

**IN THE SUPREME COURT OF JUDICATURE
CHANCERY DIVISION**

Royal Courts of Justice
Strand, London, WC2A 2LL

22/05/2009

Before:

THE CHANCELLOR OF THE HIGH COURT

Between:

BLUE SPHERE GLOBAL LTD

Appellant

- and -

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

Respondent

**Mr Michael Patchett-Joyce & Mr James Rickards (instructed by Messrs Thomas
Cooper) for the Appellant
Ms Melanie Hall QC & Mr Jonathan Hall (instructed by Messrs Howes Percival) for the
Respondent
Hearing dates : 13th and 14th May 2009**

HTML VERSION OF JUDGMENT

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The Chancellor :

Introduction

1. Blue Sphere Global Ltd ("BSG") carried on business as a distributor of computer equipment. It was registered for VAT purposes on 11th November 2004. In April 2006 it entered into two pairs of transactions. The first pair ("A") related to the purchase and sale of 10,550 Nokia N8800 mobile phones, the second ("B") to the purchase and sale of 4,300 Nokia and Samsung mobile phones. The relevant details are as follows:

A

(1) 21st April 2006

(a) Infinity Holdings Ltd ("Infinity") bought the phones on six invoices from three companies resident in the European Union, namely Vertex Trading, Esat Apps and Rachel Tel.

(b) Infinity sold those phones on four invoices to BSG for £5,206,425.

(2) 25th April 2006 BSG sold those phones to Universal Handels GmbH for £4,694,750

B

(1) 27th April 2006

(a) Infinity bought the phones from two companies resident in the EU, namely, Alpha C Aps and Vertex Trading.

(b) Infinity sold the phones to BSG for £2,186,145.

(2) 28th April 2006 BSG sold the phones to Allimpex Handels GmbH for

£1,970,000

The transactions referred to in A(1)(a), A(2), B(1)(a) and B(2) were zero-rated. In the case of the transactions referred to in A(1)(b) and B(1)(b) the purchase price included VAT at the standard rate.

2. Infinity accounted for the purposes of VAT in respect of the transactions referred to in A(1) and B(1). BSG duly accounted for the transactions referred to in A(1)(b), A(2), B(1)(b) and B(2) in its VAT return and sought the repayment of £1,100,750 as the balance of input tax after off-setting the output tax in the same period. On 25th April 2007 the claim for repayment was refused by HMRC on the ground that transactions A and B were part of an overall scheme to defraud the revenue and that there were features of those transactions and conduct on the part of BSG which demonstrated that BSG knew or should have known that such was the case. On 18th May 2007 BSG appealed to the VAT and Duties Tribunal. It contended that the input tax incurred by BSG was in respect of a taxable supply of goods in furtherance of its business so as to be deductible input tax within s.24 VAT Act 1994. BSG maintained that it did not know and had no means of knowledge of any fraud.
3. The Statement of Case of HMRC in opposition to the claim dated 21st June 2007 asserted that Infinity was a 'contra-trader' involved in frauds on the revenue in other transactions. HMRC maintained that the transactions of BSG with Infinity necessarily connected BSG with such fraud and that the available evidence showed that BSG knew or should have known it. By its order dated 12th May 2008 the Tribunal directed that all allegations that BSG knew that its purchases from Infinity were connected with the fraudulent evasion of VAT should be disregarded so that the sole issue was whether BSG should have known of that fact. The appeal was heard by the Tribunal over six days commencing on 30th June 2008. For the reasons given in their decision dated 17th December 2008 the Tribunal dismissed BSG's appeal. This is the appeal of BSG from that decision. Before I turn to the arguments of counsel for BSG in support of it I must explain what 'contra-trading' is, the contra-trading with which, HMRC allege, that BSG was involved, the legal basis on which HMRC seeks to justify its refusal to repay the input tax incurred by BSG and the decision of the Tribunal.

Contra-trading

4. Contra-trading is the name given to a method by which the fraudulent evasion of VAT may be concealed from the revenue authorities of member states. It is clearly described in paragraphs 3 to 6 of the decision of the VAT and Duties Tribunal (Dr Avery-Jones and Ms Sandi O'Neill) in **Olympia Technology Ltd v HMRC** [2008] UKVAT 20570 in the following terms:

"3. We start with a simple example of an import of goods by X who sells them to Y who exports them. The tax on acquisition (import) by X is cancelled by input tax of the same amount, and the output tax charged on sale by X will be cancelled by input tax repaid to Y on the export, so that the United Kingdom exchequer receives no net tax. If both X and Y are fraudsters Y will have to finance the output tax charged by X, which is recovered by X not paying the output tax to Customs. The only gain by the fraud is if Customs pay the input tax to Y when the exchequer is left with a loss of the amount of the input tax; the non-payment of output tax by X is merely the recovery of what Y put in. If X is a fraudster and Y is innocent, Y finances the output tax charged by X and is entitled to repayment of this input tax even though this represents tax never paid by X. The non-payment of the output tax by X is the benefit of the fraud, and the exchequer is left with the same loss of the amount of the input tax.

