[2012] UKUT 418 (TCC)

Appeal number: FTC/88/2011

VAT Default surcharge — penalty of £4,260.26 — whether disproportionate— no — principles to be taken into account by Tribunal

IN THE UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Appellants

- and-

TOTAL TECHNOLOGY (ENGINEERING) LIMITED

Respondent

Tribunal: Mr Justice Warren, Chamber President
Judge Colin Bishopp, President of the Tax Chamber

Sitting in public in London on 10 and 11 July 2012

Peter Mantle instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Appellants

Michael Matthews of Matthews Pulman, Accountants and Brian Phillips for the Respondent

DECISION

Introduction

1. This is an appeal from the decision of the First-tier Tribunal (Anne Redston and Ian Perry) ("**the Tribunal**") released on 15 July 2011 ("**the Decision**"). They allowed an appeal by Total Technology (Engineering) Ltd ("**the Company**") against a VAT default surcharge of £4,260.26 for the quarter ended 30 June 2009 ("**the Surcharge**") and discharged it. The Company's VAT payment was received one day late, on 8 July 2009 instead of 7 July 2009. There were two issues before the Tribunal. The first was whether the Company had a reasonable excuse for the late payment; the second was whether the Surcharge was disproportionate. The Tribunal found against the Company on the reasonable excuse issue: that finding is not challenged on this appeal. But the Tribunal found, in favour of the Company, that the Surcharge was disproportionate. The Appellants ("**HMRC**") now appeal against that decision with the permission of Ms Redston.

2. The outcome of this appeal is of great importance to HMRC even though the amount at stake in this particular case is not large. It is important because the integrity of the VAT surcharge provisions is in issue, as will become apparent. The appeal raises issues of EU law which are far from straightforward. We have been referred to a considerable number of authorities both in our national courts and in the European Court of Justice, now called the Court of Justice (being part of the Court of Justice of the European Union), which we will refer to as "**the ECJ"**. The law is complex.

3. Mr Peter Mantle appears before us on behalf of HMRC. Mr Michael Matthews, of the Company's accountants, appears on behalf of the Company. We have also heard from Mr Brian Phillips, a director and shareholder of the Company, who made some observations to which we will return at the end of this decision. It is not reasonable to expect a non-specialist accountant like Mr Matthews to have anything like the grasp of this subject which Mr Mantle has with a well-resourced and well-informed team to assist him. We have done our best to ensure that this disparity has not disadvantaged the Company. As a result, we have produced a decision of greater length than might have been expected in order to rehearse some, at least, of the arguments which could have been presented by a properly instructed legal team equivalent to that deployed by HMRC. We would have preferred it if it had been possible for representation to be provided for the Company equivalent to HMRC's representation. But, understandably, the Company did not go to the considerable expense of obtaining such representation (even assuming that it could afford to do so) in the light of the sum at stake. This means that Mr Mantle's arguments have been free from a real challenge from an opposing advocate.

The facts

4. The relevant facts are set out in [4] and in [7] to [17] of the Decision. They can be summarised for present purposes as follows:

a. The Company was on a quarterly accounting basis for VAT so that its VAT return and the related payment were due on or before the end of the month following each calendar quarter save that the Company took advantage of the 7 days' grace allowed for electronic payment.

b. The Company runs an employment agency. It has been trading since 1973 and has an excellent compliance record both in relation to direct and indirect tax.

c. In 2001 Mr Dean Coughlan (who represented it before the Tribunal) joined the Company. He purchased a new accounting system. Between 2001 and 2008 the Company's turnover grew by around 25% a year. In the spring of 2009 the Company began working on a new contract with the Department of Work & Pensions, which involved significant extra work. One individual was responsible for the book-keeping and accountancy.

d. Although no accounts were provided to the Tribunal, they were informed that the Company made profits of around £50,000 a year, achieving a profit margin of approximately 12%.

The VAT payments and defaults

e. The Company's VAT payment history, so far as relevant to this Appeal, is as follows:

Period to	**VAT due £**	**Due date**	**Paid by due date £**	**Paid after due date £**	**Rate of surcharge**	**Amount £**	**No of default**
31/5/08	126,246	31/7/08	125,769	476	0%	0	1
30/11/08	108,957	7/1/09	108,626	331	2%	0	2
31/5/09	85,205	7/7/09	nil	85,205	5%	4260.26	3

f. As can be seen from the table, small adjustments to the total VAT due were paid after the due dates in respect of the returns for the periods ending May and November 2008. Mr Coughlan said that these arose because of problems with the Company's accounting system.

g. Because the payments of the small additional sums were made after the due date, they were recorded as late payments.

h. Despite extensive negotiations with the Company's software supplier, it had been impossible to establish the cause of the problem and the system was replaced.

i. So far as concerns the quarter ending in November 2008, the surcharge fell below £400 and, in accordance with HMRC policy, was not collected. But the surcharge had not been withdrawn in accordance with the statutory provisions to which we come shortly.

5. The Decision does not reveal the number of returns submitted for each of the first two periods. If the initial (under)payment had been accompanied by a

return showing the amount actually paid as the amount due, then there would have been compliance with the regulations so that the underpayments would not have counted as defaults for the purposes of a default surcharge for the third period. In contrast, if the return showing the correct figure was the only return, then the initial payment was an underpayment and, since payment of the shortfall was made after the due date, there was a failure to comply with the regulations so that the underpayments would have counted as defaults for the purposes of a default surcharge for the third period. There was no evidence before the Tribunal that there was more than one return so that the point could not be, and was not, taken that there was in fact compliance with the regulations.

6. We became concerned about this point in the course of preparing this Decision. Such evidence as HMRC were able to produce suggests that there was only one return for each period; the Company was unable to produce any evidence to contradict this conclusion. There is, therefore, nothing in the point so far as this appeal is concerned.

Surcharges

7. The statutory surcharge provisions are found in a section 59 of the Value Added Tax Act 1994 ("**VATA**"). As we will see, this is a highly prescriptive regime with an inflexible table of surcharges laid down with no, or virtually no, discretion for HMRC to relieve a surcharge once imposed. We set out the provisions of section 59 in the Annex to this Decision, together with section 71(1) which is relevant to the construction of section 59. The regime and its introduction were described in some detail by the VAT Tribunal in *Greengate Furniture Ltd v CCE* [2003] V&DR 178. A more succinct (and, for present purposes, sufficient) description was given by one of us, Judge Bishopp, at [19] to [24] of his decision in *Enersys Holdings UK Ltd v HMRC* [2010] UKFTT 20 (TC) ("***Enersys***"). We take the following from that description:

a. The default surcharge regime was introduced in the United Kingdom in 1986, as one of a range of measures designed to promote VAT compliance. The measures replaced the previous system by which defaulting traders were prosecuted; delay in the submission of a return and payment, however egregious, may no longer lead to prosecution. Default surcharges are correspondingly considered in the UK's domestic law to be civil rather than criminal penalties. Some relatively minor changes to the system were made in 1992 and 1993, but its essentials remain as they were in 1986.

b. A first default gives rise to no penalty, but brings the trader within the regime; he is sent a surcharge liability notice which informs him that he has defaulted and warns him that a further default will lead to the imposition of a penalty. A second default within a year of the first leads to the imposition of a penalty of 2% of the net tax due. A further default within the following year results in a 5% penalty, the next default, again if it occurs within the following year, results in a 10% penalty, and any further default within a year of the last default results in a 15% penalty. A trader who does not default for a full year escapes the regime; if he defaults again after a year has gone by the process

starts again. The fact that he has defaulted before is of no consequence.

c. There is no fixed maximum penalty; the amount levied is simply the prescribed percentage of the net tax due. HMRC do not collect some small penalties; this concession has no statutory basis but is the product of a (published) exercise of HMRC's discretion, conferred on them by the permissive nature of section 76(1) VATA, providing that they "may" impose a penalty, and by their general care and management powers. Even though the penalty is not collected, the default counts for the purpose of the regime (unless, exceptionally, HMRC exercise the power conferred on them by section 59(10) of the Act to direct otherwise). Similarly, where the monetary penalty is nil, because no tax is due or the trader is entitled to a repayment, the default nevertheless counts for the purposes of the regime, subject again to a section 59(10) direction to the contrary.

d. The default surcharge is not included within the scope of section 70 of the Act, which enables the Commissioners or the tribunal to mitigate some civil penalties, and there is no other provision which would enable either the Commissioners or the tribunal to mitigate a surcharge.

8. Since the penalty is related to the tax due and unpaid at the due date, it will have some relationship with the turnover of the taxable person because output tax will reflect the value of taxable supplies. However, the relationship is inexact in the light of the impact of deduction of input tax incurred in making taxable supplies and of any exempt or zero-rated supplies. Thus a repayment trader (that is, one whose input tax consistently exceeds his output tax) is never exposed to a monetary penalty. The penalty, it should be emphasised, is not related to profitability or ability to pay.

9. It is also to be noted that the amount of the penalty depends on whether the return or the payment is late. Delay after the due date before the return is submitted or payment is actually made is not relevant: it is neither an aggravating factor (if long) nor a mitigating factor (if short). It differs in that respect from some other penalty regimes found within the UK tax system.

The Decision

10. The Tribunal discussed the issue of proportionality at [31] to [48] of the Decision in the light of the arguments which they had recorded earlier. The Tribunal considered that the case law of the ECJ and of the European Court of Human Rights ("**the ECHR**") did not disclose material differences in the meaning of proportionality, and that UK case law thus relies on cases from both the ECJ and the ECHR. Basing themselves on *Garage Molenheide BCBA v Belgium* (Joined cases C-286/94, C-340/95, C-401/95 and C-47/96) [1998] STC 126 ("***Molenheide***"), they concluded that if a penalty is disproportionate to the gravity of the offence, the Tribunal has a duty under EU law to intervene. Noting that the Human Rights Act 1998 obliged the Tribunal to respect a taxpayer's rights under the European Convention on Human Rights ("**the Convention**"), they considered

(see [33] of the Decision) that these rights required that there be "a reasonable relationship of proportionality between the means employed and the aim pursued", referring to *Gasus Dosier-und Fördertechnik GmbH v Netherlands* (Application 15375/89 (1995) 20 EHRR 403 ("***Gasus**").*

11. They also referred to what Simon Brown LJ had said in *International Transport Roth GmbH v Home* Secretary [2003] QB 728 ("***Roth***") at [26], setting out the test for assessing proportionality. We will need to consider that case in a little detail later in this decision. It is, however, worth setting out the passage on which the Tribunal relied, not least because Mr Mantle relies on the same passage:

> "…. it seems to me that ultimately one single question arises for determination by the court: 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? In addressing this question I for my part would recognise a wide discretion in the Secretary of State in his task of devising a suitable scheme, and a high degree of deference due by the court to Parliament when it comes to determining its legality. Our law is now replete with dicta at the very highest level commending the courts to show such deference."

