TC07830

Construction Industry Scheme – determination under regulation 13 of CIS regulations – consideration of amounts related to cost of materials to be properly deducted from gross payments – discussion of meaning of best judgement – whether or not determination made to best judgement – held not – substitution of tribunal's own judgement – appeal partially allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

Appeal number: TC/2019/00382P

BETWEEN

ELMPINE DEVELOPMENTS LTD **Appellant**

-and-

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

TRIBUNAL: JUDGE PHILIP GILLETT

The Tribunal determined the appeal on 25 July 2020 without a hearing under the provisions of Rule 29 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 having received the consent of both parties that the appeal should be determined on the basis of the papers presented to the Tribunal. A hearing was not held because a face to face hearing was considered inappropriate in the current pandemic.

The Tribunal determined this case on the basis of HMRC's Statement of Case dated 2 April 2019, their Skeleton Argument dated 14 November 2019, a Statement of Case from the Appellant dated 28 November 2019 together with a bundle of documents and authorities of 346 pages.

DECISION

INTRODUCTION

1. This is an appeal against a determination made under Regulation 13(2) of The Income Tax (Construction Industry Scheme) Regulations 2005 ("The CIS Regulations") for the year ended 5 April 2016. The amount originally assessed was £295,133, but this was reduced to £250,146 following a review, based on total gross payments of £833,820.

2. Of this amount, £58,215 (gross payments £194,050) is not in dispute, but the appellant argues that HMRC did not take into account the materials element of the remaining payments, gross - £639,770, tax - £191,931, and that this figure should therefore be reduced.

SUMMARY OF DECISION

3. The tribunal decided that the determination made by HMRC was not made to the best judgement of the HMRC officer concerned and that the appeal by Elmpine should be PARTIALLY ALLOWED. The total amount of the income tax due under the determination should therefore be reduced to the following amounts:

Subcontractor	**Gross**	**30% CIS Deduction**
AKY	£216,530	£64,959
Alfa Security Limited	£194,050	£58,215
Total	£410,580	£123,174

THE FACTS

4. I received a Statement of Case from HMRC and Skeleton Arguments from both parties, together with witness statements from Shetal Dhorda, an officer of HMRC, and Herjit Kataria, the brother of one of the directors of Elmpine Developments Ltd ("Elmpine"), who had been duly authorised by Elmpine to make a statement on its behalf. Based on these documents I make the following findings of fact.

5. In November 2016 HMRC conducted a compliance review and discovered that Elmpine Developments Limited had been in the construction business since October 2013 but had not registered for the Construction Industry Scheme.

6. Elmpine Developments Limited registered for the Construction Industry Scheme ("CIS") on 16 November 2016.

7. Following an analysis of the payments made by Elmpine during the period before it was registered under the CIS, a Regulation 13 Determination letter was issued on 9 October 2017. This covered the period October 2013 to October 2016 which covered the time from the start of construction operations to the point where Elmpine entered into the CIS.

8. Following correspondence between HMRC and Elmpine, the amounts were revised, on 8 December 2017 and 14 February 2018. The amounts for the year ended 5 April 2015 and the year ended 5 April 2017 have been agreed and are not in dispute.

9. For the year ended 5 April 2016 however Elmpine provided an invoice dated 10 December 2015 in respect of payments it had made to AKY Contractors Limited ("AKY") for a project at Star House, Maidstone. This invoice showed a split between the total payments under the invoice of £648,500, as to £423,240 related to materials and £225,260 related to labour.

10. AKY went into voluntary liquidation on 13 March 2015. There was no evidence as to when the company was finally struck off, although there was an undated statement from the

Registrar of Companies stating that "cause has been shown why the company should not be struck off the register", and that consequently the Registrar was taking no further action under s1000 Companies Act 2006.

11. The HMRC officer concerned, Mrs Dhorda, decided that she could not accept this invoice as evidence because it was dated nine months after the commencement of the liquidation. This was reflected in her file note following a conversation with liquidator on 8 December 2017:

> "Elmpine is providing me two invoices showing labour and materials separately. I can only accept pre-liquidated invoice from the director. The second invoice was dated December 2015 when company was in liquidation so the liquidators were officially responsible for the company. On that basis I can't accept the invoice."