4. In contra-trading there are, in its simplest theoretical form, two chains of transactions. First, the "dirty chain," in which there is a defaulting trader ("defaulting trader" for short), comprising A (the defaulting trader) who is the importer of goods into the UK, who sells them to B (the buffer company), who sells them to C who exports the goods, and is thus in a VAT reclaim position. (For simplicity we shall use the expressions import and export for intra-Community trade, acknowledging that these are not the proper labels.) Secondly, the "clean chain," in which there are no missing traders, comprising C, who is this time the importer of other goods, who sells to D, who sells to E, the exporter (the Appellant in this appeal is in the position of E in relation to the three alleged contra-trading deals). The effect of the clean chain is that the net input tax position of C in the dirty chain is cancelled by output VAT in the clean chain. There is no direct financial benefit to C in this as C has paid the input tax to B, and therefore C could be in league with the defaulting trader, or could be a trader who is controlled (possibly without knowing it) by a "puppet master" to enter into the cancelling transactions to disguise A's involvement a fraud, or a trader who happens to carry out both import and export transactions unconnected with any fraud,. The effect of the contra-trades is that C does not excite Customs' attention as it is not applying for a repayment; the non-payment of tax by A is less noticeable since without a return Customs do not know how much tax A owes. The input tax reclaim that C had in the dirty chain has moved to E who is at the end of a clean chain. The only way for Customs to refuse repayment of E's input tax is to show that E knew or ought to have known of A's fraud in a completely different chain, and of C's involvement in the fraud.

5. The nature of contra-trading is easy to state in the above way but the problem in real life is that there is no logical connection between the clean and dirty chains. First, the VAT accounting periods for C and E will not coincide; E may be on a monthly accounting period as it is a habitual exporter, but C may be on a three-monthly period, and C need only arrange that the net tax is nil during that three-monthly period by entering into transactions after E's transactions. Secondly, the goods dealt in may be different in the two chains. Thirdly, for a particular C there may be many different equivalents to A and E, and for a particular E there may be many equivalents of C, each with more than one equivalents to A. Fourthly, C may not have deliberately entered into imports in the clean chain in order to cancel the input in the dirty chain; C may merely be both an importer and an exporter whose outputs in relation to the former happen roughly to cancel its inputs in relation to the latter. Fifthly, there may be many Bs and Ds in between the importer and exporters.

6. The fraud in a simple MTIC fraud is that the defaulting trader always intends to default. It will normally be the case that he defaults later than the dates the deals in

the chains are executed because he fails to pay the tax due for the period in which the deals occur. One of the problems is that C, the exporter in a simple MTIC fraud, is always separated from the defaulting importer by one or more Bs and may not know of the existence of A. If C enters into a deal that is too good to be true it can be said that he ought to know of the fraud even though he does not know of A's identity. In a contra-trading fraud the question is whether E knows or ought to have known that C entered into the clean chain transactions to cover A's intention to default. Again the problem is that E may be separated from C by one or more Ds (although in this case C, the alleged contra-trader sells directly to E, the Appellant)."

5. Applying that description to the facts of this case, as I shall need to do on a number of occasions in subsequent paragraphs of this judgment, BSG is the equivalent of E, the ultimate exporter in the clean chain. There is no D, but C, the importer in the clean chain, is Infinity. In paragraph 37 of its Statement of Case dated 21st June 2007 HMRC asserted that Infinity had a significant number of defaulters in its other transaction chains, that is, those traders who were the equivalent of A. It set out the names of the alleged defaulters and the amount of the tax losses arising from their defaults. The paragraph concluded with the assertion that:

"Given that the deal chains to which [BSG]'s return relates all lead to a contra-trader, the input tax claimed is all connected with fraud."