12. We would complete the quote and also add what he said in [27]

> "[26] … I take as a single example what Lord Bingham of Cornhill said in *Brown v Stott* [2003] 1 AC 681, 703:
>
> > 'Judicial recognition and assertion of the human rights defined in the Convention is not a substitute for the processes of democratic government but a complement to them. While a national court does not accord the margin of appreciation recognised by the European Court as a supra-national court, it will give weight to the decisions of a representative legislature and a democratic government within the discretionary area of judgment accorded to those bodies …'
>
> [27] That said, the court's role under the 1998 Act is as the guardian of human rights. It cannot abdicate this responsibility. If ultimately it judges the scheme to be quite simply unfair, then the features that make it so must inevitably breach the Convention."

13. The Tribunal observed that the "not merely harsh but plainly unfair" test set a high threshold which must be surmounted before a court or tribunal could find that a penalty, correctly levied on the taxpayer by statutory provisions set by Parliament, should be struck down as disproportionate. Whether a penalty could be struck down by the First-tier Tribunal if it is found to be disproportionate is something we will come to later.

14. The Tribunal then went on, at [37] to [48] of the Decision, to apply those principles to the facts. In doing so, they considered the decision in *Enersys*. In that case, Judge Bishopp had considered five factors (listed by the Tribunal in [37] of the Decision) when addressing the question of proportionality. The Tribunal themselves addressed each of those factors. They also addressed a further factor,

namely the Company's history. This was not a case like *1st Glass and Mirror Company Ltd v HMRC* [2011] UKFTT 30 (TC) where there had been a history of defaults. As they had noted in the summary of the facts, and as was emphasised before us, the Company has had a very good compliance record. As to the defaults which had occurred, those in 2008 were in relation to very small amounts and the delays were minor; indeed, the defaults were explicable and showed that there was no wilful disregard by the Company of its obligations even though the explanations were not sufficient to amount to reasonable excuses for the reasons given by the Tribunal.

15. They concluded in favour of the Company in this way at [47] and [48]:

> "47.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.'
>
> 48. 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."

The Grounds of Appeal

16. HMRC's Notice of Appeal identifies, at paragraphs 1 and 2, seven alleged errors of law concerning proportionality. In paragraphs 3 and 4 it is said that the Tribunal erred in taking into account certain irrelevant factors and in failing to take into account certain relevant matters. And finally, in paragraph 5, it is said that the Tribunal erred in concluding that a penalty correctly imposed in accordance with the terms of section 59 VATA could be disapplied on the basis of the Human Rights Act 1998.

17. Mr Mantle submits that central to the issue of proportionality is whether the proper approach is (1) to consider if the default surcharge regime in VATA 1994, viewed in the round, is incompatible with the principle of proportionality or (2) to consider proportionality by reference to the facts and circumstances of an individual case and the particular penalty which the legislation rigidly imposes. In that context, it needs to be considered whether these different approaches really involve a false dichotomy and whether there is really any difference in substance.

Proportionality

18. It is accepted by HMRC that the default surcharge must comply with the principle of proportionality. It is necessary for us to consider in some detail what that principle is and why and how it applies in the context of the default surcharge.

19. For a concise description of the principle, we can turn to Lord Hoffmann's speech in *C R Smith* Glaziers *(Dunfermline) Ltd v C&E Commissioners* [2003] STC 419. That case related to UK provisions which deprived certain services of the exemption afforded by mandatory provisions of Art 13B(a) of the Sixth VAT Directive (concerning the exemption of insurance-related services from VAT). Lord Hoffmann said at [23] of his speech that the only way in which the UK could justify rules depriving such services of exemption was by reliance on Article 13B which permitted Member States to lay down conditions "for the purpose of ensuring the correct and straightforward application of the exemption and of preventing any possible evasion, avoidance or abuse". He then referred to an opinion of the Advocate General that prevention of evasion could justify a domestic provision and said, at [25]:

> "The Advocate General did not enlarge upon what kind of conditions might be regarded as appropriate for this purpose. But in general European law would require them to satisfy the principle of proportionality in its broad sense, which, following German law, is divided into three sub-principles: first, a measure must be suitable for the purpose for which the power has been conferred; secondly, it must be necessary in the sense that the purpose could not have been achieved by some other means less burdensome to the persons affected and thirdly, it must be proportionate in the narrower sense, that is, the burdens imposed by the exercise of the power must not be disproportionate to the object to be achieved. In the particular instance of conditions for allowing a VAT exemption, the Court of Justice of the European Communities has recently said that such conditions must be 'necessary for the attainment of the specific objective which [the legislation] pursues and have the least possible effect on the objectives and principles of the Sixth Directive'…"

referring to *Ampafrance SA v Directeur des Services Fiscaux de Maine-et-Loire* and *Sanofi Synthelabo v Directeur des Services Fiscaux du Val-de-Marne* (joined cases C-177/09 and C-181/99) [2000] ECR I-7013 (concerning a purported derogation in French legislation pursuant to an apparent authorisation under a Council Decision which was held to be invalid).

20. The principle of proportionality has an important role in the jurisprudence of both the ECJ and the ECHR. Mr Mantle submits that there is no material difference between the concept of proportionality in EU law and in the jurisprudence of the ECHR. In particular, a wide discretion is to be afforded to Member States when implementing penalty regimes (such as the UK VAT default surcharge) equivalent to the wide margin of appreciation afforded in cases under the Convention.

21. Care must be taken, however, in applying the decisions made in one jurisdiction to a case which falls to be treated according to the principles applicable in the other jurisdiction. Mr Mantle's proposition requires examination. It may not be correct to equate the wide margin of appreciation available to a Member State in the context of the European Convention on Human Rights with the principle of proportionality as applied in EU law. Indeed, EU law itself might

require a more nuanced approach so that what is proportionate in one case is not proportionate in another. For instance, an express power of derogation from the provisions of a Directive such as Article 90 of EC Council Directive 2006/112 (the Principal VAT Directive, to which we will refer as "**the Directive**"), might be treated differently from an exercise by a Member State of the power conferred on it by Article 65 of the Treaty on the Functioning of the European Union.

22. There are two potential sources for the imposition of a proportionality requirement in relation to the default surcharge regime. The first source is EU law in the light of the Directive. The second source is the Human Rights Act 1998. We will consider both of those sources in the course of this decision.

Decisions relating to EU law

23. EU law concerning proportionality is engaged in this way. The Directive provides for a common system of value added tax across the EU, making provision for the payment of VAT by traders and the submission of returns. It says very little, however, about how these obligations are to be enforced and in particular says nothing express about the imposition of penalties for non-compliance. The area of enforcement is one which has not been harmonised, the only relevant general provision being found in Article 273 which provides that Member States "may impose other obligations which they deem necessary to ensure the correct collection of VAT and to prevent evasion" but not so as "to impose additional invoicing obligations over and above those laid down in Chapter 3".

24. It is clear that Member States are expected to take measures to enforce the requirements of the Directive imposing obligations on traders to pay VAT and to make returns. Such measures may include penalty regimes: such regimes serve a legitimate and important purpose in the public interest. The position was encapsulated by Judge Bishopp at [18] of his decision in *Enersys* and more fully explained by the ECJ at [21] and [22] of its judgment in Case C-188/09 *Dyrektor Izby Skarbowej w Bialymstoku v Profaktor Kulesza, Frankowski, Jóźwiak, Orlowski sp. j.* (29 July 2010) ("***Profaktor***"):

> "21 The normal functioning of the common system of VAT, which must thereby ensure the neutrality of taxation of all economic activities, requires that the tax be collected accurately. It follows from Articles 2 and 22 of the Sixth VAT Directive, and from Article 10 EC, that every Member State is under an obligation to take all legislative and administrative measures appropriate for ensuring collection of all the VAT due on its territory…..
>
> 22 Under the common system of VAT, Member States are required to ensure compliance with the obligations to which taxable persons are subject and they enjoy in that respect a certain measure of latitude, inter alia, as to how they use the means at their disposal (*Commission* v *Italy*, paragraph 38)."

25. But a Member State is constrained in the measures which it may take. As it was put in [26] of *Profaktor*,

"26 However, the measures which the Member States may thus adopt must not go further than is necessary to attain the objectives of ensuring the correct levying and collection of the tax and the prevention of tax evasion. Such measures may not therefore be used in such a way that they would have the effect of undermining the neutrality of VAT, which is a fundamental principle of the common system of VAT (see, to that effect, inter alia, Joined Cases C-286/94, C-340/95, C-401/95 and C-47/96 *Molenheide and Others* [1997] ECR I-7281, paragraph 47; Case C-25/03 *HE* [2005] ECR I-3123, paragraph 80; and Joined Cases C-95/07 and C-96/07 *Ecotrade* [2008] ECR I-3457, paragraph 66)."

26. We do not need to set out what was said in *Molenheide* at [48] to the same effect. But we do mention [49] where it was noted that so far as concerned the specific application of the principle of proportionality, it is for the national court to determine whether the national measures are compatible with EU law.

27. In *Profaktor*, the national legislation required traders effecting sales to persons not engaged in economic activity to keep records of turnover and the amount of tax due through the use of cash registers. Where the taxpayer had not installed cash registers, the trader forfeited the right to reduce the amount of tax due in an amount equivalent to 30% of the amount of input tax paid on the acquisition of goods and services. It was common ground that the national measure sought to ensure that tax was levied accurately and to prevent tax evasion, so that it could not be disputed that the obligation thus imposed on taxable persons was among the measures which Member States could adopt.