12. Elmpine had also supplied a schedule of payments to AKY showing payments to AKY of £789,725 in relation to the Star House project which HMRC decided was the most reliable evidence to determine the payments made by Elmpine to AKY for the year ended 5 April 2016.

13. When Elmpine supplied this schedule to HMRC they stated that it contained elements of materials costs and Elmpine contends that these payments include the direct costs of materials and that these should be deducted from the figure deemed by HMRC to be a pure labour element before applying the CIS tax deduction.

14. HMRC asked for evidence to show the amount of the direct material costs but, apart from the invoice previously rejected by HMRC, no further evidence was supplied.

15. Mrs Dhorda therefore issued a Regulation 13 Determination letter on 9 October 2017.

16. Elmpine asked for a Statutory Review of Mrs Dhorda's decision and the conclusion of that review was to uphold the decision not to accept the invoice but to vary the amount of the gross payments from £789,725 to £639,770. The schedule of payments showed a total paid of £789,725 but £22,000 of this related to the tax year 2014-15. This reduced the total paid for 2015-16 to £767,725, but this figure also included VAT. The amount paid to AKY by Elmpine in 2015-16, excluding VAT at 20%, was therefore determined to be £639,770.

17. The HMRC review therefore revised the amount of the determination from £983,775 to £833,820. These amounts are the total of payments made by Elmpine in the year ended 5 April 2016 and are analysed as follows:

Subcontractor	**Gross**	**30% CIS Deduction**
AKY	£639,770	£191,931
Alfa Security Limited	£194,050	£58,215
Total	£833,820	£250,146

The amounts in respect of Alfa Security Limited are not in dispute.

18. Elmpine appealed to the Tribunal on 16 January 2019.

THE LAW

19. The legislation governing the deduction of tax under the CIS are set out in s60 Finance Act 2004 as follows:

> "**60 Contract payments**
>
> (1) In this Chapter "contract payment" means any payment which is made under a construction contract and is so made by the contractor (see section 57(3)) to—
>
> (a) the sub-contractor,

(b) a person nominated by the sub-contractor or the contractor, or

(c) a person nominated by a person who is a sub-contractor under another such contract relating to all or any of the construction operations.

(2) But a payment made under a construction contract is not a contract payment if any of the following exceptions applies in relation to it.

(3) This exception applies if the payment is treated as earnings from an employment by virtue of Chapter 7 of Part 2 of the Income Tax (Earnings and Pensions) Act 2003 (c. 1) (agency workers).

(4) This exception applies if the person to whom the payment is made or, in the case of a payment made to a nominee, each of the following persons—

(a) the nominee,

(b) the person who nominated him, and

(c) the person for whose labour (or, where that person is a company, for whose employees' or officers' labour) the payment is made, is registered for gross payment when the payment is made. But this is subject to subsections (5) and (6).

(5) Where a person is registered for gross payment as a partner in a firm (see section 64), subsection (4) applies only in relation to payments made under contracts under which—

(a) the firm is a sub-contractor, or

(b) where a person has nominated the firm to receive payments, the person who has nominated the firm is a sub-contractor.

(6) Where a person is registered for gross payment otherwise than as a partner in a firm but he is or becomes a partner in a firm, subsection (4) does not apply in relation to payments made under contracts under which—

(a) the firm is a sub-contractor, or

(b) where a person has nominated the firm to receive payments, the person who has nominated the firm is a sub-contractor.

(7) This exception applies if such conditions as may be prescribed in regulations made by the Board of Inland Revenue for the purposes of this subsection are satisfied; and those conditions may relate to any one or more of the following—

(a) the payment,

(b) the person making it, and

(c) the person receiving it.

(8) For the purposes of this Chapter a payment (including a payment by way of loan) that has the effect of discharging an obligation under a contract relating to construction operations is to be taken to be made under the contract; and if—

(a) the obligation is to make a payment to a person ("A") within paragraph (a) to (c) of subsection (1), but

(b) the payment discharging that obligation is made to a person ("B") not within those paragraphs, the payment is for those purposes to be taken to be made to A."

20. Section 61 FA 2004 then defines the amount to which the deduction must be applied and the amount of the deduction:

"**61 Deductions on account of tax from contract payments**

(1) On making a contract payment the contractor (see section 57(3)) must deduct from it a sum equal to the relevant percentage of so much of the payment as is not shown to represent the direct cost to any other person of materials used or to be used in carrying out the construction operations to which the contract under which the payment is to be made relates.