6. In subsequent paragraphs of its statement of case HMRC set out at some length the facts and matters on which it relied in support of its allegation that BSG should have known that it was taking part (as E) in a transaction (the clean chain) connected (because C is concerned in both chains) with fraudulent evasion of VAT (by A in the dirty chain). Such facts and matters included prior warnings given by HMRC to Mr Peters, the controlling shareholder and director of BSG, of the risks of MTIC fraud both generally and specifically in relation to his business between October 2002 and March 2006. HMRC asserted that BSG had not carried out due diligence in relation to Infinity, Universal Handels or Allimpex. It relied on a large number of specific features of the clean chain including unusual or non-commercial aspects of them. HMRC asserted in paragraph 43 of its Statement of Case that in all those circumstances it properly concluded that BSG should have known that the transactions in the clean chain were "connected with fraudulent evasion of VAT".
7. When it came to the hearing of the appeal HMRC relied on the chain of transactions between Infinity (as C in the dirty chain) and A.S.Genstar Ltd and Wade Tech Ltd as the original suppliers (A) in the dirty chains. A.S.Genstar Ltd was a missing trader. It had vacated its premises and gone missing leaving an outstanding VAT liability of £48m. Wade Tech Ltd was a 'hijacked trader' in the sense that its identity had been stolen so that the liabilities to VAT in excess of £25m incurred in its name could not be enforced against it.
8. HMRC's statement of case concluded in paragraph 45:

"In the premises, the available evidence enables the Tribunal to be satisfied to the requisite standard of proof that:

(a) [the clean chains] formed part of transaction chains in which one or more of the transactions was "connected with fraudulent evasion of VAT", and

(b) [BSG]...."should have known" of that fact."

HMRC's right to refuse repayment

9. At this stage I should explain the legal bases for BSG's claim for repayment and of HMRC's right to refuse. The right of a registered trader to deduct input tax paid by

him in respect of the supply of goods or services to him from output tax received by him in relation to goods or services supplied by him and to pay or be reimbursed the difference arises under both EU law and the VAT Act 1994. In respect of EU law the relevant provisions at the material time were Articles 17(2), 22(8) and 28 of the Sixth VAT Directive. Article 22(8) recognised the entitlement of member states to impose other obligations necessary for the correct collection of tax and for the prevention of evasion. Similarly Article 28c(A) enabled member states to impose conditions for ensuring the straightforward application of the exemption thereby conferred in respect of intra-community trade "and preventing any evasion, avoidance or abuse".

10. The relevant provisions of domestic law in relation to the right of a registered person to deduct input tax from output tax and to be paid or reimbursed the difference are sections 24, 25 and 26 of the VAT Act and regulation 29 of the VAT Regulations 1995. Notwithstanding the terms of Articles 22(8) and 28c(A) of the Sixth Directive there is no provision in the VAT Act qualifying the registered person's right to repayment at the end of an accounting period of any excess of input over output tax.
11. The right to refuse such repayment on which HMRC relies arises from a series of decisions of the ECJ to which effect has been given in a number of decisions of the VAT and Duties Tribunal and puisne judges in England. It has not been suggested that they were wrong to have done so. Consequently it is my duty to follow where they have led notwithstanding my concern as to whether this is an appropriate manner in which effectively to impose a liability for tax.
12. The starting point is the opinion of the Advocate-General and the judgment of the ECJ in **Optigen Ltd v Commissioners for Customs & Excise** [2006] Ch.218. That case concerned a 'carousel' fraud. Optigen sought to deduct input tax on their purchases. Customs & Excise refused to allow such a deduction on the ground that the participants in the carousel fraud had no genuine business motive but only the aim of misappropriating VAT. The questions referred to ECJ by the High Court sought to ascertain whether it should consider the chain or carousel as a whole, as suggested by Customs & Excise, or each transaction individually, as contended by Optigen.
13. The Advocate-General and the ECJ concluded that each transaction must be considered individually and that "the character of a particular transaction in the chain cannot be altered by earlier or subsequent events", see paragraph 27 of the Opinion of the Advocate-General and paragraph 47 of the judgment of the ECJ. Similarly the Advocate-General and the ECJ rejected the argument of Customs & Excise that unlawful or fraudulent transactions were beyond the scope of VAT, see paragraph 32 of the Opinion of the Advocate-General and paragraph 49 of the judgment of the ECJ. The consequences were spelled out in paragraphs 51 and 52 of the judgment of ECJ as follows:

"51 It follows that transactions such as those at issue in the main proceedings, which are not themselves vitiated by VAT fraud, constitute supplies of goods or services effected by a taxable person acting as such and an economic activity within the meaning of Articles 2(1), 4 and 5(1) of the Sixth Directive, where they fulfil the objective criteria on which the definitions of those terms are based, regardless of the intention of a trader other than the taxable person concerned involved in the same chain of supply and/or the possible fraudulent nature of another transaction in the chain, prior or subsequent to the transaction carried out by that taxable person, of which that taxable person had no knowledge and no means of knowledge.

52 Nor can the right to deduct input VAT of a taxable person who carries out such transactions be affected by the fact that in the chain of supply of which those transactions form part another prior or subsequent transaction is vitiated by VAT fraud, without that taxable person knowing or having any means of knowing."