28. In that context, it was pointed out that the discretion conferred on Member States and the restrictions on that discretion are not unconstrained:

"29 It is necessary to point out in this connection that, in the absence of harmonisation of European Union legislation in the field of sanctions applicable where conditions laid down by arrangements under that legislation are not complied with, Member States are empowered to choose the sanctions which seem to them to be appropriate. They must, however, exercise that power in accordance with European Union law and its general principles, and consequently in accordance with the principle of proportionality (Case C-262/99 *Louloudakis* [2001] ECR I-5547, paragraph 67).

30 As regards the specific application of that principle of proportionality, it is for the national court to determine whether the national measures are compatible with European Union law, the competence of the Court of Justice being limited to providing the national court with all the criteria for the interpretation of European Union law which may enable it to make such a determination as to compatibility (see, inter alia, Case C-55/94 *Gebhard* [1995] ECR I-4165 and *Molenheide and Others*, paragraph 49)."

29. The ECJ then went on to consider the particular sanction with which it was concerned in *Profaktor*:

"31 It must therefore be stated, first, that the provisions of the 2004 Law on VAT do not bring into question the actual principle of the right to deduct, to

which every taxable person continues to be entitled. That right is not lost even though the taxable person concerned has failed to comply with the obligation set out in those provisions.

32 Secondly, the administrative sanction attached to that obligation is in the nature of a financial burden which the national legislature seeks to impose on the taxable person in breach of those provisions, and solely for the duration of that infringement. Such a choice, which comes within the competence of the Member State concerned, does not appear to be manifestly inappropriate in relation to the objective which it seeks to attain.

33 Thirdly, the choice made to apply that financial burden by withholding a portion of the tax which may be deducted from the VAT payable and not, inter alia, by means of payment by the taxable person of a sum to the public purse, also comes within the competence of the Member State concerned.

34 However, in so far as they affect the extent of the right to deduct, those rules are liable to undermine the principle that the tax burden must be neutral in relation to all economic activities if, inter alia, the procedure for determining the amount of the sanction and the conditions under which the facts relied on by the tax authorities in order to apply that sanction are recorded, investigated and, as the case may be, adjudicated upon effectively render meaningless the right to deduct VAT.

35 Although it is for the referring court to check that that procedure and those conditions, as they follow from the 2004 Law on VAT, do not lead to such a consequence, it must be observed in this connection that the rate of the amount withheld in the main proceedings, which is limited to 30% and thus preserves the greater part of the input tax paid, appears neither excessive nor inadequate for the purpose of ensuring that the sanction in question is deterrent and, therefore, effective.

36 Moreover, such a reduction on the basis of the amount of tax paid by the taxable person is not manifestly without any link to the level of the economic activity of the person concerned.

37 Furthermore, in so far as the purpose of that sanction is not to correct accounting errors but to prevent them, its flat-rate nature, resulting from the application of the fixed rate of 30%, and, consequently, the lack of any correspondence between the amount of that sanction and the extent of any errors which may have been made by the taxable person cannot be taken into account in the assessment of whether that sanction is proportionate. Moreover, it is precisely the absence of cash registers which prevents the amount of sales made from being accurately established and therefore precludes any assessment as to whether the sanction is commensurate with the amount of any accounting errors.

38 In addition, in the event, as described by the Commission, that the failure to use cash registers resulted from circumstances outside the taxpayer’s control, it would be for the national court, were such circumstances to be duly established in accordance with the national rules governing procedure and evidence, to take this into account in order to establish, in the light of all

the factors in the case, whether the fiscal sanction must nevertheless be applied and, if so, to ascertain that it is not disproportionate.

39 It follows from the foregoing that the answer to the first question is that the common system of VAT, as defined in Article 2(1) and (2) of the First VAT Directive and in Articles 2, 10(1) and (2) and 17(1) and (2) of the Sixth VAT Directive, does not preclude a Member State from imposing a temporary restriction on the extent of the right of taxable persons who have not complied with a formal requirement to keep accounting records of their sales to deduct input tax paid, on condition that the sanction thus provided for complies with the principle of proportionality."

30. The reference in [32] of *Profaktor* to "manifestly inappropriate" must be read in the context of the judgment as a whole. It would not, we consider, be correct to say that *Profaktor* is a decision which establishes the proposition that, simply because a choice made by a Member State is not manifestly inappropriate or, to use different language found in the cases, devoid of reasonable foundation, it satisfies the principle of proportionality as that principle falls to be applied in relation to the Directive.

31. Quite clearly, the ECJ did not base its decision on that proposition. If that had been the proposition which the ECJ was propounding, that would have been an end of the case.

32. Instead, the Court went on to consider other elements. It will be recalled that the penalty in that case took the form of a refusal of deduction of a proportion of input tax rather than a penalty by way of payment. As was pointed out at [34], those rules (*ie* the rules disallowing part of the input tax as a deduction) might undermine the principle that the tax burden must be neutral in relation to all economic activities, and might render meaningless the right to deduct VAT. But the ECJ observed in this connection (at [35]) that the rate of the amount withheld appeared neither excessive nor inadequate for the purpose of ensuring that the sanction in question was deterrent and, therefore, effective. So in those paragraphs of the judgment, one sees the ECJ addressing what measures are proportionate – neither excessive nor inadequate – when viewed in the context of the purpose of the permitted objective of deterring incorrect returns.

33. *Profaktor*, it can be seen, is one of those cases where the ECJ was prepared to give some fairly detailed guidance. Whilst maintaining the strict position that the decision whether the legislation is proportionate or not is one for the national court, it might be thought that the guidance gives a strong pointer to the decision which the national court should make.

34. Case C-262/99 *Louloudakis v Elliniko Dimosio*, ("***Louloudakis***") to which the Court referred in *Profaktor* (at [29]) related to Council Directive 83/182/EEC on tax exemptions within the Community for certain means of transport temporarily imported into one Member State from another. Greek law imposed a financial penalty in certain circumstances of such importation. At [67] of its judgment in *Louloudakis*, the ECJ stated:

"…it must be borne in mind that, in the absence of harmonisation of the Community legislation in the field of the penalties applicable where conditions

laid down by arrangements under such legislation are not observed, the Member States are empowered to choose the penalties which seem appropriate to them. They must, however, exercise that power in accordance with Community law and its general principles, and consequently with the principle of proportionality…. The administrative measures or penalties must not go beyond what is strictly necessary for the objectives pursued and a penalty must not be so disproportionate to the gravity of the infringement that it becomes an obstacle to the freedoms enshrined in the Treaty …"

35. The reference to the freedoms enshrined in the Treaty is a reference to the freedom of movement of Community residents within the Community, which was one of the objectives expressly pursued by the directive in question in that case. The final sentence in the quote is the articulation in the context of the facts of *Louloudakis* of the principle which had just been stated.

36. The first part of the paragraph quoted from *Louloudakis* (the part preceding "The administrative measure" *etc*) is effectively repeated at [23] of the judgment in Case C-210/10 *Márton Urbán v Vám-és Pénzügyőrség Észak-alföldi Regionális Parancsnoksága* ("***Urbán***"). Applying those principles, the ECJ in *Urbán* then added at [24]:

"Thus, in the present case, the measures imposing penalties permitted under national legislation must not exceed the limits of what is appropriate and necessary in order to attain the objectives legitimately pursued by the legislation in question; when there is a choice between several appropriate measures, recourse must be had to the least onerous, and the disadvantages caused must not be disproportionate to the aims pursued."

37. That case was decided in a very different context from *Profaktor*, a context which related to the numerous obligations, of varying degrees of importance, on employers and drivers in respect of the use of recording equipment in coaches and lorries. Further, Member States were required specifically to take action pursuant to the express obligation in a Council Regulation; that Regulation contains guidelines on the weighting of infringements of the Regulation according to the seriousness of their breach, leaving the Member States with what Mr Mantle describes as an unusually limited margin of appreciation. Whether that is an accurate assessment is debateable. But what we do accept is that the relevant legislation, in laying down a hierarchy of seriousness of breach, gave a very strong indication that the different breaches warranted different penalties. It was in that context that the ECJ considered that a flat-rate penalty across the board did not satisfy the principle of proportionality.

38. On the facts of the case, what Mr Mantle says may be correct. But proportionality was dealt with at a much more general level in [45]*ff*. Thus we find, arriving at [53]:

"53 … Measures imposing penalties must not, therefore, inter alia, exceed the limits of what is necessary in order to attain the objectives legitimately pursued by the legislation in question or be disproportionate to those aims.

54 It is, however, necessary to point out, in that respect, that Member States are required to comply with the principle of proportionality not only as regards the determination of factors constituting an infringement and the

determination of the rule concerning the severity of fines, but also as regards the assessment of the factors which may be taken into account in the fixing of a fine.

55 In the light of the foregoing, it must be stated that the obligation on the national authorities tasked with penalising infringements of [the relevant regulations] to impose a fine at a flat rate of HUF 100,000, without being able to take account of the actual circumstances of the individual case and, if appropriate, to reduce the amount of that fine, does not satisfy the conditions required by the case-law …"

39. The ECJ referred, in *Profaktor*, to *Molenheide.* In that case, the Court having held that a national measure was not in principle precluded by article 18(4) of the Sixth VAT Directive (concerning the right of deduction) concluded at [46] and [48] of the judgment as follows:

"46. Thus, in accordance with the principle of proportionality, the member states must employ means which, whilst enabling them effectively to attain the objective pursued by their domestic laws, are the least detrimental to the objectives and the principles laid down by the relevant Community legislation …

48….the principle of proportionality is applicable to national measures which, like those at issue in the main proceedings, are adopted by a member state in the exercise of its powers relating to VAT, since, if those measures go further than necessary in order to attain their objective, they would undermine the principles of the common system of VAT and in particular the rules governing deductions which constitute an essential component of that system."

40. Returning to *Louloudakis*, the objective of the directive in that case was to encourage freedom of movement for residents of Member States and of goods within the EU. In that connection, national legislation setting penalties could be justified by overriding requirements of enforcement and prevention. Even so, penalties could prove to be disproportionate and constitute an obstacle to those freedoms. After giving some examples (see [69]) of what the ECJ clearly considered would be disproportionate penalties, it observed (see [70]) that

"it is for the national court to assess whether, in view of the overriding requirements of enforcement and prevention, as well as the amount of the taxes in question and the level of the penalties actually imposed, those penalties do not appear so disproportionate to the gravity of the infringement that they become an obstacle to the freedoms enshrined in the Treaty."

