[2015] UKFTT 0458 (TC)

TC04626

Appeal number: TC/2014/05932

PAYE - under deduction by employer - HMRC discretion to direct tax to be paid by employee - failure by employer to take reasonable care to comply with the PAYE regulations – appeal dismissed.

FIRST-TIER TRIBUNAL
TAX CHAMBER

CHAPTER TRADING LTD **Appellant**

- and -

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

TRIBUNAL: JUDGE NIGEL POPPLEWELL
MRS NORAH CLARKE

Sitting in public at Cardiff on 26 August 2015

Mrs Ruth Kehoe, Finance Director of the Appellant, for the Appellant

Mrs Anne Rees, Officer of HM Revenue and Customs, for the Respondents

DECISION

Introduction and Outline

1. This is an income tax case concerning the application of the Pay As You Earn ("**PAYE**") regime. It involves underpaid income tax of £694. The appellant (or "**Chapter Trading**") has been assessed for this sum. It claims that the respondents should exercise their discretion under Regulation 72 of the Income Tax (Pay As You Earn) Regulations 2003 SI 2003/2682 ("**PAYE Regulations**"), so that the tax should be recovered from the employee.

2. In order to exercise its discretion, an employer must satisfy the respondents that it took reasonable care to comply with the PAYE Regulations. It is the respondent's case that the appellant has not taken reasonable care, and in the circumstances has declined to make a direction.

3. For the reasons given below, we agree with the respondents that the appellant has not taken reasonable care, and consequently dismiss the appellant's appeal.

Evidence and Findings of Fact

4. The evidence submitted to the Tribunal comprised a bundle of documents including correspondence between the parties, and extracts from the payroll exception reports generated by the appellant's payroll computer. Oral evidence was given by Mrs Kehoe and the appellant's current payroll supervisor, Mr James Watkins. Both gave sworn evidence as part of the blend of evidence and submissions that each made during the course of the hearing.

5. The evidence of fact given by Mrs Kehoe and Mr Watkins was not challenged by Mrs Rees. We found both to be straightforward and honest witnesses.

6. However, neither Mrs Kehoe nor Mr Watkins were employed by the appellant during the period under appeal (tax year 2011 - 2012).

7. From the evidence we make the finding followings of fact.

> (1) The appellant, Chapter Trading Ltd, is a company established by Chapter, a registered charity, to carry on trading activities, which includes operating a cafe in the charity's premises.
>
> (2) The charity has about 100 employees, who work for both the charity and the appellant, and there is a considerable coming and going of these employees.
>
> (3) The employee whose tax is at stake in this appeal is Miss Elinor Young. She had been employed by the appellant during the tax year 2010 – 2011. At the beginning of the tax year 2011 – 2012, the appellant deducted tax from Miss Young's pay on the basis of a tax code of 647L. Miss Young was paid on a fortnightly basis.
>
> (4) The appellant had operated a PAYE employer system since 2007. On 28 August 2011 a code of 418L was issued to Chapter Trading in respect of Miss Young. Chapter Trading operated this code with effect from week 26 of the tax year 2011 - 2012.

(5) As a result of changes in the Budget, in 2011 – 2012, Miss Young's tax code had increased from 647L to 747L after week 10 of the tax year 2011 – 2012.

(6) So between weeks 24 and 26, the code (and thus the tax free amount allowed to Miss Young) fell from 747L to 418L.

(7) When the revised notice of coding of 418L was given to the appellant, it was to be used on a cumulative basis.

(8) When it was input into the appellant's payroll computer, it resulted, for the pay period in week 26, in the cumulative tax due for week 26 (£331.40) being greater than the salary which Miss Young was due to receive for that fortnightly period (£299.39).

(9) The payroll computer had been set up to operate, in these circumstances, so as to deduct **no** tax from employees' pay. The result of this was not only was there no tax deducted from Miss Young's pay for week 26, but no tax was deducted, at all, for weeks 26 – 52.

(10) The second consequence of there being no tax deducted was that the payroll computer generated an exception report (an exception report being one which identifies PAYE consequences which are not normal). In the two sample extracts from such an exception report (dated 20/9/2011 and 23/12/2011), Miss E Young is identified with the entry "Insufficient Pay for Tax". We are told by both Mr Watkins and Mrs Kehoe that this would have been the case for all reports generated for week 26 – 52 for the year 2011 – 2012.