(2) In subsection (1) "the relevant percentage" means such percentage as the Treasury may by order determine.

(3) That percentage must not exceed—

(a) if the person for whose labour (or for whose employees' or officers' labour) the payment in question is made is registered for payment under deduction, the percentage which is the basic rate for the year of assessment in which the payment is made, or

(b) if that person is not so registered, the percentage which is the higher rate for that year of assessment."

21. Where there is a dispute between the parties or HMRC is of the view that the incorrect amount of tax has been deducted Regulation 13 of the CIS Regulations provides as follows:

"**Determination of amounts payable by contractor and appeal against determination**

13.—(1) This regulation applies if—

(a) there is a dispute between a contractor and a sub-contractor as to—

(i) whether a payment is made under a construction contract, or

(ii) the amount, if any, deductible by the contractor under section 61 of the Act from a contract payment to a sub-contractor or his nominee, or

(b) an officer of Revenue and Customs has reason to believe, as a result of an inspection under regulation 51 or otherwise, that there may be an amount payable for a tax year under these Regulations by a contractor that has not been paid to them, or

(c) an officer of Revenue and Customs considers it necessary in the circumstances.

(2) An officer of Revenue and Customs may determine the amount which **to the best of his judgment** a contractor is liable to pay under these Regulations, and serve notice of his determination on the contractor.

(3) A determination under this regulation must not include amounts in respect of which a direction under regulation 9(5) has been made and directions under that regulation do not apply to amounts determined under this regulation.

(4) A determination under this regulation may—

(a) cover the amount payable by the contractor under section 61 of the Act for any one or more tax periods in a tax year, and

(b) extend to the whole of that amount, or to such part of it as is payable in respect of—

(i) a class or classes of sub-contractors specified in the notice of determination (without naming the individual sub-contractors), or

(ii) one or more named sub-contractors specified in the notice.

(5) A determination under this regulation is subject to Parts 4, 5 and 6 of TMA (assessment, appeals, collection and recovery) as if—

(a) the determination were an assessment, and

(b) the amount determined were income tax charged on the contractor,

and those Parts of that Act apply accordingly with any necessary modifications, except that the amount determined is due and payable 14 days after the determination is made.

(6) If paragraph (1)(a) applies and an officer of Revenue and Customs does not make a determination under paragraph (2), either the contractor or the sub-contractor may on giving notice to an officer of Revenue and Customs, apply to the General Commissioners to determine the matter.

(7) For the purposes of paragraph 3(1)(a) of Schedule 3 to TMA(1) (rules for assigning proceedings to General Commissioners), the relevant place for an appeal against a determination under this regulation is the place where the determination was made.

(8) If paragraph (1)(a) applies—

(a) the contractor must make the deduction required by section 61 of the Act from the contract payment or the part of the contract payment, to which the dispute relates, and the amount so deducted is treated as a sum which he is liable to pay to the Commissioners for Her Majesty's Revenue and Customs under these Regulations; and

(b) any amount which, on a final determination of the dispute, is shown not to have been so payable is, except where regulation 56 (application by the Commissioners for Her Majesty's Revenue and Customs of sums deducted under section 61 of the Act) applies, treated as an overpayment of income tax or corporation tax by the sub-contractor."

22. Importantly, the effect of clause (5) of Regulation 13 is to give the taxpayer full appeal rights to a tribunal as if the appeal were an appeal against a normal assessment to income tax.

23. In summary ss60 and 61 require a person paying a sub-contractor working in the construction industry to deduct income tax, at a rate of 30%, when making payments to the sub-contractor, except to the extent that those payments include payments for materials. The percentage is reduced to 20% where the payments are made to someone who is registered under the CIS.

24. If there is a dispute between HMRC and the person making the payments then HMRC may issue a determination under Regulation 13 to recover the amount of tax which they consider has been under-deducted.

25. In accordance with Regulation 13(2) that determination must be made to the "best of [the officer's] judgement".

26. I was also referred to the case of *Pegasus Birds Ltd v Commissioners of HM Customs and Excise* [2004] EWCA Civ 1015.

DISCUSSION

27. This appeal in essence turns on the meaning of the words "the best of [her] judgement" in Regulation 13(2) and the question of whether or not the tribunal should interfere with that judgement and substitute its own.