41. In infraction proceedings, Case C-156/04 EC *Commission v Greece* [2007] ECR I-4129, the ECJ applied [69] and [70] of *Louloudakis* recognising that the level of severity of a penal measure legislated for by the system might be such that, in certain circumstances, the severe penalty prescribed might be disproportionate. In such a case the consequence was that the question whether the penalties applied are proportionate or disproportionate had to be assessed on the basis of the level of penalties applied in the individual case: see [72].

42. There is one other decision of the ECJ to which we would refer. It is *Goldsmiths (Jewellers) Ltd v Customs & Excise Commissioners* C-330/95 [1997] STC 1073, ("***Goldsmiths***"). In that case, the appellant (which had suffered from a failure by the counter-party to a contract to provide certain non-monetary consideration for a supply) challenged the limitation of the UK domestic bad debt provisions to supplies which had been made for consideration in money. The ECJ noted that Article 11A(1)(a) of the Sixth VAT Directive embodied "one of the fundamental principles of the directive". Article 11C(1) required Member States to provide for a reduction in the taxable amount in certain cases including total or partial non-payment of the price; in such cases, however, Member States were permitted to derogate from the rule. The ECJ had this to say about the power to derogate:

> "18. The power to derogate … is based on the notion that in certain circumstances and because of the legal situation prevailing in the member state concerned, non-payment of consideration may be difficult to establish or may only be temporary. It follows that the exercise of that power must be justified if the measures taken by the member states for its implementation are not to undermine the object of fiscal harmonisation pursued by the Sixth Directive.
>
> 19. With regard to section 11 of the [Finance Act 1990], the United Kingdom seeks to justify the refusal to refund the tax on the ground that there is a greater risk of evasion where the underpaid consideration is not expressed in money.
>
> 20. That justification is unacceptable for two reasons."

43. The two reasons given by the ECJ were these:

> a. Measures intended "to prevent tax evasion or avoidance" (see [21]) may not in principle derogate from the basis for charging VAT "except within the limits strictly necessary for achieving that specific aim". The exclusion by the UK legislation of all non-money transactions from the refund of VAT went beyond what was strictly necessary.
>
> b. No distinction was to be drawn between money and other consideration in Article 11A(1)(a) or Article 11C(1). The distinction drawn in the treatment of the different transactions under UK legislation was discriminatory and restricted traders from choosing the contract which they considered to be most suitable to their economic interests.

44. The validity of the derogation could be judged, of course, only against the permissible objectives of the power to derogate. The Advocate General at [19] of his opinion said that the "member states must use the discretion so provided in such a way as to comply with the aims of harmonisation and the underlying principles of the legislation." Those principles include the principle of fiscal neutrality, preventing evasion and avoidance of tax and the fundamental principles of Article 11. The ECJ itself, at [18] of the judgment, described the power to derogate as based on the notion that non-payment may be difficult to establish and may be temporary, from which it followed that the derogation had to be justified.

45. We refer to *Goldsmiths* because it is an example of the principle of proportionality at work in relation to VAT, albeit in the context of a derogation from an aspect of VAT subject to harmonisation, and not, as in the present case, in the context of penalties which are not, as yet, subject to harmonisation. It does, however, provide a useful illustration of the need to identify the permitted objectives at which national legislation may be directed and of the proposition that such legislation must not undermine the principles of the common system of VAT.

46. A domestic decision to which we should refer is *C&EC v Peninsular and Oriental Steam Navigation Co* [1992] STC 809 ("***P&O***"). This case concerned the serious misdeclaration penalty imposed by section 14 Finance Act 1985. One of P&O's arguments was that section 14 infringed the principle of proportionality. Simon Brown J considered that aspect of the case in the section of his judgment beginning at page 819. In order to succeed, P&O needed to establish (i) that EU law, and thus the principle of proportionality, applied to misdeclaration legislation so that the UK courts would be able and bound to determine the legality of section 14 and (ii) that the application of section 14 to the class concerned (*ie* those like P&O) whose misdeclarations involved merely errors of timing and from whom no tax was outstanding at the time when the penalty arose was disproportionate.

47. As to (i), the Judge's inclination was to think that the court could strike down national penal legislation simply on the ground that it offended the principle of proportionality. The case law of both the ECJ and of our domestic courts has moved on since the decision in *P&O* so that today there can be no doubt that this tribunal can, and must, mould or adapt the legislation so as to make it compliant with EU law and, in an extreme case, disapply it altogether.

48. But he added that only most exceptionally could the court properly do so. In saying that, he noted that Member States must "inevitably have the very widest margin of appreciation for determining just what penalties are appropriate to underpin the efficient functioning of the value added tax system operating in their own country". He thought that was implicit from the decision in *Anklagemyndigheden v Hansen und Søn I/S* (Case C-326/88) [1990] 1 ECR 2911 and that nothing in the cases encouraged the view that the court would readily regard a system of penalties as falling foul of the doctrine of proportionality. He quoted approvingly from the decision of the VAT Tribunal in *W Emmett & Son Ltd v CEC* [1991] VATTR 456 who, after setting out some history and rejecting any challenge based on domestic law, said this at p 464:

> "Furthermore the penalty, to avoid offending against the doctrine of proportionality, must be no more than is 'strictly necessary' to obtain the purposes of the public interest for which it was imposed. To answer the question whether or not the penalty imposed by Section 14 Finance Act, 1985, was strictly necessary for the purpose of effectively enforcing the provisions of the United Kingdom legislation which require taxpayers not to render returns which are seriously inaccurate, would necessarily involve a detailed inquiry into matters which are of an essentially administrative nature. This Tribunal is certainly not in a position to undertake such an inquiry and we rather doubt whether the Court of Justice is better placed."

49. The jurisprudence has moved on and there must be some doubt that that statement of the Tribunal, if it was intended as a statement of principle, would withstand the scrutiny of the ECJ. It is the duty of the national courts to give effect to the principle of proportionality and it cannot simply wash its hands of the matter by saying that it is not equipped to carry out such an enquiry. A penalty system which was clearly unfair and devoid of rational foundation would surely be open to challenge. The point can perhaps be put a different way which is that the principle of proportionality as applied to a penalty system, such as the serious misdeclaration penalty in that case or the default surcharge system in the present case, is to be applied in such a way as to give the Member States the widest discretion in deciding the balance between the public interest and the interests of individual taxpayers. This is in effect what Simon Brown J said in the penultimate paragraph of his judgment. First he rejected P&O's reliance on the commissioners' policy statement ("… serious misdeclaration penalties will not normally be imposed when a VAT return for a registered trader is misdeclared but this has been corrected by a compensating misdeclaration in respect of the same transactions for the following accounting period with no overall loss of VAT") to support the contention that the substantial penalty imposed was plainly disproportionate. Then he said this:

> "Nor does such disproportionality seem to me in any way self evident from the bare facts of the case itself. Section 14 may indeed, on occasions, operate as a blunt and heavy instrument. Doubtless it does here. But that, like the doctrine of strict liability, is a feature of penalties imposed to encourage the initiation and maintenance of better procedures rather than necessarily any indication of disproportionality."

Decisions relating to Human Rights

50. We now move from the case law of the ECJ to that of the ECHR. Mr Mantle correctly submits that it has been consistently recognised that the existence of a choice on the part of Member States, and a margin of appreciation in deciding what is appropriate, must inform the approach that ought to be taken by the courts to challenges based on the principle of proportionality in the context of the Convention:

a. The ECHR has referred, in the context of laws for the purpose of securing the payment of taxes, to a "wide margin of appreciation" and the need for it to respect the legislature's assessment unless it is "devoid of reasonable foundation". Mr Mantle refers us to [60] of *Gasus* as an example, and in particular to the third paragraph. Referring to tax laws (substantive or procedural) the Court said this:

> "In passing such laws the legislature must be allowed a wide margin of appreciation, especially with regard to the question whether – and if so, to what extent – the tax authorities should be put in a better position to enforce tax debts than ordinary creditors are in to enforce commercial debts. The Court will respect the legislature's assessment in such matters unless it is devoid of reasonable foundation."

b. That decision was concerned with Article 1 Protocol 1 ("**A1P1**"), that is to say the entitlement to the peaceful enjoyment of possessions. It was not concerned in the slightest with the effect of EU legislation on the way in which a Member State is permitted to legislate in the tax field. The second paragraph of A1P1 expressly provides that the first paragraph is not to impair the right of a State to enforce such laws as it deems necessary to secure the payment of taxes or other contributions or penalties. It is thus to be noted first, that A1P1 itself envisages that taxes will have to be levied, and that they can be levied without a breach of a person's entitlement to peaceful enjoyment of his possessions; and secondly, that A1P1 itself provides that the State may enforce such laws as it deems necessary. In those circumstances, it is not at all surprising that the State is entitled to a wide margin of appreciation, so wide as to allow imposition of taxes, contributions or penalties unless the legislature's assessment of what is necessary is devoid of reasonable foundation.

c. *Gasus* was applied in *R oao Federation of Tour Operators v HM Treasury* [2008] STC 2524, CA. That case concerned a doubling of air passenger duty ("**APD**"). Airlines were likely to pass the extra cost on to passengers with whom they had direct contracts and to the relevant tour operator when they did not. Tour operators were effectively precluded from passing the increase on to passengers who had already booked their flights prior to a cut-off date of 6 December 2006. Representatives of the tour operators brought judicial review proceedings challenging the increase in APD. That challenge failed and the tour operators appealed. In rejecting the appeal, Waller LJ (with whose judgment Buxton and Smith LLJ agreed) referred to [134] to [138] of the judgment of Stanley Burnton J at first instance as accurately reflecting the law to this effect:

i. The latitude to be accorded by the judicial branch to the Executive and Legislative branches varies with the context: see *A v SoS for the Home Department* [2004] UKHL 56 at [80] where Lord Nicholls referred to the latitude varying "according to the subject matter under consideration, the importance of the human right in question and the extent of the encroachment upon that right".

ii. In that context, the A1P1 right was seen as less important than some other Convention rights. The primary object was to guard against arbitrary confiscation of property. In the case of the tour operators, the encroachment did not approach confiscation and did not demand anxious scrutiny by the court.

iii. Far from it, according to Stanley Burnton J. In expressing that view, he referred to *James v UK* (Application 8793/79) (1986) 8 EHRR 123 ("***James***") at [46] where the Court said this:

"…. The Court, finding it natural that the margin of appreciation available to the legislature in implementing social and economic policies should be a wide one, will respect the legislature's

judgment as to what is 'in the public interest' unless that judgment be manifestly without reasonable foundation….."

iv. Stanley Burnton J concluded in order to challenge successfully the measure concerned, it must be shown that the legislature's assessment is "devoid of reasonable foundation". He added that the jurisprudence of the ECHR did not justify the English court in declaring a tax measure incompatible because its objects could have been secured more efficiently or effectively by a different measure. *James* and *Gasus* showed that the fact that a particular class of persons is subject to a measure that engages A1P1 is a factor to be taken into account but does not of itself lead to a conclusion of incompatibility.