(11) Following the end of the 2011 – 2012 tax year, the respondents reviewed Miss Young's tax liabilities, and discovered an under deduction of tax as a result of under deductions made by the appellant under the PAYE system.

(12) The respondents initially sought to collect such tax from Miss Young by amending her tax code for the year 2014 – 2015. Her tax code was reduced to 619L, initially, in January 2014 and then subsequently increased at Miss Young's request, to 810L.

(13) Following HMRC's review of the situation, and their decision that no direction under Regulation 72 should be made, Miss Young's tax code was subsequently increased to 1000L on 19 February 2014.

(14) In a letter to the respondents dated 4 May 2013, Miss Young suggested that the underpayment was the responsibility of the appellant. Following communications between the appellant and the respondents, the respondents determined (on 4 July 2014) that the underpayment was due to a failure by the appellant to take reasonable care and declined to make a direction that Miss Young should pay the tax under Regulation 72(5). The appellant appealed against that decision 16 July 2014.

(15) The appellant then sought a review of that decision and by way of a letter dated 20 October 2014, the respondents confirmed to the appellant

that the outcome of that review was that the original decision not to make a direction would not be changed.

(16) The appellant appealed to the Tribunal Service on 3 November 2014.

The Relevant Law

PAYE

8. PAYE is a system of collecting income tax by deducting it at source from wages, salaries, pensions etc, payable to an individual employee or pensioner. That person then receives his or her wages net of the tax paid. The employer or other payer accounts to HMRC for that tax.

9. The statutory framework for the PAYE regime is found in part 11 of the Income Tax (Earnings and Pensions) Act 2003.

10. The main governing provision is Section 684(1) which states that "*The Commissioners must make regulations ("PAYE regulations") with respect to the assessment, charge, collection and recovery of income tax in respect of all PAYE income*".

11. Section 684(2) then goes on to provide that

> "*The provision that may be made in PAYE Regulations includes any such provision as it set out in the following list*
>
> *LIST OF PROVISIONS*
>
> *1. Provision-*
>
> *(a) for requiring persons making payments of, or on account of, PAYE income to make, at the relevant time, deductions or repayments of income tax calculated by reference to tax tables prepared by The Commissioners, and*
>
> *(b) for making persons who are required to make any deductions or repayments accountable to or, as the case may, entitled to repayment from the Board."*

12. The Regulations that have been made by The Commissioners to govern PAYE are the PAYE Regulations.

13. Under Regulation 21, *"on making a relevant payment to an employee during a tax year, an employer must deduct or repay tax in accordance with these Regulations by reference to the employee's code, if the employer has one for the employee".*

14. Regulation 13 obliges HMRC to determine the code for use by an employer in respect of an employee for a tax year, and when making such determination, the Inland Revenue must have regard to the matters identified in Regulation 14. Code is colloquially known as tax code.

15. Deduction of tax under the PAYE system must be made on a cumulative basis unless otherwise provided, and Regulation 23 describes how the cumulative basis

should apply - this is set out in more detail below, together with an illustration as to how it operates in practice.

16. The tax tables referred to in paragraph 11 above show, in relation to an employee's tax code, the cumulative free pay for each pay period. This is then subtracted from the total gross pay, on a cumulative basis, for the periods in the tax year, which then identifies the taxable pay. The appropriate percentage (20% for the year in question in this appeal) is then applied to the total taxable pay to date. This is then compared with the cumulative tax paid to date, and the difference is the amount of tax which is then deducted from the employee's pay for that period.

17. A tax code is a number reflecting, essentially, the total allowances against tax (personal allowances, reliefs etc) to which an employee is entitled for a period, less the final digit. So, in this appeal, Miss Young's initial code of 647 means that she would have had allowances of £6470-9 available. This then changed for pay period 13 (ie. week 26), to allowances amounting to only £4180-9.

