 1.75% and that was in an environment where the "generally available" base interest rate was only 0.5% so that made them feel that they were paying far too much. They were undoubtedly at a disadvantage, as Ms McIntyre pointed out, but that was the funding structure that they had chosen. Therefore it is not appropriate to look at the difference between the interest rates available in the general marketplace and that which they were paying. Had interest rates in the market place risen, they would have been sheltered from the full impact of that. The inherent risk in any "fixing" of interests rates is that the market will move; that is precisely why such instruments are sold.

Automatic deduction of interest payments

19. Whilst we note that that was the mechanism negotiated with the Bank, and accept that it had an impact on cash flow, it was measurable, predictable and wholly foreseeable and had been so from 2007. They should have ensured that they budgeted for it.

General

20. The appellants may well be taking, or considering taking legal action against the Bank in relation to potential mis-selling of the hedging agreements but that is not a matter for this Tribunal. The appellants chose to enter into the funding arrangements and they should have been aware of the terms and implications from the outset.

21. Mr Wallace's oral evidence was quite clear to the effect that the appellants had been "pretty much OK" until the end of 2008.

22. Mr Wallace also said that there had been frequent communication with HMRC throughout the default period because it had been a priority to keep HMRC informed. He was equally clear, in response to a direct question, that someone from his company would approach HMRC to discuss possible payment arrangements although it would not have been before the due date for payment but possibly shortly thereafter. He also described the VAT position as a chain of non-payments. He said that HMRC were well aware that the appellants were in arrears and that the reason was cash flow problems and for the last 18 months the delays related to difficulties in refinancing. Basically, from time to time, the appellants would ask for extended time to pay arrangements which fitted in with the cash flow.

23. Mr Wallace agreed that the crux of the matter was as articulated in his witness statement at paragraph 27(b):- "Had we not ensured that sufficient funds were always available to cover the interest on the Glasgow loan, in addition to the interest for the three trading hotel loans, the bank would have withdrawn our banking facilities." That would have meant insolvency. He and Mr Finnie, his co-director, had provided a personal guarantee in the sum of £3 million. They were also concerned about their reputation and local suppliers and they wished to trade out of the situation.

24. It was argued for the appellants that the choice to keep trading had been the best choice for HMRC itself since the outstanding VAT was eventually paid in full which would not otherwise have happened. That is not an argument that this Tribunal can consider.

25. The appellants were aware of the Default Surcharge regime and the first surcharge document was issued to them both on 16 May 2008. They had repeatedly been issued with the explanatory Notes which clearly state:- "An agreement with HM Revenue and Customs office to defer payment does not prevent a surcharge being imposed for defaulting." They were in correspondence with HMRC in August 2009 referring to press publicity about surcharges and asking for leniency.

26. HMRC's argument was succinctly put as long ago as 28 May 2010 when the then outstanding VAT debts were transferred to Enforcement and Insolvency in HMRC who dealt with the appellants from July 2010 onwards. The reason for the transfer was articulated as "….reason for this Co has been using the TTP facility since June 08 and therefore it would appear that they are using the capital to finance their business….". In other words since hotels are largely a cash business, the VAT received was then used to pay other creditors, such as suppliers and the bank interest.

27. That is wholly consistent with Mr Wallace's evidence to the effect that they looked at their cash flow constraints each month and decided how much they had available to pay each creditor; he said that they "spread the cash around as far as we could". They tried to come to an arrangement with everyone to keep "ticking over" but the bank was the key creditor, followed by their suppliers as otherwise they could not continue to function.

28. There was no dispute about the legal framework. We were invited to look at all of the circumstances or factors pertaining to these appeals when considering whether there was a reasonable excuse. We did.

29. We accept that although insufficiency of funds is not itself a reasonable excuse it is incumbent on us to decide whether the underlying factual situation, which brought about that insufficiency gives a reasonable excuse for non-payment.

30. Further we endorse and adopt the reasoning of Lord Donaldson in *Steptoe v Customs and Excise Commissioners* [1992] STC 527 which states, in summary that a taxpayer must use reasonable foresight and due diligence with a proper regard for the fact that the tax will become due. We also agree with Judge Medd in *The Clean Car Co Ltd v Customs and Excise Commissioners* [1991] VATTR 234 when he states that the test of whether something is reasonable is an objective one.

Time to Pay (TTP)

31. The TTP agreement provisions, which provided for a suspension of a penalty, were introduced with effect from 24 November 2008 and are contained in Section 108 Finance Act 2009 (FA 2009). At no stage did the appellants seek such an agreement in relation to VAT liabilities **prior** to the due date for the return and payment. They could have done so but did not do so.