51. On appeal, Waller LJ (see [32] of his judgment) was in agreement with the decision of Stanley Burnton J; it was impossible to conclude that, by failing to exempt passengers who booked with tour operators prior to 6 December 2006, the UK legislation imposed either an excessive or individual burden on tour operators and/or was devoid of reasonable foundation.

52. The next case to refer to is *Roth*. This case was concerned with alleged breach of Convention rights under Article 6 and under A1P1. The context of the challenge was a scheme which imposed significant penalties on lorry drivers and haulage companies who intentionally or negligently allowed clandestine immigrants entry into the UK, usually by concealment in freight vehicles arriving from continental Europe. Simon Brown LJ recorded (see [23] of his judgment) that the Court had been referred, either orally or in skeleton arguments, to no fewer than 227 authorities, noting that none of the cases came near to reproducing the singular features of the case before him. He identified the most critical features in [24] and [25], before identifying, in [26], the central question for the Court in the passage which we have set out in paragraph 11 above.

53. It is, however, important also to read what Simon Brown LJ said about proportionality later in his judgment. He referred at [51] to the speech of Lord Steyn in *R (Daly) v SoS for the Home Department* [2001] 2 AC 532 at [27], referring to the three-stage test adopted by the Privy Council in *de Freitas v Permanent Secretary of Ministry of Agriculture, Fisheries, Lands and Housing* [1999] 1 AC 69 in relation to determining whether a limitation (by an act, rule or decision) is arbitrary or excessive: "whether: (i) the legislative objective is sufficiently important to justify limiting a fundamental right; (ii) the measures designed to meet the legislative objective are rationally connected to it; and (iii) the means used to impair the right or freedom are no more than is necessary to accomplish the objective".

54. Then, at [52] Simon Brown LJ said this:

> "It is further implicit in the concept of proportionality, however, that not merely must the impairment of the individual's rights be no more than necessary for the attainment of the public policy objective sought, but also that it must not impose an excessive burden on the individual concerned."

55. He went on cite from *James* at [50]:

> "Not only must a measure depriving a person of his property pursue, on the facts as well as in principle, a legitimate aim 'in the public interest', but there must also be a reasonable relationship of proportionality between the means employed and the aim sought to be realised. This latter requirement was expressed in other terms in the *Sporrong and Lönnroth* judgment by the notion of the 'fair balance' that must be struck between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights. The requisite balance will not be found if the person concerned has had to bear 'an individual and excessive' burden."

adding that that principle seemed to him to be of the first importance.

56. Mr Mantle relies strongly on the passage in [26] (set out at para 11 above) as a succinct demonstration of the correct approach to proportionality. He also relies to like effect on [32] of the judgment of the ECJ in *Profaktor* (see paragraph 23 above) referring to the choice made by the Polish government in that case:

> "Such a choice, which comes within the competence of the Member State concerned, does not appear to be manifestly inappropriate in relation to the objective which it seeks to attain."

57. *Wilson v SoS for Trade and Industry* [2003] UKHL 40 [2004] 1 AC 816 was not a tax case. It concerned the requirements of a regulated contract under the Consumer Credit Act 1974. The issue was whether a £250 "document fee" was part of the amount of the "credit" afforded by the lender (a pawnbroker). If it was, then the agreement signed by Ms Wilson correctly stated the amount of the loan and was valid; if it was not, then the agreement failed to do so and was unenforceable. The County Court judge held against Ms Wilson. The Court of Appeal held in her favour as a matter of construction of the legislation. But, following a further hearing, the court held that the inflexible exclusion of a judicial remedy by section 127(3) (which precluded the court from enforcing the agreement) preventing the court from doing what is just in the circumstances of the case, was disproportionate to the legitimate policy objective of ensuring that particular attention is paid to the inclusion of certain terms in the document signed by the borrower. The court made a declaration of incompatibility with Article 6(1) and with A1P1. An appeal to the House of Lords was allowed, the House being of the view that there was no breach of Convention rights.

58. At [62] of his decision, Lord Nicholls said this (the same passage is cited by Judge Bishopp at [41] of his decision in *Enersys*):

> "The legislation must not only have a legitimate policy objective. It must also satisfy a 'proportionality' test. The court must decide whether the means employed by the statute to achieve the policy objective is appropriate and not disproportionate to its adverse effect. This involves a 'value judgment' by the court, made by reference to the circumstance prevailing when the issue has to be decided. It is the current effect and impact of the legislation which matter, not the position when the legislation was enacted or came into force."

59. A case concerning both the Convention and EU law is the decision of the Court of Appeal in *Lindsay v CEC* [2002] EWCA Civ 267, [2002] STC 588. Mr Lindsay was stopped by a British customs official when he was about to drive onto the shuttle at Calais. He was carrying a substantial quantity of cigarettes and tobacco. He said he had purchased them for friends and family with money provided by them. The officer told him that he should have paid duty as the goods were held for a commercial purpose. The result was that the goods were forfeited, as was Mr Lindsay's car which he had bought about four months earlier for £12,000. Mr Lindsay challenged the right of the commissioners to forfeit his car on the grounds that they had wrongly found that there was a commercial purpose behind the importation of the goods. He asked for his case to be reviewed. The review officer refused to reverse the commissioners' decision. Mr Lindsay appealed to the VAT & Duties Tribunal. The tribunal ruled that the decision to deprive Mr Lindsay of his car was disproportionate and would cause him undue hardship and it ordered, pursuant to section 16(4) Finance Act 1994, that the car should be restored to him or that he should be paid compensation in lieu.

60. In the light of the importance of the case, an appeal by the commissioners was heard by the Court of Appeal which held that the tribunal was correct to decide that the review officer's decision could not stand because she had failed, when reaching it, to have regard to all material considerations. Whilst the policy of the commissioners in relation to the forfeiture of vehicles could not be condemned in so far as it applied to those who were using their cars for commercial smuggling (*ie* with a view to resale at a profit), it did not draw a distinction between the commercial smuggler and the driver importing goods for social distribution to family or friends with no profit motive. Even in such a case, the scale of the importation might justify forfeiture of the car. But where the importation was not for the purpose of making a profit, the principle of proportionality required that each case should be considered on its particular facts, which would include the scale of the importation, whether it was a first offence, whether there was an attempt at concealment or dissimulation, the value of the vehicle and the degree of hardship which would be caused by forfeiture. However, the tribunal did not have jurisdiction under section 16(4) of the Act to order restoration or compensation. The appropriate order was that there should be a further review in the light of the decision of the tribunal and of the court.

61. In relation to Convention rights, the Master of the Rolls, Lord Phillips, noted at [52] of his judgment the now familiar proposition that under A1P1, deprivation of possession can only be justified if it is in the public interest. But the action taken must strike a fair balance between the rights of the individual and the public interest. There must be "a reasonable relationship of proportionality between the means employed and the aim pursued". It was accepted that one must consider the individual case to ensure that the penalty imposed is fair. However strong the public interest, it cannot justify subjecting an individual to an interference with his fundamental rights that is unconscionable. That general statement of principle must apply as much where there is a review procedure (when the review must comply with that requirement of proportionality) as when there is not, in which case the legislation may be incompatible with the Convention so that the Court can make a declaration of incompatibility.

62. At [53], the Master of the Rolls turned to consider the EU law aspects of the case. He said this:

> "It does not seem to me that the doctrine of proportionality that is a well established feature of European Community law has anything significant to add to that which has been developed in the Strasbourg jurisprudence. There is however, a passage in [*Louloudakis*] which is helpful in the present context in that it is of general application."

63. He then went on to quote from [67] the same passage as we have set out at paragraph 34 above. The only other matter in the judgment to which we wish to draw attention is in [55]. The issue identified was whether the policy of the commissioners "is liable to result in the imposition of a penalty in the individual case that is disproportionate having regard to the legitimate aim of the policy namely the prevention of the evasion of excise duty".

Enersys

64. Before deciding what principles can properly be drawn from the case law which we have considered above in relation to the validity of the VAT surcharge regime, we refer to the decision of Judge Bishopp in *Enersys*, which is the most significant of the first-instance decisions in the Tax Chamber, several of which we have been referred to but which we do not consider it necessary to examine. In *Enersys*, due to a human error, the relevant return was submitted, and payment made, one day late. This resulted in a 5% penalty amounting to slightly over £130,000. The Judge held that the penalty imposed was wholly disproportionate to the gravity of the offence. It was not merely harsh but plainly unfair and in the absence of any justification it could not be saved by the State's margin of appreciation.

65. The Judge was referred to a number of authorities, including decisions of the ECHR. It was common ground that there was no material difference between "Community law and Convention concepts in this respect", that is to say in relation to proportionality. As he put it at [36] after citing the passages from *Roth* which we have repeated at paragraph 11 above, what Simon Brown LJ and Lord Bingham before him said was "clearly of general application, taking as I do Convention and Community law rights to be indistinguishable for practical purposes". In the light of the approach taken by the Judge, it did not matter whether the test of proportionality which Mr Mantle now advances was correct (*ie* to apply the concept of margin of appreciation as established in relation to Convention rights to the powers of a Member State to legislate for penalty regimes in the context of VAT) since, in the Judge's view, the UK had failed to act within any margin of appreciation. It is an aspect which we do need to consider and will turn to in due course.