18. An employer is obliged to use a non-cumulative basis under Regulation 26 if it is so directed by HMRC, or it is otherwise provided for in the Regulations. There was no suggestion in this appeal that there had been such an HMRC direction or that the Regulations obliged the appellant to use a non-cumulative basis.

19. Where a tax code is amended, HMRC must issue that amended code to the employer, who is then obliged to operate PAYE and deduct in accordance with that amended code (Regulation 20).

20. There is nothing in the PAYE Regulations which restricts the amount of tax which can be deducted from an employees' salary on a cumulative basis where the overriding limit does not apply (which it does not in this case). On the contrary, the employer should make such a deduction in order to comply with the Regulations. So if the tax due on a cumulative basis is £350 and yet the employee's wages for that period are only £300, there is nothing which restricts the employer from deducting the entire £350 from the employee's wages of £300 (resulting in no payment to the employee for that period).

21. Under Regulation 72, HMRC have a discretion to direct that the employer is not liable to pay any under deducted tax, and instead can seek to recover that tax from the employee (Regulation 72(5)).

22. However, HMRC can only exercise its discretion if one of two conditions is met.

23. One of these "*is that the employer satisfies the Inland Revenue –*

> *(a) that the employer took reasonable care to comply with these Regulations, and*
>
> *(b) that the failure to deduct the excess was due to an error made in good faith".*

24. The crux of this appeal is that HMRC, whilst content that the failure to deduct was due to an error made in good faith, do not accept that the appellant took reasonable care to comply with the PAYE Regulations.

25. Regulation 72A enables an employer to make a request to HMRC that HMRC should make a direction under Regulation 72(5), and HMRC, in turn, may refuse the employer's request by notice to the employer giving grounds for such refusal (a "refusal notice").

26. The employer then has an appeal right (Regulation 72A(4)) to appeal against the refusal notice on the grounds, inter alia, that the employer did take reasonable care to comply with the Regulations.

27. The Tribunal has power on the appeal that, if it appears to the Tribunal that the refusal notice should not have been issued, it may direct that HMRC makes a direction under Regulation 72(5) in an amount determined by the Tribunal corresponding to the tax which is due.

28. Finally, if the Tribunal does make such a direction, the employee has a right of appeal against that direction on various grounds; including that the employer did not act in good faith, the employer did not take reasonable care, or that the tax is overstated.

Reasonable care

29. The legal test in Regulation 72(3) is that the employer took "*reasonable care to comply with these Regulations*".

30. What comprises reasonable care is to be determined in the context of the Regulations. We have come across no case in which the phrase has been judicially considered in this context.

31. However, it is instructive to note that the test is the same as that contained in paragraph 3 of Schedule 24 to the Finance Act 2007, which deal with penalties for careless inaccuracies.

32. Paragraph 3 provides (insofar as relevant)

> "*(1) For the purposes of a penalty under paragraph 1, inaccuracy in a document given by P to HMRC is –*
>
> *a. "careless" if the inaccuracy is due to failure by P to take reasonable care...*"

33. This was considered in the case of *Hanson (JR Hanson v The Commissioners for HMRC* [2012] UKFTT 314 (TC))

34. In that case Judge Cannan said as follows:

> "In my view carelessness can be equated with "negligent conduct" in the context of discovery assessments under *section 29 Taxes Management Act 1970*. In that context, negligent conduct is to be judged by reference to the reasonable taxpayer. The test was described by Judge Berner in *Anderson (deceased) v Revenue and Customs Commissioners* [2009] UKFTT 206 at [22] , cited with approval by the

Upper Tribunal in *Colin Moore v Revenue and Customs Commissioners* [2011] UKUT 239 (TCC):

> *"The test to be applied, in my view, is to consider what a reasonable taxpayer, exercising reasonable diligence in the completion and submission of the return would have done.""*

35. In the context of Schedule 24, Judge Cannan took the view that there was a subjective element in the test of reasonable care. "*What is reasonable care in any particular case will depend on all the circumstances".*

36. This view was endorsed in the case of Martin *(Catherine Grainne Martin v HMRC)* [2014] UKFTT 1021 (TC). Judge Redston recognised that the concept of taking reasonable care in the context of Schedule 24 penalties does import a subjective element since "*If failure to take reasonable care were to be an objective test, sch 24 would be much harsher than the TMA penalty provisions, because the objective test of negligence at TMA s.95 can be mitigated by the reasonable excuse provisions.....*". She therefore considered that "negligence" under TMA s.95 is different to "careless" under the new penalty rules. The former being objective, the latter including an element of subjectivity.