14. The ECJ answered the questions referred to it in the following terms:

"Transactions such as those at issue in the main proceedings, which are not themselves vitiated by value added tax fraud, constitute supplies of goods or services effected by a taxable person acting as such and an economic activity within the meaning of Articles 2(1), 4 and 5(1) of Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, as amended by Council Directive 95/7/EC of 10 April 1995, where they fulfil the objective criteria on which the definitions of those terms are based, regardless of the intention of a trader other than the taxable person concerned involved in the same chain of supply and/or the possible fraudulent nature of another transaction in the chain, prior or subsequent to the transaction carried out by that taxable person, of which that taxable person had no knowledge and no means of knowledge. The right to deduct input value added tax of a taxable person who carries out such transactions cannot be affected by the fact that in the chain of supply of which those transactions form part another prior or subsequent transaction is vitiated by value added tax fraud, without that taxable person knowing or having any means of knowing."

The proposition on which HMRC relies, which has been developed in later cases, arises from the reservations and limitations in that answer in respect of the possible fraudulent nature of another transaction in the chain "of which that taxable person had no knowledge and no means of knowledge" or the vitiation of another transaction in the chain by some VAT fraud "without that taxable person knowing or having any means of knowing".

15. Those reservations and limitations were developed into affirmative principles by the ECJ in **Kittel v Belgium** [2008] STC 1537 delivered on 6th July 2006. In that and its conjoined case **Belgium v Recolta Recycling SPRL** the Belgian tax authorities were concerned with carousel frauds. In the former case a deduction for input tax was refused, in the latter an allegation of being party to the conspiracy to commit a VAT fraud was rejected. In each case questions were referred to the ECJ by the Cour de Cassation in Belgium in relation to a rule of Belgian law avoiding all fraudulent or illegal transactions. The questions posited "a recipient of a supply of goods who has entered into a contract in good faith without knowledge of a fraud committed by the seller". The ECJ also considered (paragraph 28) that the referring court wished to know if the answer of the ECJ would be different if the taxable person knew or should have known that by his purchase he was participating in a transaction connected with a fraudulent evasion of VAT.

16. In its findings the ECJ noted its conclusions in **Optigen**. In paragraphs 46 to 50 it reiterated that the trader's right to deduct in respect of a transaction unaffected by other transactions, whether previous or subsequent, so that (para 51):

"...traders who take every precaution which could reasonably be required of them to ensure that their transactions are not connected with fraud, be it the fraudulent evasion of VAT or other fraud, must be able to rely on the legality of those transactions without the risk of losing their right to deduct the input VAT..."

17. The ECJ then considered the converse cases and stated:

"53 By contrast, the objective criteria which form the basis of the concepts of 'supply of goods effected by a taxable person acting as such' and 'economic activity' are not met where tax is evaded by the taxable person himself (see Case C-255/02 *Halifax and Others* [2006] ECR I-0000, paragraph 59).

54 As the Court has already observed, preventing tax evasion, avoidance and abuse is an objective recognised and encouraged by the Sixth Directive (see Joined

Cases C-487/01 and C-7/02 *Gemeente Leusden and Holin Groep* [2004] ECR I-5337, paragraph 76). Community law cannot be relied on for abusive or fraudulent ends (see, inter alia, Case C-367/96 *Kefalas and Others* [1998] ECR I-2843, paragraph 20; Case C-373/97 *Diamantis* [2000] ECR I-1705, paragraph 33; and Case C-32/03 *Fini H* [2005] ECR I-1599, paragraph 32).

55 Where the tax authorities find that the right to deduct has been exercised fraudulently, they are permitted to claim repayment of the deducted sums retroactively (see, inter alia, Case 268/83 *Rompelman* [1985] ECR 655, paragraph 24; Case C-110/94 *INZO* [1996] ECR I-857, paragraph 24; and *Gabalfrija*, paragraph 46). It is a matter for the national court to refuse to allow the right to deduct where it is established, on the basis of objective evidence, that that right is being relied on for fraudulent ends (see *Fini H*, paragraph 34).

56 In the same way, a taxable person who knew or should have known that, by his purchase, he was taking part in a transaction connected with fraudulent evasion of VAT must, for the purposes of the Sixth Directive, be regarded as a participant in that fraud, irrespective of whether or not he profited by the resale of the goods.

57 That is because in such a situation the taxable person aids the perpetrators of the fraud and becomes their accomplice.

58 In addition, such an interpretation, by making it more difficult to carry out fraudulent transactions, is apt to prevent them.

59 Therefore, it is for the referring court to refuse entitlement to the right to deduct where it is ascertained, having regard to objective factors, that the taxable person knew or should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of VAT, and to do so even where the transaction in question meets the objective criteria which form the basis of the concepts of 'supply of goods effected by a taxable person acting as such' and 'economic activity'.