32. They had consistently sought additional time to pay since June 2008 but the many arrangements reached were not FA 2009 compliant, that is to say where the surcharge would not have been levied had they adhered to a TTP negotiated prior to the due date for payment.

33. Bluntly put, we take the view that a tax payer who is aware of the Default Penalty regime and has financial constraints should have tried to negotiate a FA 2009 compliant TTP. There was no attempt to do so whether through lack of awareness or otherwise.

34. In the absence of a FA 2009 compliant TTP, one possibility would have been to have paid the current liabilities first thereby avoiding penalties and extend the payment terms for the arrears. That did not happen. On the balance of probabilities that was because the appellants viewed it all as one matter and had not focused on the impact and magnitude of the penalties.

35. HMRC repeatedly asked the appellants to pay the current liabilities timeously. They did not.

36. In the Notices of Appeal the appellants argued that "the payments should be allocated to minimize the default surcharges due. It is unfair of the Commissioners to do otherwise." By contrast, Mr Simpson argued for the appellants that they did not seek to avoid surcharges by "artificial allocation of payments to later VAT debts before earlier ones. Gordon Smith of HMRC states that HMRC allocate payments to the oldest liabilities first. In the Tribunal's experience that is what happens where the taxpayer does not allocate the payments, as happened in this case. Had the appellants filed the tax returns with the payments, timeously, and allocated each payment to the appropriate period, HMRC should have followed those instructions. It has happened in other cases. It was an option open to the appellants and actively and repeatedly requested by HMRC.

The Glasgow Development

37. In 2006 the appellants had established EDC Glasgow and purchased a hotel in central Glasgow with a view to redeveloping it. EDC Glasgow continued to trade until March 2007 when the hotel was closed. It was subsequently demolished. Planning permission for the redevelopment was sought but not obtained within the expected timescale.

38. Although the primary focus of the arguments for the appellants was on the interest payable under the financing arrangements and the consequential impact on cash flow, nevertheless the failure to obtain planning permission until 3 August 2010, the increased costs of demolition and the further expenditure on new architects etc would also have had a fairly significant impact on cash flow since there was no income arising in EDC Glasgow after March 2007.

39. The appellants, through their long experience in property would have been aware that grants of planning applications and the negotiation of section 75 agreements are rarely achieved particularly fast. It should have been obvious at an early stage, if not from the outset, and long before the first VAT default, that there was going to be a significant delay with consequential cost and cash flow implications.

40. However, by the end of 2007, the appellants knew that, to put it colloquially, the Glasgow project was back on the drawing board with the stresses that would put on cash flow. The hotel had ceased trading in March 2007 and they decided to embark on the demolition in the July and so they must have known about the apparently major and costly issues with that.

41. At best the appellants would have known that there would have been no income stream from the Glasgow project for three years whilst there was significant expenditure. A prudent businessman would have allowed for slippage and, in the absence of fully fixed price contracts (which would be very rare indeed) for budgeted costs to be exceeded. By March 2007, when apparently they had anticipated having

planning permission (paragraph 5 of Mr Wallace's witness statement) they would have known that they were already well behind schedule since matters had not even reached recommendation by the planners, let alone negotiation of the Section 75 agreement. Their budgeting process should have taken account of that as well as the problems with demolition.

42. The accounts for Hotels to 31 December 2009 disclose that EDC Glasgow was not considered to be a going concern as at 31 December 2009 which gave rise to an exceptional irrecoverable debtor of £2,466,106 in that year. In 2010, under the heading "Related Party Disclosures" the accounts disclose further irrecoverable expenditure relating to EDC Glasgow of £1,016,978, and in 2011 the figure was £853,444. That must have had a major impact on cash flow.

Conclusion

43. The appellants were aware of the approximate level of their quarterly VAT exposure. Although it is not part of this appeal, the first default was in the first quarter of 2008 and there were others after that. This was before the economic downturn and before the increase in the interest rate margin to 3% over base rate which, Mr Wallace states at paragraph 11 in his witness statement, happened soon after the banking financial crisis.

44. By very early 2009, they were well aware of the increased interest burden but did not explain the position to HMRC. For example, when writing to HMRC on 21 August 2009 objecting to a default surcharge notice they blamed the "unhealthy economic climate" when asking for leniency. On 25 September 2009, they were duly informed that the fact that they had a (non FA 2009 compliant) TTP for the outstanding debts did not cancel the surcharge. They were warned that if there was a further late payment then the surcharge would be at 10%. There were further defaults.