37. In the context of Regulation 72(3), however there has never been any possibility of mitigating the objective failure to take reasonable care by establishing a reasonable excuse (which has a subjective element). Reasonable care in the context of 72(3) is simply a pre-condition to the possibility of HMRC exercising their discretion to make a direction under Regulation 72(5).

38. In our view, therefore, it is intended to reflect the "harsher" position of negligence (ie. an objective test with no element of subjectivity).

39. The test, therefore, that we shall apply in this case is to consider what a reasonable taxpayer exercising reasonable diligence in the application of Miss Young's revised tax code would have done.

Burden of Proof

40. Under Regulation 80, a determination by HMRC that an employer has underpaid PAYE is treated as if the determination were an assessment (Regulation 80(5)) for the purposes of the Taxes Management Act 1970 ("**TMA**").

41. Section 50(6) of the TMA provides (so far as relevant) *if, on an appeal it appears to the [Tribunal] that the appellant is overcharged by an assessment…..the assessment…shall be reduced accordingly, but otherwise…. the assessment shall stand good.*

42. That puts the burden of proving that the taxpayer has been overcharged by an assessment on the taxpayer.

43. In this case, the basis of the appeal is that HMRC should have made a direction under Regulation 72(5) and that the basis of their failure to do so is flawed in that the

appellant did take reasonable care. So, the burden of proving that it took reasonable care is on the appellant.

44. The applicable standard of proof is the usual civil standard, namely the balance of probabilities.

The Cumulative Basis

How it operates

45. As mentioned above, unless Regulation 26 applies, PAYE operates on a cumulative basis.

46. Mrs Rees helpfully provided a table which set out how the cumulative basis worked in the context of this appeal in relation to Miss Young's payments for the year 2011 – 2012.

47. We use her figures to illustrate how the cumulative basis works.

48. In simple terms, in the first pay period (week 2 in Miss Young's case, since she was paid fortnightly) you assess the pay for the period and then need to decide how much tax to deduct from it. This is done by calculating, first, the amount of "free pay" to which the employee is entitled in that period. Free pay is a proportion of the tax free amount as identified by the employee's tax code. For Miss Young, it is $1/26^{th}$ of the tax free amount identified in her tax code. That is $1/26^{th}$ of £6479 ie. £249. The £6479 derives from her tax code 647L (which, as mentioned above, is an employees tax free amount less the last digit).

49. When the free pay of £249 is then deducted from the pay to which Miss Young was due for that period ie. £293, the amount of taxable pay is ascertained, (namely £44), on which tax at 20% is then due ie. £8.80.

50. Cumulation then bites when the next amount of pay is due (in Miss Young's case a fortnight later). The amount of free pay is simply doubled ie. it is £498 for the second pay period. This is then deducted from the total taxable pay which has been, and is to be, made to the employee. In Miss Young's case, in her second pay period, this is the original pay of £293 and pay for the second period of £359. So her total taxable pay for the second period was £652. When this has £498 deducted from it, the taxable pay of £154 is identified which, when taxed at 20% means the total cumulative tax is £30.8. Since £8.80 was paid in the first period, an additional £22 must be paid and deducted from Miss Young's pay packet for her second pay period.

51. This regime then continues. The free pay is simply totted on a cumulative basis. It is then deducted from the total taxable pay. The tax on that total taxable pay is then calculated. Credit is given for the tax previously paid, and the amount of tax payable for that period is the difference.

Its relevance to the appeal

52. In the case of Miss Young, her code was increased between her 5^{th} and 6^{th} pay period from 647L to 747L. This meant that the amount of free pay increased disproportionately compared with the position had she remained on 647L.

53. It is inherent in the workings of the cumulative basis that where a tax code increases, the cumulated tax is likely to be affected, and this was the case for Miss Young.