60 It follows from the foregoing that the answer to the questions must be that where a recipient of a supply of goods is a taxable person who did not and could not know that the transaction concerned was connected with a fraud committed by the seller, Article 17 of the Sixth Directive must be interpreted as meaning that it precludes a rule of national law under which the fact that the contract of sale is void - by reason of a civil law provision which renders that contract incurably void as contrary to public policy for unlawful basis of the contract attributable to the seller - causes that taxable person to lose the right to deduct the VAT he has paid. It is irrelevant in this respect whether the fact that the contract is void is due to fraudulent evasion of VAT or to other fraud.

61 By contrast, where it is ascertained, having regard to objective factors, that the supply is to a taxable person who knew or should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of VAT, it is for the national court to refuse that taxable person entitlement to the right to deduct."

18. Counsel for BSG suggests that the French text "impliquée dans" suggests a closer involvement with the fraud than the English translation "participating in". I express no view on that submission. The importance of **Kittel** is that it is the first affirmative formulation of the principle on which HMRC relies for its refusal to repay to BSG the excess of input tax over its output tax for the period 04/06. The principle, as expressed in paragraphs 59 and 61, is that deduction/repayment should be refused to "a taxable person who knew or should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of VAT".

19. This principle was referred to by ECJ in the later cases of **R v Commissioners Customs & Excise, ex parte Teleos plc** [2008] QB 600 and **Netto Supermarkt GmbH v Finanzamt Malchin** [2008] STC 3820. The judgments of the ECJ were delivered in the former on 27th September 2007 and in the latter on 21st February 2008. In **HMRC v Livewire Telecom Ltd** [2009] STC 643 Lewison J suggested (paragraph 89) that in both **Teleos** and **Netto** the ECJ had narrowed the test formulated in **Kittel**. This was disputed before me by counsel for HMRC so I must consider those cases in rather more detail than would otherwise be necessary.
20. In **Teleos** Teleos had sold mobile phones to a Spanish undertaking for the latter to export from the UK to other member states. Teleos claimed that its supply was zero-rated as an intra-community supply pursuant to Article 28c(A)(a). HMRC discovered that the relevant documents supplied by the Spanish undertaking to Teleos evidencing the export to the other member states were false and the goods had never left the UK. HMRC required Teleos to account for VAT in respect of its supply to the Spanish undertaking. The High Court found that Teleos had not known and could not reasonably have known of the fraud. The questions it referred to the ECJ related to the conditions necessary for an intra-community supply, in particular whether the goods had to be actually exported and whether innocent suppliers could be required to account for the VAT.
21. The ECJ considered that last question in relation to the principles of legal certainty (paragraphs 48 to 51), proportionality (paragraphs 52 to 58) and fiscal neutrality (paragraphs 59 to 60). In paragraphs 61 to 64 the ECJ considered arguments in relation to freedom of movement. In that connection it referred to the settled case law of the ECJ:
- "...which is applicable to the main proceedings by way of analogy, it would not be contrary to Community law to require the supplier to take every step which could reasonably be required of him to satisfy himself that the transaction which he is effecting does not result in his participation in tax evasion (see, as regards 'carousel' type fraud, *Federation of Technological Industries and Others*, paragraph 33, and *Kittel and Recolta Recycling*, paragraph 51)."
- That formulation was repeated in paragraph 68 where the ECJ added the proviso that:
- "...the supplier took every reasonable measure in his power to ensure that the intra-Community supply he was effecting did not lead to his participation in such evasion."
22. **Netto** concerned the refund of VAT by a supermarket chain to customers who bought from its stores goods for export outside the Community. The conditions to be observed to entitle it to a refund of VAT in those circumstances included documents duly stamped by the relevant customs authority. It was later discovered that the documents on which Netto relied were forged and Netto was assessed to VAT. The question referred to the ECJ asked whether a member state was precluded from granting the exemption even where the taxable person was unable even by exercising due care to ascertain that the documents on which the exemption depended were forged.
23. The ECJ considered that it would clearly be disproportionate to hold a taxable person liable for the shortfall in tax caused by fraudulent acts of third parties over which he has no influence whatsoever (paragraph 23). The ECJ continued:
- "24. On the other hand, as the Court has already held, it is not contrary to Community law to require the supplier to take every step which could reasonably be required of him to satisfy himself that the transaction which he is effecting does not result in his

participation in tax evasion (see *Teleos and Others*, paragraph 65, and the case-law cited there).

25. Accordingly, the fact that the supplier acted in good faith, that he took every reasonable measure in his power and that his participation in fraud is excluded are important points in deciding whether that supplier can be obliged to account for the VAT after the event (see *Teleos and Others*, paragraph 66)."

Thus, as in **Teleos**, the formulation adopted by the ECJ was 'participation in' 'fraud' or 'tax evasion'.