66. The Judge identified two essential disputes. The first was whether the focus had to be on the default surcharge system taken as a whole rather than the penalty imposed on a single trader as HMRC contended; or whether the proper approach was to consider the individual penalty so that there was no need to attack the system itself. The second was whether the penalty or, depending on the approach to be adopted, a system which is capable of imposing a penalty of such magnitude

represents a disproportionate approach to the offence which it is designed to penalise. Those are the central issues identified by Mr Mantle on the appeal before us: see paragraphs 16 and 17 above.

Discussion

67. We have dealt with (some at least) of the authorities, and with *Enersys*, at some length because they assist in resolving what we see as a tension between the margin of appreciation afforded to a State in cases concerning Convention rights and the discretion afforded to Member States in relation to the imposition of penalties or the exercise or rights of derogation on the one hand, and the principle of proportionality on the other hand. The former, at one extreme, can be said to give the State or Member State a licence to do anything in furtherance of a legitimate objective provided that it is not devoid of rational foundation or, to use different language to similar effect, that it is not found to be not only harsh but plainly unfair. The latter, at the other extreme, can be said to preclude any furtherance of a legitimate objective other than by the imposition of measures which are strictly necessary as those words would ordinarily be understood.

68. Although there is a tension, we do not consider that there is an inconsistency. The tension is simply a reflection of the competition between the public interest and the individual entitlement. In this context, we would mention that the discussion in the judgment of Laws LJ in *Roth* is illuminating, although we do not think it appropriate to consider it further in this already long decision. And although the Master of the Rolls in *Lindsay* considered that the doctrine of proportionality under EU law had nothing significant to add to the Strasbourg jurisprudence, that was said in the context of the particular issues which arose in that case. What is more, the Master of the Rolls himself referred to *Louloudakis* with approval and quoted the passage in which the ECJ in that case stated that the penalties "must not go beyond what is strictly necessary for the objectives pursued" and a penalty "must not be so disproportionate to the gravity of the infringement that it becomes an obstacle to the freedoms enshrined in the Treaty". It cannot be said that the Master of the Rolls saw any inconsistency between "what is strictly necessary" on the one hand and the margin of appreciation which is afforded to States in relation to Convention rights on the other hand.

69. Quite apart from that, the judgment in *Urbán* sets out the current state of EU law whatever, if any, divergence there may be from the Strasbourg jurisprudence: see [23] and [24] of the judgment of the ECJ referred to at paragraph 34 and 36 above. In the absence of harmonisation, Member States are empowered to choose the penalties which seem to them to be appropriate but that power must be exercised in accordance with the principle of proportionality. However wide the scope of the margin of appreciation as applied to Convention rights may be (and, as we have seen, that scope will vary depending on the particular right at issue), penalties in a case such as *Urbán* must not exceed the limits of what is "appropriate and necessary" in order to obtain the objectives legitimately pursued.

70. Moreover, where there is a choice of appropriate measures, recourse must be had to the least onerous, and the disadvantages caused must not be disproportionate to the aims pursued. That is not to say that the least onerous measure must always be adopted. It is true that where there is a choice of measure each of which is equally

appropriate in the sense of being (or anticipated to be) equally efficacious in achieving the aim pursued, then the least onerous should be adopted.

71. But if there is a choice of, say two, measures, one of which is likely to be significantly more efficacious than the other in achieving the aim pursued, then the Member State may, we consider, adopt the former. Faced with the choice between those two measures, the Member State is entitled, in our view, to consider that the former is an appropriate measure but that the latter is not. The latter may be capable of having some effect in relation to the aim pursued but it not an appropriate measure if a significantly more efficacious alternative exists. That is subject, of course, to the proviso that the disadvantages caused are not disproportionate to the aim pursued.

72. The decisions in *Louloudakis* and *Urbán* each state that Member States are empowered to choose the penalties which seem appropriate to them but must exercise the power in accordance with the principle of proportionality. In [67] of *Louloudakis* it was said (i) that penalties must not go beyond what is strictly necessary for the objectives pursued and (ii) that a penalty must not be so disproportionate to the gravity of the infringement that it becomes an obstacle to the freedoms enshrined in the Treaty (as to which see paragraph 34 above). Transposing the reference to the Treaty to the present case, we would say that the penalty must not become an obstacle to the underlying aims of the Directive: an excessive penalty would impose a disproportionate burden on a defaulting trader and distort the VAT system as it applies to him, for the reasons we develop at paragraph *77ff* below.

73. It is thus possible to envisage a penalty regime the architecture of which is unobjectionable, but which nevertheless leads occasionally to the imposition of a penalty so high as to be disproportionate. One might, however, expect UK courts and tribunals to be cautious in the extreme in saying that national legislation has overstepped the mark in setting the level of penalty. That is consistent with our analysis in paragraph 68 above. A smaller penalty will always be less interventionist than a larger one; but it cannot sensibly be argued that the State must therefore impose the minimum penalty which might have some deterrent effect. The State must be entitled to impose the penalty which it considers to be the most efficacious for achieving the aim pursued constrained only by the requirement that the penalty is not disproportionate to the gravity of the infringement. And here we would accept that, to use the words of the Convention jurisprudence, a wide margin of appreciation should be afforded to the State.

74. We turn then to the question whether proportionality is to be assessed at a high level, that is to say whether it is correct to view the default surcharge regime as a whole, recognising the possibility of its producing, in some cases, a disproportionate and possibly entirely unfair result; or whether proportionality is to be assessed at an individual level by asking whether the penalty imposed on a particular taxpayer on the particular facts of its case is disproportionate. This is the issue raised by Mr Mantle as we have identified it at paragraph 17 above.

75. The question of an infringement of Convention rights is clearly to be addressed at an individual level. The Convention affords rights to persons as such and not as members of a group or members of society. In the present case, the Company has its own rights under A1P1 and the question is whether the interference with those rights by the VAT surcharge regime in the public interest is within the margin of appreciation afforded to States under the second paragraph

of A1P1: see [72] of *Commission v Greece.* The same applies in our own courts: see [52] of the judgment of the Master of the Rolls in *Lindsay*.

76. We consider that the same approach should be applied when the tribunals come to consider whether a VAT default surcharge is compliant with the principle of proportionality under EU law. Even if the structure of the surcharge regime is a rational response to the late filing of returns and late payment of VAT, it is, nonetheless, necessary to consider the effect of the regime on the individual case in hand. It is necessary to do so not least because *Louloudakis* and *Urbán* show that a penalty must not be disproportionate to the gravity of the infringement in the sense described in those decisions, that is to say the penalty must not become an obstacle to, as we identify it, the underlying aims of the Directive. If the penalty is simply too great, at least in a large number of cases - imagine a flat rate penalty of £50,000 for a third default which no-one could possibly say was a permissible penalty for ordinary small traders – there would be an illegitimate distortion of the VAT system and it might then be said that the regime viewed as a whole, is a disproportionate to the legitimate aim pursued. But if a smaller flat-rate penalty were put in place – sufficiently small as to be seen as not unfair to large or medium sized traders but still large enough to be manifestly unfair to small traders generally – it could not be said that the regime, viewed as a whole, was disproportionate. But it could properly be said that it was disproportionate so far as concerns the small traders. Viewed in the context of the Directive, the penalty would go beyond what was necessary in relation to such traders and would distort the VAT system so far as they are concerned: the burden on a smaller trader of a penalty for failure to pay his VAT on time would bear more heavily than the same penalty imposed on a large trader.

77. Interestingly, Mr Mantle, in identifying this issue asked whether there might be a false dichotomy. In one sense there is. It seems to us (as it seemed to Judge Bishopp in *Enersys*) that if the regime leads to a result in a particular case which is disproportionate in the sense that the penalty does not reflect the gravity of the infringement in the material sense, then there must be a flaw in the regime. But even if that is wrong and the architecture, as we have called it, of the regime is unobjectionable, it remains necessary that the resulting penalty in a particular case is proportionate to the gravity of the infringement.

78. We accordingly consider, as did Judge Bishopp in *Enersys*, that it is open to us to consider the individual penalty without having first concluded that the system as a whole is disproportionate. We reject Mr Mantle's submissions to the contrary. That does not, of course, preclude consideration of the regime as a whole: if there is some flaw which offends against the principle of proportionality, that flaw can be relied on by any person on whom a penalty is imposed.

79. We have not, so far, given any consideration to precisely what the aim of the default surcharge regime actually is. It is, of course, broadly speaking to ensure compliance with a taxpayer's obligations to file returns and to pay tax. But it is important to be more specific than that because questions of proportionality can only be judged against the aim of the legislation. It is clear, as we have explained at paragraph 24 above, that Member States must take measures to enforce the requirements of the Directive imposing obligations on traders to pay

VAT and to make returns. Parliament was entitled, in carrying out its obligations, to introduce a penalty regime of some sort.

80. In contrast with other default regimes within the UK tax system, the VAT default surcharge regime penalises only the failure to deliver a return and to make payment of the tax owed by the due date. It is manifest from the legislation itself that this is its purpose. It is to be noted that the penalty does not increase as time goes by: the penalty is for a failure to do something by a due date, not a penalty for a continuing failure to put right the original default. Thus the only consequence of an ongoing failure to pay the tax is a liability to pay interest. It would not be right, therefore, to view the aim, or even one of the aims, of the legislation as being to ensure that HMRC are paid the tax owing just as soon as possible even where there has been an initial default.

81. The aim which we have identified is, in our judgment, a legitimate aim. The fact that a wider aim (to ensure the payment of tax as speedily as possible even after an initial default) would also be a legitimate aim, is not to the point: it is not the aim of the legislation with which we are concerned. It is no part of the principle of proportionality that a Member State should not pursue a legitimate aim unless, at the same time, it pursues another closely related aim. The imposition of *some* penalty for making a late filing of a return and late payment of tax is clearly unobjectionable provided that it is proportionate to the gravity of the offence; it does not become objectionable and disproportionate because the Member State fails, at the same time, to introduce a further penalty for delay after the due date in correcting the initial default.

82. It seems to us, therefore, that the issue is whether the default surcharge regime is a proportionate response to the aim of ensuring submission of returns and payment of tax by the due date. If it is, then it is neither here nor there that the UK has not implemented further legislation (*eg* a scheme the aim of which is to encourage taxpayers to pay tax which is overdue by imposing a time-related penalty) to penalise a defaulting tax payer who continues to fail to file a return or pay the tax which is owed.