54. In the 6th pay period, the tax previously paid amounted to £106.20. On the application of the new code, the total tax due had fallen to £82.80. In other words Miss Young was due a rebate of £23.40.

55. But as will be appreciated, should the tax code reduce in value, it is likely that the cumulative tax paid will be much lower than would have been the case had the lower tax code been used throughout.

56. And so it has proved when the appellant was told to use tax code 418L. That occurred between pay periods 12 and 13. In period 12, Miss Young's cumulated free pay was £3452.

57. However, for period 13, the first period in which code 418L was used, that cumulated free pay had fallen to £2094.

58. When this was applied to the cumulative pay in period 13, it meant that the total tax to date should have been £468. However, the amount paid up to that date (ie. at the end of the 12th pay period), was only £137. So for period 13, a whopping £331 had to be deducted from Miss Young's pay packet.

59. Unfortunately, Miss Young's pay for that period was only £299. So had the appellant deducted the tax due Miss Young would have received nothing in her pay packet.

60. As mentioned above, Chapter Trading's computer was programmed so as to deduct no tax in those circumstances. So far from reducing Miss Young's pay packet to zero, Miss Young would have received £299 (less national insurance if any) ie. would have been paid on a gross basis.

61. Because of the way the cumulative basis worked for this particular employee, the cumulative tax would have been greater than each subsequent pay packet for the rest of the tax year, and so no tax was deducted for the pay periods 13 through to 26.

Week 1 Basis

62. An alternative to the application of the tax code on a cumulative basis is to apply it on a week 1 basis. A week 1 basis is straightforward. You simply take each pay period and treat it in isolation. You deduct the proportion of the tax free amount as identified in the tax code to calculate the free pay to which an employee is entitled for that particular period. That is then deducted from the total salary which gives the taxable pay in the period to which the tax rate (20%) is then applied to identify the amount of tax payable in the period.

63. Applying this principle to Miss Young's pay for week 26 (the first period in which her tax code reduced from 747L to 418L), results in the following calculation. Her total pay in the period was £299. 1/26th of the tax free pay as identified in her tax code is £161. Deducting £161 from £299, results in taxable pay of £138 which suffers tax at 20% ie. a tax liability of £27.60. This is to be contrasted with the tax due on a cumulative basis of £331.

64. The relevance the week 1 basis is that it is the appellant's submission that it is this basis which HMRC should have told the appellant to operate when it gave the appellant the new tax code for Miss Young.

65. We now turn to the parties submissions in greater detail.

Appellant's Submissions

66. The appellant's submissions (set out in their notice of appeal and elaborated upon by Mrs Kehoe and Mr Watkins at the hearing) were:

> (1) HMRC had based the revised tax code for 2011 - 2012 on an estimate of Miss Young's earning from Chapter Trading in the year 2009 - 2010 and then pro-rated upwards to come up with an annualised figure of approximately £4,000 for her earnings for 2011 - 2012.
>
> (2) This "theoretical" information has been superseded by the real position in 2010 – 2011 in which Miss Young earned more than £8,000 from Chapter Trading.
>
> (3) So any amendment to her tax code should have been based on the real numbers, rather than the annualised preceding year numbers.
>
> (4) Had HMRC done this, there would have been no need to revise Miss Young's tax code in so far as it applied to Chapter Trading.
>
> (5) Miss Young's allowances, therefore, would have accrued against her pay from Chapter Trading (there was enough pay to use these up) and a flat rate code would then have been applied to any wages she received from her other employments.
>
> (6) The revised code of 418L should have been applied on a week 1 basis, and HMRC should have told the appellant to apply it accordingly.
>
> (7) HMRC had enough information to realise that unless a week 1 basis was used, the reduction in Miss Young's code could result in her tax liability for the first period in which it was used being greater than her salary.
>
> (8) The appellant had operated the new code correctly. The issue is that HMRC did not (which they should have done) foresee that when the new tax code was applied on a cumulative basis, the deductions arising from the application of the new tax code could outweigh Miss Young's wages.
>
> (9) So it was HMRC who failed to take reasonable care and that is the real reason why the tax has been underpaid.