24. In **Livewire** para 89 Lewison J said:

"As I have noted the ECJ has used various phrases to describe the link between the fraud and the impugned transaction. In **Optigen** the phrase was 'a chain of supply of which those transactions form part'; in **Kittel** the phrase was 'connected with fraud'. In **Teleos** and in **Netto** it was 'participation in tax evasion'. Both **Teleos** and **Netto** are, in my judgment, a narrowing of the test. As I have noted the ECJ has used various phrases to describe the link between the fraud and the impugned transaction. In **Optigen** the phrase was 'a chain of supply of which those transactions form part'; in **Kittel** the phrase was 'connected with fraud'. In **Teleos** and in **Netto** it was 'participation in tax evasion'. Both **Teleos** and **Netto** are, in my judgment, a narrowing of the test."

25. As I have noted, counsel for HMRC takes issue with the views of Lewison J as to whether the tests as formulated in **Optigen** and/or **Kittel** have been narrowed. She points out that the reference in **Teleos** to **Kittel** is only to paragraph 51 of the latter. She submits that such a reference is limited to direct involvement in the fraudulent evasion of VAT. By contrast the ECJ did not refer to paragraphs 56 to 59 in **Kittel** which deal with constructive knowledge of a connection. The verbal formulations in **Teleos** and **Netto** do, as a matter of English, narrow the formulation of the principle of **Kittel** as expressed in paragraphs 56 to 59 in **Kittel**. But I do not think that the test has, as a matter of law, been narrowed. Not only was the reference in **Teleos** to **Kittel** limited to paragraph 51 of the latter, neither **Teleos** nor **Netto** involved any form of carousel fraud, nor was there any argument in either of them as to whether the precise connection should be the narrower concept of participation. Nothing in this case turns on any narrow distinction between the test as formulated in **Optigen** and **Kittel** on the one hand and as formulated in **Teleos** and **Netto** on the other. If it did I should respectfully differ from Lewison J in this respect.

26. In the event the test adopted by Lewison J does not appear to have been any narrower than that formulated in **Optigen** and **Kittel**. At paragraphs 102 and 103 he said:

"102. In my judgment in a case of alleged contra-trading, where the taxable person claiming repayment of input tax is not himself a dishonest co-conspirator, there are two potential frauds:

(i) The dishonest failure to account for VAT by the defaulter or missing trader in the dirty chain; and

(ii) The dishonest cover-up of that fraud by the contra-trader.

103. Thus it must be established that the taxable person knew or should have known of a connection between his own transaction and at least one of those frauds. I do not consider that it is necessary that he knew or should have known of a connection between his own transaction and both of these frauds. If he knows or should have known that the contra-trader is engaging in fraudulent conduct and deals with him, he

takes the risk of participating in a fraud, the precise details of which he does not and cannot know."

27. Lewison J expanded on those propositions in paragraphs 105 to 109. Thus in paragraph 105 he noted that if the taxable person knew of the fraudulent purpose of the contra-trader it matters not that he did not know of fraud in the dirty chain. In paragraph 106 he recognised that if the contra-trader was not himself dishonest then there will have been only one fraud, namely the dishonest failure to account for VAT by the defaulter in the dirty chain and the taxpayer will not be deprived of his right to reclaim input tax unless he knew or ought to have known of that fraud. Lewison J continued in paragraph 107:

"there is an evidential or factual difficulty in proving a connection with fraud in a case of contra-trading, where the contra-trading is not part of an overall scheme to defraud the Revenue. The [Tribunal in Livewire] noted...that the problem in real life is that there is no logical connection between the clean and dirty chains. As [counsel for Livewire] said, the connection is an accounting connection in that the alleged contra-trader offsets his input tax in the dirty chain against output tax in the clean chain. But since the whole system of VAT works on the basis of constant offsetting of input and output tax, the implication of HMRC's case is that every taxable person could be connected with every other taxable person."

He added in paragraph 109:

"...Indeed it seems to me that the whole concept of contra-trading (which is HMRC's own coinage) necessarily assumes that to be so [sc.the clean and dirty chains are part of an overall scheme to defraud the Revenue]. But that assertion is the assertion of a factual conclusion which HMRC is required to prove on the facts of an individual case."

28. In **Livewire** Lewison J was concerned with two cases of contra-trading. In **Livewire** itself the taxable person was at the end of the clean chain. In the associated case of **Olympia** the taxable person was at the end of the dirty chain in most of the transactions but in three of them was at the end of the clean chain. In the event Lewison J upheld the decision of the Tribunal in **Livewire** that HMRC had not established the requisite knowledge but allowed HMRC's appeal in **Olympia** and remitted the case to the Tribunal for it to apply the correct test. Thus the decision of Lewison J is of direct relevance to the issues arising on this appeal.