28. The leading case on the meaning of "the best of [her] judgement" is generally regarded as being *Van Boeckel v Customs & Excise Commissioners* [1981] STC 290 and in particular, the words of Woolf J at p835:

> "The passages I have underlined show that the Tribunal should not treat an assessment as invalid merely because they disagree as to how the judgment should have been exercised. A much stronger finding is required: for example, that the assessment has been reached 'dishonestly or vindictively or capriciously'; or is a 'spurious estimate or guess in which all elements of judgment are missing'; or is 'wholly unreasonable'. In substance those tests are indistinguishable from the familiar *Wednesbury* principles ([1948] 1 KB 223). Short of such a finding, there is no justification for setting aside the assessment."

29. This sets a fairly high bar for a tribunal to disturb the decision of an HMRC officer and also introduces what has been referred to as the "two stage" process. Stage one involves an assessment as to whether or not the officer's decision was unreasonable and if, and only if, the tribunal finds that the decision was unreasonable, stage two is then the substitution of the tribunal's own judgement.

30. The test for *Wednesbury* unreasonableness is generally stated to be that the officer took into account irrelevant information or failed to take into account relevant information or other wise reached a decision that ho properly directed officer could reasonably have reached. This is a high bar.

31. However these words were also considered by Carnwath LJ in the Court of Appeal in *Pegasus Birds Ltd v Commissioners of HM Customs and Excise* [2004] EWCA Civ 1015. He added a very important gloss on *Van Boeckel* and suggested strongly that a tribunal should not stick too rigidly to the "two stage" approach prescribed in *Van Boeckel*, saying, at [38]:

> "In the light of the above discussion, I would make four points by way of guidance to the Tribunal when faced with "best of their judgment" arguments in future cases:
>
> (i) The Tribunal should remember that its **primary task is to find the correct amount of tax, so far as possible on the material properly available to it, the burden resting on the taxpayer**. In all but very exceptional cases, that should be the focus of the hearing, and the Tribunal should not allow it to be diverted into an attack on the Commissioners' exercise of judgment at the time of the assessment.
>
> (ii) Where the taxpayer seeks to challenge the assessment as a whole on "best of their judgment" grounds, it is essential that the grounds are clearly and fully stated before the hearing begins.
>
> (iii) In particular the Tribunal should insist at the outset that any allegation of dishonesty or other wrongdoing against those acting for the Commissioners should be stated unequivocally; that the allegation and the basis for it should be fully particularised; and that it is responded to in writing by the Commissioners. The Tribunal should not in any circumstances allow cross-examination of the Customs officers concerned, until that is done.
>
> (iv) There may be a few cases where a "best of their judgment" challenge can be dealt with shortly as a preliminary issue. However, unless it is clear that time will be saved thereby, the better course is likely to be to allow the hearing to proceed on the issue of amount, and leave any submissions on failure of best of their judgment, and its consequences, to be dealt with at the end of the hearing."

32. In raising the determination Mrs Dhorda decided that she could not consider as acceptable evidence the invoice from AKY dated 10 December 2015 because AKY had entered liquidation in March 2015. This is reflected in her file note following a conversation with the liquidator on 8 December 2017:

> "Elmpine is providing me two invoices showing labour and materials separately. I can only accept pre-liquidated invoice from the director. The second invoice was dated December 2015 when company was in liquidation so the liquidators were officially responsible for the company. On that basis I can't accept the invoice."

33. Mrs Dhorda provided no further explanation of her decision to reject the invoice. She made no comment on the reasonableness of the labour/materials split. She did not challenge the authenticity of the invoice in any way. The liquidator she spoke to did not cast doubt on the genuineness of the invoice, although he did say that the company's records were in a poor state. Mrs Dhorda did not however give this as a reason for her rejection of the invoice. She rejected it simply because it had been issued by a company in liquidation.

34. Mrs Dhorda therefore informed Elmpine that she could not accept this invoice. Elmpine then suggested that if it was an invalid invoice, which is what she was effectively saying, then perhaps it would be better if she were to leave the invoice out of consideration altogether. Mrs Dhorda seems to have misunderstood this suggestion. Instead of ignoring the whole of the transaction set out in the invoice completely, as I believe Elmpine had suggested, Mrs Dhorda decided to use a schedule of payments to AKY which had been provided to her by the company as her base document and treated **all** the payments on that schedule as being for labour alone, in spite of Elmpine's consistent protestations that it contained elements of materials costs.