Respondents Submissions

67. Mrs Rees submitted as follows:

> (1) The appellant does not dispute that it received the revised tax code, and that it appreciated that it should be operated on a cumulative basis (as is required by law). Indeed the appellant did so.

(2) How and why the revised tax code was calculated is not relevant. The appeal concerns whether the appellant properly operated PAYE using the revised code that was issued to it.

(3) The employer has no discretion. If, as happened in this case, the tax exceeded the salary, the employer should deduct all the tax even if that meant that the employee would receive no salary.

(4) The exception report generated by the appellant showed that Miss Young's situation was anomalous. And this was apparent from not just one report but many.

(5) The appellant failed to properly investigate these reports.

(6) The fact that the computerised payroll system could not calculate the tax due does not relieve the appellant from operating PAYE correctly.

(7) The appellant deducted no tax for Miss Young's pay periods 13-26 for 2011 - 2012. It should have been apparent to them that this could not have been correct given that the amount of tax free pay which she could have received had been reduced by the change in her tax code.

(8) Although this is not relevant to the appeal for the reasons given at sub-paragraph (2) above, the information available to HMRC for the year 2011 – 2012, is based on the P14 submitted by the appellant. At the time Miss Young's tax code was amended on 28 August 2011, the P14 for the period 2010 – 2011 would have been submitted by Chapter Trading (some 3 months earlier; at the latest, on 19 May 2011). But it is not possible for HMRC's systems to update employee information within that time, and HMRC does not do so unless a specific concern is raised in respect of an employee (which it wasn't in this case). So, to the extent that this is relevant (and Mrs Rees says it is not) it was reasonable for HMRC to use the annualised 2009 -2010 figure as the basis for the amended code.

Discussion

68. We have considerable sympathy with the appellant's position. The consequence of HMRC's assessment is that it has paid Miss Young her gross pay (ie including an amount equivalent to the tax which should have been deducted) and now has to pay that amount again (this time as tax to HMRC).

69. We are not certain whether Miss Young, therefore, has received an unconscionable benefit. In all likelihood, she has ended up paying the right amount of tax since additional tax would have been deducted from her pay from other relevant employments. But that is of no comfort to the appellant.

70. Had the figures been slightly different, we have little doubt that the issue would have been sorted out in 2012 as Mr Watkins had suggested (probably by means of a telephone call to the relevant HMRC unit). If Miss Young had, for example, earned £332 in period 13 then the cumulative tax of £331 would have been deducted leaving Miss Young with only £1 in her pay packet (ignoring National Insurance). Miss Young would no doubt have queried this with Chapter Trading and/or HMRC, an

investigation would have followed which might have established that the amendment to Miss Young's tax code was based on an out of date value of her earnings from Chapter Trading for 2011 - 2012; and it may well have been that a further revised tax code would have been generated to reflect the up to date position.

71. However, unfortunately for Chapter Trading, this did not happen. Instead, it paid Miss Young without deducting any tax for 13 pay periods in circumstances where:

> (1) there were exception reports identifying "Insufficient Pay for Tax" in respect of Miss Young's pay, for each of these 13 periods; and
>
> (2) the reduced tax code should have resulted in more tax being paid, rather than less.

72. We agree with Mrs Rees that the appellant has inadequately investigated these reports. In our view, a reasonable taxpayer exercising reasonable diligence would have undertaken a more detailed investigation. It is no defence for Chapter Trading to say that these reports were imprecise. In other words, the steer provided by the reports (Insufficient Pay for Tax) did not give them enough to go on. In such a case it is more incumbent on the employer to get to the bottom of the situation evidenced by the report. And it is not as if there were very many of these ambiguously worded reports. In the ones we have seen, Miss Young was the only employee to be identified as "Insufficient Pay for Tax" out of 13 in the September 2011 report, and only one of two out of 14 in the December 2011 report.

73. Furthermore, the words "Insufficient Pay for Tax" should have put the appellant on notice that, as the expression states, Miss Young's pay was insufficient to bear the tax that was being deducted.