83. We cannot be at all certain that we have identified all of the features of the VAT default surcharge regime which might be said to result in unfairness in different circumstances. But we think that the main possible areas of complaint have been identified as follows:

a. The regime does not distinguish between a trader who has made a trivial slip and a trader who deliberately fails to file a return and to pay on the due date. Nor does it cater for degrees of culpability between those two extremes.

b. A trader who is late but has a reasonable excuse is not subject to a penalty. Nor, however long he then delays in payment, is he subjected to a penalty.

c. In contrast, a trader who is late is subject to a penalty which cannot be reduced even though his payment is only a single day late.

d. The regime does not distinguish between traders who are a day late, a week late or even a month late, in contrast with some other regimes to be found in the UK tax system.

e. The potential hardship to a trader is not a factor to be taken into account. In particular, the amount of the penalty is not related to profitability.

f. The previous compliance record of the trader is not taken into account save in the negative sense that previous defaults within the preceding 12 months affect the amount of the penalty (as a percentage of the tax overdue).

g. The correlation between the turnover of the trader and the size of the penalty is far from exact even where there is a failure to pay any of the tax due. This aspect is described in more detail at paragraph 6 above.

h. There is no maximum penalty.

i. There is no discretion to reduce or waive a penalty once imposed. Although the "reasonable excuse" exception provides some relief from the harshness of the regime, there are meritorious cases where a penalty, it is suggested, should not be paid that cannot be brought within that exception.

84. However, from HMRC's point of view, the regime has a lot to commend it. It is mechanistic and therefore comparatively easy to administer. There is no need for hard-pressed officers of HMRC to spend scarce time and resources in dealing with a vague and amorphous power to mitigate a penalty. The following factors can be prayed in aid in response to the unfairness alleged by the Company:

a. The simplicity of the system makes it easily understood, as well as being relatively easy to operate.

b. The surcharge is only imposed on a second or subsequent default, and after the taxpayer has been sent a surcharge liability notice warning him that he will be liable to surcharge if defaults again within a year. Taxpayers thus know their positions and should be able conduct their affairs so as to avoid any default.

c. The penalty is not a fixed sum but is geared to the amount of outstanding VAT. Although a somewhat blunt instrument, it does bring about a broad correlation between the size of the business and the amount of the penalty. It does not suffer from the objections which could be made to the fixed penalty in *Urbán*.

d. The percentage applicable to the calculation of the penalty increases with successive defaults if they occur within 12 months of each other. This is a rational and reasonable response to successive defaults by a taxpayer.

e. The "reasonable excuse" exception strikes a fair balance. The gravity of the infringement is reflected in the absence of "reasonable excuse" and the amount of the penalty reflects the extent of the default, that is to say the amount of tax not paid by the due date.

85. We need now to address each of the criticisms of the regime which we have identified.

86. *The regime does not distinguish between a trader who has made a trivial slip and a trader who deliberately fails to file a return and to pay on the due date. Nor does it cater for degrees of culpability between those two extremes.* We do not consider that this complaint can result in a lack of proportionality. Although it might be possible to identify cases at either end of the spectrum, and although it would be possible to design a system which imposed penalties according to some scale of culpability, placing a particular case in a scale of culpability would in any case require a judgment to be made in each case, placing a huge and disproportionate (to use the word again) burden on HMRC and no doubt leading to a multitude of appeals. Accordingly, viewing the regime as a whole, the principle of proportionality is not breached. At the level of the taxpayer concerned, the question is whether the penalty imposed on him is proportionate. Either it is or it is not: but the answer does not depend on how others are treated.

87. *A trader who is late but has a reasonable excuse is not subject to a penalty. Nor, however long he then delays in payment, is he subjected to a penalty*. This, as we see it, is not a valid criticism of a regime which imposes a penalty for late filing of a return and late payment of tax. Rather, it is criticism of HMRC in failing to procure the passing of legislation which imposes a penalty for delay in payment once the reasonable excuse has ceased to exist. It is not as though such a trader escapes liability to pay tax and any interest due. This feature does not result in a breach of the principle of proportionality at either the level of the regime viewed as a whole or from the point of view of the individual taxpayer concerned.

88. *In contrast, a trader who is late is subject to a penalty which cannot be reduced even though his payment is only a single day late.* This, as we see it, is a reflection of the aim of the legislation which, as we have explained, is to ensure compliance with the obligation to file and pay by the due date. The issue is not, in our view, whether the absence of a different treatment depending on the extent of the delay in filing the return undermines the system; the issue is whether the amount of the penalty is proportionate to the breach of duty in being a single day late. At the level of the scheme viewed as a whole, a penalty which is incurred as the result of a particular failure is entirely acceptable and compliant with the principle of proportionality provided that the amount of the penalty for that failure (however innocent its cause) is itself proportionate to the failure. At the level of the individual taxpayer, the question is not whether it would be a more coherent regime to have sequential penalties as time passes without the default having been remedied. Rather it is whether the amount of the penalty for the failure to file and pay by the due date is proportionate. If it is of an appropriate amount, then there is no need for a power to mitigate.

89. *The regime does not distinguish between traders who are a day late, a week late or even a month late.* This is really another aspect of the previous complaint. If the penalty imposed on the person who is a day late is proportionate, it is not to the point that a different regime might properly impose further penalties on a person who continues in default. The penalty is for failure to file and pay by the due date, not for delay after the due date. See also paragraph 80 above.

90. *The potential hardship to a trader is not a factor to be taken into account. In particular, the amount of the penalty is not related to profitability.* We do not consider that there is anything in this point at the level of the regime viewed as a whole or at the level of the individual taxpayer. The penalty is not related to profitability but it is related to the tax unpaid. A penalty, if it is not a fixed-rate penalty, must vary according to some objective criteria. It is not immediately apparent to us why a penalty linked to profitability would be any fairer than one linked to the outstanding tax although some penalty regimes do have that result. It may be possible to design a system which brought into account many factors – turnover, profitability, proportion of exempt or zero rated supplies to name but three – so as to produce a more sophisticated system which would produce a result that some people might perceive as more fair. The fact that that might be done does not make the actual regime non-compliant with the principle of proportionality.

91. *The previous compliance record of the trader is not taken into account save in the negative sense that previous defaults within the preceding 12 months affect the amount of the penalty (as a percentage of the tax overdue)*. We do not consider that there is any unfairness, let alone anything approaching a lack of proportionality, in the penalty being assessed without regard to the previous compliance record. A default surcharge can only be imposed if there has been at least one previous default. It is well within the discretion afforded to a Member State, in our view, to decide that two defaults within a period of 12 months should lead to a penalty on the second or subsequent occasion without the need to take into account a previous exemplary compliance record for VAT. We can also see no reason at all why satisfactory compliance with statutory requirements in relation to other taxes should be of any relevance at all. We do not perceive this factor as presenting HMRC with any difficulties at either level.

92. *The correlation between the turnover of the trader and the size of the penalty is far from exact even where there is a failure to pay any of the tax due. This aspect is described in* more *detail at paragraph 8 above.* This aspect is sufficiently dealt with in paragraph 90 above where we consider hardship and profitability.

93. *There is no maximum penalty*. This, we think, is a real flaw at both the level of the regime viewed as a whole and potentially at the individual level of a taxpayer with a very large payment obligation. In *Enersys*, Judge Bishopp considered it unimaginable that a tribunal imposing a penalty would do so in an amount as much as £130,000 for the sort of error in that case. We have adopted a slightly different analysis of the purpose of the legislation from that set out in *Enersys*, and have taken a slightly different view of the requirements of the principle of proportionality, as a reflection of the changed focus of the arguments presented to us. But any approach to the analysis must pay due regard to the principle that the absolute amount of the penalty must be proportionate in the context of the aim pursued and in the context of the objectives of the Directive. We agree therefore that there must be some upper limit, although it is not sensible for us in the present case to suggest where that might be. That is because the penalty imposed on the Company here, of £4,260, is clearly of a wholly different character from the £130,000 in issue in *Enersys*. If one accepts, as our conclusions

above show must be the case, that a substantial, rather than purely nominal, penalty may legitimately be imposed it is in our judgment plain that the penalty imposed on the Company cannot properly be described as "devoid of reasonable foundation" (*Gasus Dosier*) or "not merely harsh but plainly unfair" (*Roth*) and that it correspondingly falls and, we would say, comfortably so, below any possible upper limit.

94. *There is no discretion to reduce or waive a penalty once imposed. Although the "reasonable excuse" defence provides some relief from the harshness of the regime, there are, it is suggested, meritorious cases where a penalty should not be paid that cannot be brought within that defence*. We have found this a very difficult aspect of the case. The complaint really raises two points. The first is whether the default surcharge regime fails to comply with the principle of proportionality because it contains no power to mitigate; the second is, if it does fail to comply, in what circumstance should the power be exercisable.

95. As to the first point, we do not consider that the absence of a power to mitigate results in the regime failing to comply with the principle of proportionality at the level of the scheme viewed as a whole. The regime does contain a "reasonable excuse" exception which represents a significant safeguard for those subject to the penalty regime. Insofar as it applies in a particular case, it goes further than a mere power to mitigate; rather, there is no penalty imposed at all.

96. It may well be true that a regime with a power to mitigate is as likely to be effective in achieving the aim pursued as the same regime without that power. It might therefore be said that the power must be included since the principle of proportionality obliges the UK to adopt the least onerous measure. But that is to ignore important countervailing considerations. As we have mentioned, the regime is mechanistic and therefore comparatively easy to administer. There is an obvious reason why hard-pressed officers of HMRC should not be required, in every case, to spend scarce time and resources in dealing with a vague and amorphous power to mitigate a penalty. In our judgment the "reasonable excuse" defence, albeit not the same as mitigation, strikes a fair balance between fairness to the taxpayer and the effective and economical deployment of the State's resources. In addition, the absence of mitigation is deliberate and followed on from the Report of the Keith Committee stating that "the scope for administrative discretion should be reduced to a minimum" as explained in *Enersys* at [64] with Judge Bishopp's comments at [65]. Of course, the Report could not alter the requirements of the principle of proportionality, but the reason for that recommendation is a factor. It was so that particular consequences would follow from particular acts or rather failures, everyone knew where they stood and, most importantly, the knowledge that there could be no appeal to discretion was likely to bring about the likelihood of improved compliance.