45. In summary, this problem of cash flow started before the economic downturn, although subsequently it was slightly affected by the economic downturn and was aggravated by an increase in interest rates by 1.75% taking the rate to 9.09%. Changing interest rates are a normal and everyday hazard of business. The appellants were not alone in having entered into a hedging agreement. It is, or should be, a calculated risk and a not unusual business risk. The fact that cheaper money was available elsewhere is not the point. The appellants had freely entered into the financing agreements. They knew precisely what their finance costs would be and how that would be collected. It was wholly foreseeable from the outset and the rate did not change after early 2009. In any event, when the increase was first applied it did not appear to present a problem and their banking problems apparently only started some months later.

46. We only had the benefit of abbreviated accounts. However, as we pointed out in the course of the hearing those accounts do not support the arguments advanced about the economic downturn (paragraphs 10-13 above) and more pertinently did not show that interest payments were the major problem. Those accounts (for Westhill in

2009) record that the interest rates were fixed when rates were generally higher but it was hoped that they would fall when refinancing was in place.

47. In the course of the Hearing, we pointed out that in the accounts to which we refer above, although interest charges were high rising to £1,046,998 in 2009 from £878,343 in 2008 for Westhill and falling for Hotels from £1,525,729 in 2008 to £1,381,207 in 2009 (so the overall rise was very small), the major cost, other than cost of sales, was administrative expenses. Those stayed at approximately £3,000,000 for Westhill but rose for Hotels from £5,440,565 in 2008 to £8,113,651 in 2009. No analysis or explanation was proffered.

48. Initially, the appellants attempted to restructure their existing financing with their existing lender (HBOS) but that failed. In June 2010, HBOS asked the appellants to refinance their debt elsewhere and on 30 September 2010 HBOS told the appellants that they had to find replacement finance, albeit finance continued on an *ad hoc* basis in the interim. As at the date the accounts were signed off, 12 May 2011, the appellants indicated that they were confident that they would secure refinancing. That took a long time and refinancing was apparently in place in June 2012.

49. It seems clear that, on the balance of probabilities, the real problem with the cash flow, which would have been alleviated if the appellants had been free to seek, or able to obtain cheaper funding, was the expenditure on the Glasgow development project and the large inter-company debts which crystallised after EDC Glasgow ceased to be a going concern. From the available accounts we note that the total of those debts, by 31 December 2011, amounted to £4,366,528. That is more than the sum still due to HMRC in August 2012.

50. We do not accept the argument that the economic downturn seriously decreased the appellants' turnover; the impact of the general economic downturn in these appeals is comparatively marginal and on the facts of this case cannot be a reasonable excuse.

51. As we indicate above, the interest rate agreements were freely entered into and if appropriate advice had been taken the appellants would and should have known precisely what their interests costs would be. That is the point of such agreements. Indeed Mr Wallace freely conceded that the interest costs were not really a problem until they became aware that funding would be cheaper elsewhere. The problem is not the rate of interest *per se*, since that was freely negotiated but rather that the higher rate of interest meant that the spiraling costs for the Glasgow project were more difficult to support. That cannot amount to a reasonable excuse.

52. The decision to continue with a new planning application and demolition was in order to maximise the value of the site, as Mr Wallace states in his witness statement at paragraph 20. Those were commercial decisions. Certainly, the appellants were entitled to make and implement those decisions. However, in our view, a prudent and diligent taxpayer, in the full knowledge of the existing commitments and the well publicised likely longevity of the economic downturn would have been expected to

weigh in the balance whether or not that should be done whilst still being in a position to honour all relevant responsibilities in terms of the Taxes Acts.

53. The total of the amended surcharges, which are the subject matter of these appeals, is £439,861.71. Mr Wallace and Mr Finnie are very experienced businessmen with professional advisors. Before this hearing they and their professional advisor raised their concerns about the default surcharge regime. That was at both Ministerial and MP level. As Dame Anne Begg rightly says, the fact that the penalties are very high compared with bank interest rates is a policy issue. It is not something with which this Tribunal can be concerned.

54. We can only consider whether there was a reasonable excuse for the late payments of VAT throughout the period. There was not. Accordingly, the appeals are dismissed.

56. 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.

ANNE SCOTT, LLB, NP

TRIBUNAL JUDGE

RELEASE DATE: 18 November 2013

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