35. I find Mrs Dhorda's approach very hard to understand:

> (1) I do not understand how she came to the conclusion that she could not accept as evidence an invoice from AKY solely because it was in liquidation at the time of its issue, and
>
> (2) I do not understand how, having decided to ignore the invoice, she then simply took a schedule of payments to AKY, which Elmpine had consistently maintained contained elements of the cost of materials.

36. Looking first at the invoice I see no reason why a company in the process of liquidation, especially a company in a voluntary liquidation, ie, not an insolvent liquidation, cannot issue a perfectly valid invoice. Mrs Dhorda is correct when she states that the issue of such an invoice must effectively be under the control of the liquidators and not the directors, but in my view it would be perfectly normal practice for liquidators to continue trading in order to complete existing projects. If the project did not come to an end until December 2015 I consider it totally reasonable for the liquidators of AKY to continue trading until the project was finished and then to issue a satisfactory invoice once the works were completed. I see no good reason for Mrs Dhorda to dismiss the evidence of invoice out of hand.

37. Secondly, having decided that she could not rely on the invoice, she used as her base document a schedule of payments which Elmpine had consistently maintained contained an element of materials costs. There were many possible alternative approaches she could have taken at that time, such as using the proportion of the value of materials included within the previous invoice from AKY, which might have provided a reasonably representative picture of a normal split of labour and materials, but one thing she must have known was that totally ignoring the possibility that there were any materials costs included in the schedule of payments was bound to be incorrect.

38. Carnwath LJ, in *Pegasus Bird*, encouraged tribunals not to be too rigid in their application of the "two stage" approach when considering the question of "best judgement", but instead to try to find the correct answer on the basis of the information before them.

39. Nevertheless, to the extent that it is necessary, I find that Mrs Dhorda's judgement was not reasonable in the *Wednesbury* sense, in that she ignored the invoice from AKY, which was very relevant information, and ignored the statements from Elmpine and the previous invoice and estimates from AKY that their work would include significant elements of materials costs, which were also very relevant information. In my view therefore she came to an unreasonable decision.

40. I am therefore required, in accordance with the words of Carnwath LJ, to ascertain the correct amounts of tax payable "so far as possible on the material properly available to [me], the burden resting on the taxpayer."

41. In my view, the best information available to me is the invoice from AKY dated 10 December 2015. I see no reason to ignore it, even if it does not carry a statement that it has been issued by a company in the process of liquidation, should such a statement be necessary. The invoice is still good information and seems to be the best information available. That invoice states that, of the total payments made to AKY under it of £648,500, £423,240 related to materials and £225,260 related to labour.

42. These figures are stated to be exclusive of VAT and I do not therefore need to worry about that complication. However, the HMRC review also concluded that some of the payments under this invoice related to 2014-15. I do not have the necessary information before me to determine how much of the payments made under the invoice related to 2014-15 because I was not given a reconciliation between the invoice and the schedule of payments which was used by Mrs Dhorda. I cannot therefore make any findings of my own to that effect but I think it is sensible for me to follow the approach taken by the HMRC review as regards those payments.

43. I therefore find, on the balance of probabilities, that the analysis set out in the invoice from AKY dated 10 December 2015 is the most likely analysis of the element of costs of materials, and that therefore the amount of the payments to AKY which should be subject to deduction of income tax under the CIS in accordance with the determination should be reduced from £639,770 to £216,530. These figures also reflect the reduction due to the exclusion of the payments which the HMRC review found related to 2014-15.

DECISION

44. For the reasons set out above therefore I have decided that the appeal by Elmpine should be PARTIALLY ALLOWED and that the total amount of the income tax due under the determination should be reduced as follows:

Subcontractor	**Gross**	**30% CIS Deduction**
AKY	£216,530	£64,959
Alfa Security Limited	£194,050	£58,215
Total	£410,580	£123,174

RIGHT TO APPLY FOR PERMISSION TO APPEAL

45. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The

application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

PHILIP GILLETT
TRIBUNAL JUDGE

RELEASE DATE: 02 SEPTEMBER 2020