74. Mrs Rees is correct when she says that the appellant's statutory duty is to operate the code on a cumulative basis even if this would have meant that Miss Young would have received no pay at all. We have some sympathy with Chapter Trading's submission that this would have meant that Miss Young would have received no pay for the period in question, and this is surely something that HMRC will not have wanted. But this lack of deduction was not as a result of a conscious humanitarian decision made by the appellant, but simply a result of the way in which the payroll computer had been set up. Had the software behind the payroll system operated in accordance with the appellant's statutory obligation, Miss Young would have received no pay in week 13 (following which, we suspect, either she or Chapter Trading would have contacted HMRC, with the consequences mentioned at paragraph 70 above).

75. It was apparent to the appellant that it was to operate the new code on a cumulative basis, and indeed it did so. Mrs Kehoe's submission was that in response to the exception report, the appellant established that it was operating the code in the correct manner. But they did not investigate the consequence of operating the code in this manner.

76. It is our view that having installed payroll software which produces an exception report which identifies anomalies, a reasonable taxpayer exercising reasonable diligence would have done more than simply investigating whether the code was being operated correctly. It would have investigated the consequence of using that code.

77. Mrs Kehoe also says that HMRC should have told Chapter Trading to use the code on a week 1 basis. We can see no statutory justification for any such obligation on HMRC. But in any case, HMRC at that time did not know that there was an issue with the revised tax code since they had, in their view, used the correct basis for assessing the PAYE income from the appellant by taking the 2009/10 income and annualising. In fact, it should have been equally, if not more, apparent to Chapter Trading who knew the actual amounts being paid to Miss Young each fortnight, that operating the code on a cumulative basis would cause a problem. Indeed it did have such evidence through the exception reports, but it analysed these with insufficient diligence.

78. Finally, Mrs Kehoe says that it was HMRC who failed to exercise reasonable care. In response, Mrs Rees says that the basis on which the revised code was computed is largely irrelevant, and the statutory obligation on Chapter Trading is to operate the code with which it is supplied, properly (ie on a cumulative basis). We think Mrs Rees is correct on this although HMRC are under an obligation pursuant to Regulation 14 of the PAYE Regulations that when determining a code, they must have regard to a number of matters. We raised Regulation 14 at the hearing, but neither party had considered it prior to the hearing, and were not able to make detailed submissions on whether, and if so to what extent, HMRC had or had not complied with those matters to which they must have regard.

79. We have considered Regulation 14 in more detail since the hearing.

80. The only two paragraphs which might be relevant are Regulation 14(1)(b), ie "*any PAYE income of the employee (other than the relevant payments in relation to which the code is being determined)*", and 14(1)(g), ie "*such other adjustments as may be necessary to secure that, so far as possible, the tax in respect of the employee's income in relation to which the code is determined will be deducted from the relevant payments made during that tax year*".

81. As regards Regulation 14(1)(b), HMRC did have regard to Miss Young's PAYE income other than that in relation to the employment with Chapter Trading. Indeed this was the reason why HMRC amended Miss Young's code. It was because they had learned of her other employments, over and above her employment with Chapter Trading.

82. As regards 14(1)(g), the revised tax code was intended to secure that, as far as possible, the tax from Miss Young's employment with Chapter Trading would be deducted from her pay with Chapter Trading.

83. So it is our view that HMRC have complied with their statutory obligations under Regulation 14.

84. We therefore agree with Mrs Rees. The fact that the payroll software was set up to deduct no tax where, on a cumulative basis, the tax exceeded an employee's pay is no excuse for failing to operate the PAYE system properly.

85. A reasonable taxpayer exercising reasonable diligence in the application of the revised tax code would have investigated the exception reports with greater forensic acuity than that undertaken by the appellant. It is our view that it should have been apparent to those reviewing the payroll (and the exception reports) that the application

of the revised tax code was not operating properly. It was not deducting any tax at all from Miss Young's wages which it clearly should have been given that the revised tax code was lower than the code previously used, (when tax had been deducted).

86. In saying this, we make no criticism, of either Mr Watkins or Mrs Kehoe, neither of who were working for the appellant at the relevant time.

Decision and appeal rights

87. For the foregoing reasons, we dismiss the appellant's appeal.

88. 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.

NIGEL POPPLEWELL
TRIBUNAL JUDGE

RELEASE DATE: 16 SEPTEMBER 2015