The decision of the Tribunal

29. The Tribunal started by setting out the four questions they considered that they must answer. It is common ground that they were the correct questions. They were:
- (1) Was there a VAT loss?
 - (2) If so, did this loss result from a fraudulent evasion?
 - (3) If there was a fraudulent evasion, were the BSG transactions the subject of this appeal connected with that evasion?
 - (4) If such a connection was established, should BSG have known that its purchases were connected with a fraudulent evasion of VAT?
30. In paragraphs 111 to 133 the Tribunal answered the first question in the affirmative. Their finding related to ten chains originating with A.S.Genstar or Wade Tech (A). These were the dirty chains which went through four or five intermediaries (B) and ended with Infinity (C) on various dates from 17th May to 21st June 2006. The

Tribunal answered the second question in the affirmative as well, for the reasons given in paragraphs 134 and 135, because of the fraud of A.S.Genstar and Wade Tech to which I have referred in paragraph 7 above. There is no appeal from either of those conclusions.

31. In paragraphs 136 to 147 the Tribunal considered whether the transactions entered into by BSG in April 2006, namely the clean chains summarised in paragraph 1 above, were connected to those fraudulent evasions. The Tribunal started by recognising the problems which arise if the contra-trader, as in this case, is not himself involved in the fraud in the sense of helping to cover it up but concluded in paragraph 137 that it was not necessary for HMRC to prove that the contra-trader is himself fraudulent. They continued:

"All that is required to demonstrate a connection, in a case where the fraud has occurred at some point elsewhere in the chain, is for it to be established that the actions of the contra-trader facilitated the transactions which led to the tax loss, by either reducing or eliminating the contra-trader's input tax recovery claim which would otherwise have been brought to HMRC's attention (and which as a result would thus have prompted much earlier investigation of the deal chain or chains leading to it, as well as the probable refusal of the claim)."

32. The Tribunal then considered the quantity of transactions with which Infinity was concerned and concluded in paragraph 138 that:

"Infinity did assist in concealing the missing traders' defaults by using the output tax on its "acquisition" transactions as a means of setting off the input tax claims in respect of its "despatch" transactions."

The acquisition and despatch transactions referred to are respectively the clean chains whereunder Infinity supplied goods to BSG and the dirty chains whereby Infinity acquired different goods originating with A.S.Genstar and Wade Tech. They elaborated the point in paragraph 140, where, having referred to paragraph 61 of the ECJ's judgment in **Kittel**, they concluded that:

"The test applicable at this stage (before considering whether the taxable person "knew or should have known") appears to us to be an objective examination of any possible connection between the taxable person's purchase and a wider transaction involving the fraudulent evasion of VAT. This does not appear to us to impose a specific requirement to establish that fraud has taken place at a series of points elsewhere in the chain of transactions, as long as it has already been objectively established that there is fraud in the chain. In order to have reached such a conclusion, we accept that sufficient evidence is required by way of proof of that proposition. As already indicated, we are satisfied on the evidence before us that the actions of A.S.Genstar Ltd and the hijacked trader Wade Tech Ltd were fraudulent."

33. In paragraph 141 the Tribunal considered that the evidence was insufficient to enable them to find that Infinity was itself fraudulent but that:

"...at the very least [Infinity] must either have known or have had reason to suspect that within its transaction chains there were missing, hijacked or otherwise defaulting traders."

34. The Tribunal then dealt with the fact that the dirty chains with which Infinity was involved followed, chronologically, the clean chains which included BSG. They did not accept (paragraph 145) that:

"...a purchase in a "clean" chain can automatically be assumed not to be connected with a fraudulent evasion which in point of time comes after that

purchase.....Logically, there can be a connection, of which the exporter may or may not be aware."

35. They concluded in paragraph 146, having taken into account the matters relating to Infinity referred to in paragraph 147, that:

"BSG's two transactions entered into with Infinity in April 2006 were connected to the fraudulent evasions by AS Genstar Ltd and Wade Tech Ltd, because the transactions were used as a basis for offsetting the input tax claims which Infinity would otherwise have had to make at the end of its 06/06 VAT return period in respect of the "despatch" deals for which one or other of those two entities was the supplier at the head of the relevant chain."

36. The Tribunal then considered in paragraphs 148 to 228 whether BSG should have known of that connection. They adopted the view of the Tribunal in **Honeyfone Ltd v HMRC** [2008] UKVAT 20667 and Burton J in **R v HMRC, ex parte Just Fabulous (UK) Ltd** [2008] STC 2123 that it is sufficient if the trader should have known that there was some fraud even though he does not have the means of knowing the details of that fraud but preferred to formulate it, as in **Kittel**, as "participating in a transaction connected with fraudulent evasion of VAT". In applying those propositions to the facts of the case before them they said (paragraph 151):

"On that basis, the fact that Infinity's despatch deals post-dated BSG's purchases from Infinity and sales, respectively, to Universal and Allimpex, does not preclude a finding that BSG should have known that, by such purchases, it was taking part in transactions connected with fraudulent evasion of VAT. However, sufficient proof is required to establish this in the context of a trader which is the exporter in a "clean" chain, having purchased from a supplier alleged to be a contra-trader."