97. At the individual level, however, the question is whether the actual penalty is disproportionate in all of the circumstances and not whether there is a power to mitigate. The relevance of a power to mitigate is that an unreasonable penalty can be reduced and the question of proportionality of the penalty then falls to be answered by reference to the penalty as mitigated. Accordingly, we do not

consider that the absence of a power to mitigate a penalty renders the regime non-compliant with the principle of proportionality. It is the level of the penalty, if anything, which will bring about that result.

98. As to the second point referred to in paragraph 92 above, and if we are wrong on the first point so that some power to mitigate has to be included, it may be right to say that such a power should extend only to exceptional circumstances. We are aware, of course, that that is to beg a serious question, namely what is exceptional. Whether a case is exceptional can only be decided on the facts of a particular case. But what can be said as a matter of generality is that a case is not exceptional simply because it falls within one of the complaints which we have addressed in paragraphs 8*6ff* above. Each of those complaints arises out of the design of the regime and cannot, of themselves, be said to give rise to exceptional circumstances.

99. In our judgment, there is nothing in the VAT default surcharge which leads us to the conclusion that its architecture is fatally flawed. There are, however, some aspects of it which may lead to the conclusion that, on the facts of a particular case, the penalty is disproportionate. But in assessing whether the penalty in any particular case is disproportionate, the tribunal must be astute not to substitute its own view of what is fair for the penalty which Parliament has imposed. It is right that the tribunal should show the greatest deference to the will of Parliament when considering a penalty regime just as it does in relation to legislation in the fields of social and economic policy which impact upon an individual's Convention rights. The freedom which Parliament has in establishing the appropriate penalties is not, we think, necessarily exactly the same as the freedom which it has in accordance with its margin of appreciation in relation to Convention rights (and even there, as we have explained, the margin of appreciation will vary depending on the right engaged).

100. Our conclusion, therefore, is that with the possible omission of an upper limit on the penalty which may be imposed, the regime viewed as a whole does not suffer from any flaw which renders it non-compliant with the principle of proportionality in the sense that it, or some aspect of it, falls to be struck down.

101. Nor, on the facts of the present case, do we consider that the penalty imposed on the Company is disproportionate in the sense that its imposition is a breach of EU law and in particular of the principle of proportionality. The Company's essential complaint is that the amount of the penalty is unfair. It is unfair because of the following factors:

a. the payment was only one day late;

b. the previous defaults had been due to errors which were innocent even if the Company could not establish a reasonable excuse for them;

c. the Company had an excellent compliance record prior to the first of the defaults leading to the penalty;

d. the amount of the penalty represents an unreasonable proportion of the Company's profits.

102. Each of those factors falls within one of the heads of complaint which we have addressed. None of those complaints results in the default surcharge being non-compliant with the principle of proportionality; nor, in our view, do they have that result even if taken collectively. At the level of the Company, the amount of the penalty has been arrived at by applying a rational scheme of calculation which involves no breach of the principle of proportionality. That amount cannot, even if looked at in isolation, be said to be disproportionate in the sense of giving rise to a breach of the principle of proportionality. And even if the penalty is more than would be imposed if it were a matter for the decision of a tribunal, the amount of the penalty does not approach the sort of level which Judge Bishopp described as unimaginable in *Enersys*.

103. So far as concerns A1P1, we find it impossible to say that the default surcharge regime falls outside the margin of appreciation afforded to States under the Convention. The result for the Company may be seen by some as harsh, but we do not consider that it can be regarded as plainly unfair. Clearly the regime itself is not devoid of rational foundation. Accordingly, we do not consider that the Company's Convention rights have been infringed by the imposition of the penalty.

104. The Tribunal relied on the following factors in determining that the penalty was disproportionate:

a. The number of days of the default;

b. The absolute amount of the penalty.

c. The "inexact correlation of turnover and penalty".

d. The absence of any power to mitigate.

105. We have in the course of this decision addressed each of those matters. Our conclusion is that none of them leads to the conclusion that the default surcharge regime infringes the principle of proportionality or to the conclusion that the actual penalty imposed on the Company does so either.

Disposition

106. HMRC's appeal is allowed.

Post-script

107. We cannot leave this appeal without referring to one matter arising from what Mr Phillips said to us in an impassioned address at the end of the hearing. It concerns the reputational concerns to which this penalty gives rise in his view. He considers that his integrity is being impugned. After many, many years of excellent compliance, he is now to be seen in the business community as no different from smugglers and the tax avoiders or evaders about whom so much as been said recently in the press. We would like to assure him that he is not to be compared with such persons even if it is right to take a poor a view of tax avoiders (a matter on which we express no opinion). Although the Company has been in default three times within 12 months, it is clear that those defaults were not deliberate. The computer system which led to them has been replaced. The first two defaults involved almost trivial underpayments. It is unfortunate that the third

default – which was put right a day late without any intervention by HMRC – involved the full amount of tax due for the relevant quarter. As a result, the Company has been caught by a very strict regime giving rise to a penalty of an amount which might be considered harsh by many and which Mr Phillips describes as daylight robbery and totally unfair. We have taken full account of everything which Mr Phillips has said in reaching our conclusions. We do not see them as implying any more than that the Company has made an unfortunate error; but it is an error for which Parliament has chosen to impose a penalty.

Mr Justice Warren
Chamber President

Judge Colin Bishopp

Released: 29 November 2012

ANNEX

The Value Added Tax Act 1994

Section 59: Default Surcharge

59 The default surcharge

(1) Subject to subsection (1A) below If, by the last day on which a taxable person is required in accordance with regulations under this Act to furnish a return for a prescribed accounting period—

(a) the Commissioners have not received that return, or

(b) the Commissioners have received that return but have not received the amount of VAT shown on the return as payable by him in respect of that period,

then that person shall be regarded for the purposes of this section as being in default in respect of that period.

(1A) A person shall not be regarded for the purposes of this section as being in default in respect of any prescribed accounting period if that period is one in respect of which he is required by virtue of any order under section 28 to make any payment on account of VAT.

(2) Subject to subsections (9) and (10) below, subsection (4) below applies in any case where—

(a) a taxable person is in default in respect of a prescribed accounting period; and

(b) the Commissioners serve notice on the taxable person (a "surcharge liability notice") specifying as a surcharge period for the purposes of this section a period ending on the first anniversary of the last day of the period referred to in paragraph (a) above and beginning, subject to subsection (3) below, on the date of the notice.

(3) If a surcharge liability notice is served by reason of a default in respect of a prescribed accounting period and that period ends at or before the expiry of an existing surcharge period already notified to the taxable person concerned, the surcharge period specified in that notice shall be expressed as a continuation of the existing surcharge period and, accordingly, for the purposes of this section, that existing period and its extension shall be regarded as a single surcharge period.

(4) Subject to subsections (7) to (10) below, if a taxable person on whom a surcharge liability notice has been served—

(a) is in default in respect of a prescribed accounting period ending within the surcharge period specified in (or extended by) that notice, and

(b) has outstanding VAT for that prescribed accounting period,

he shall be liable to a surcharge equal to whichever is the greater of the following, namely, the specified percentage of his outstanding VAT for that prescribed accounting period and £30.

(5) Subject to subsections (7) to (10) below, the specified percentage referred to in subsection (4) above shall be determined in relation to a prescribed accounting period by reference to the number of such periods in respect of which the taxable person is in default during the surcharge period and for which he has outstanding VAT, so that—

(a) in relation to the first such prescribed accounting period, the specified percentage is 2 per cent;

(b) in relation to the second such period, the specified percentage is 5 per cent;

(c) in relation to the third such period, the specified percentage is 10 per cent; and

(d) in relation to each such period after the third, the specified percentage is 15 per cent.

(6) For the purposes of subsections (4) and (5) above a person has outstanding VAT for a prescribed accounting period if some or all of the VAT for which he is liable in respect of that period has not been paid by the last day on which he is required (as mentioned in subsection (1) above) to make a return for that period; and the reference in subsection (4) above to a person's outstanding VAT for a prescribed accounting period is to so much of the VAT for which he is so liable as has not been paid by that day.

(7) If a person who, apart from this subsection, would be liable to a surcharge under subsection (4) above satisfies the Commissioners or, on appeal, a tribunal that, in the case of a default which is material to the surcharge—

(a) the return or, as the case may be, the VAT shown on the return was despatched at such a time and in such a manner that it was reasonable to expect that it would be received by the Commissioners within the appropriate time limit, or

(b) there is a reasonable excuse for the return or VAT not having been so despatched, he shall not be liable to the surcharge and for the purposes of the preceding provisions of this section

he shall be treated as not having been in default in respect of the prescribed accounting period in question (and, accordingly, any surcharge liability notice the service of which depended upon that default shall be deemed not to have been served).

(8) For the purposes of subsection (7) above, a default is material to a surcharge if—

(a) it is the default which, by virtue of subsection (4) above, gives rise to the surcharge; or

(b) it is a default which was taken into account in the service of the surcharge liability notice upon which the surcharge depends and the person concerned has not previously been liable to a surcharge in respect of a prescribed accounting period ending within the surcharge period specified in or extended by that notice.

(9) In any case where—

(a) the conduct by virtue of which a person is in default in respect of a prescribed accounting period is also conduct falling within section 69(1), and

(b) by reason of that conduct, the person concerned is assessed to a penalty under that section,

the default shall be left out of account for the purposes of subsections (2) to (5) above.

(10) If the Commissioners, after consultation with the Treasury, so direct, a default in respect of a prescribed accounting period specified in the direction shall be left out of account for the purposes of subsections (2) to (5) above.

(11) For the purposes of this section references to a thing's being done by any day include references to its being done on that day.

Section 71 Construction of sections 59 to 70

(1) For the purposes of any provision of sections 59 to 70 which refers to a reasonable excuse for any conduct-

(a) an insufficiency of funds to pay any VAT due is not reasonable excuse; and

(b) where reliance is place on any other person to perform any task, neither the fact of that reliance nor any dilatoriness or inaccuracy on the part of the person relied upon is a reasonable excuse.