In that last sentence the Tribunal recognised that the burden of proof lay on HMRC. Counsel for HMRC accepted that the Tribunal was right to do so in this case.

37. The Tribunal then evaluated the evidence on the various matters relied on by HMRC and foreshadowed in its original statement of case. Thus they referred in considerable detail to Mr Peters' previous experience, the warnings given to him, his investigations of Infinity, Universal and Allimpex and their perceived inadequacies, certain surprising and uncommercial aspects of the purchases from Infinity and the sales to Universal and Allimpex and what happened to the goods the subject of the clean chain. In paragraph 223 the Tribunal found that:

"Our overall conclusion, taking into account the deficiencies in BSG's due diligence procedures and the dating of the commitments to buy and sell the stock, before those procedures had even been completed, is that Mr Peters did not do enough to protect himself (and therefore BSG) from the risk of becoming enmeshed in transactions which might prove to be connected in some way to fraud. The ease with which he was able to find purchasers of large consignments of mobile phones, as well as a supplier able at virtually no notice to fulfil orders for precisely the types of phones required, should have put him on notice that the arrangements called for further investigation, particularly as the invoicing for the transactions was organised to coincide on the same day for all stages in each chain. This insufficiency of action to protect BSG leads us to the view that, in terms of the statement in *Kittel* at [61] he

"... should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of VAT".

38. The Tribunal elaborated on the experience of Mr Peters in paragraph 224 and on the lack of commerciality of some aspects of the clean chain. In paragraph 226 they

rejected an allegation that Mr Peters had been manipulated. In that connection they said:

"We do not find on the evidence before us that there was control and manipulation, although we do consider that Mr Peters was much too ready, without careful and detailed review and exhaustive checks of all aspects of the proposed transactions, to become committed to them. It is not correct that he turned a blind eye to the various elements of the transactions, but his enquiries were not sufficiently exhaustive to protect BSG. In *Honeyfone* at paragraph 47, the Tribunal said:

"It seems to us that in these contexts what a trader "should have known" may include what he ought to have known or had the means of knowing. Those phrases [*sic*, ie phrases] indicate to us that it therefore may include what he could have found out if he had made further enquiries."

38. The Tribunal then set out the enquiries Mr Peters should have undertaken before BSG became committed to the relevant transactions and concluded in paragraph 228:

"His failure to make full enquiries and investigations in advance meant that he did not discover information which ought to have led him into yet further investigations. In turn, the result was that BSG became committed, without sufficient protection, to enter into the transactions with Infinity linked by way of contra-trading to the other transactions derived from two traders established to be fraudulent, namely A.S.Genstar Ltd and Wade Tech Ltd. We think that if he had asked and obtained answers to the appropriate questions, he would have concluded that the uncommercial features of the deals being offered to BSG could only be explained by taking into account other transactions which Infinity was entering into, and that the most probable explanation was that those other transactions were connected in some way with fraud. Our conclusion is that BSG ought to have known that, by its purchases, it was participating in transactions connected with fraudulent evasion of VAT."

The submissions of the parties and my conclusion

39. It is common ground that this appeal brought under s.11 Tribunals and Inquiries Act 1992 is limited to points of law so that I must accept the Tribunal's findings of fact unless counsel for BSG can satisfy me that no tribunal properly directing itself could have reached them, see **Edwards v Bairstow** [1956] AC 14. Indeed I did not understand counsel for BSG to challenge any findings of fact. Rather, he submitted that (1) there was no sufficient connection between the fraudulent evasion of VAT by A.S.Genstar and Wade Tech and the transactions carried out by BSG, but even if there was (2) BSG did not have the means of knowledge to justify a conclusion that BSG should have known of that connection. It is convenient to deal with these two points separately.

Connection

40. Counsel for BSG emphasises the statements in **Optigen** and **Kittel** (see paragraphs 13 and 16 above) that the character of a particular transaction in the chain cannot be altered by earlier or subsequent events. He points out, correctly, that at the time BSG entered into the transactions specified in paragraph 1 above, namely April 2006, the transactions giving rise to the tax loss had not occurred. Further, as he stresses, the allocation of those transactions for VAT purposes to the earlier transactions involving BSG were made after the event by HMRC selecting 10 transactions, at random, from some 623 transactions involving Infinity as importer in the period 06/06. Those ten chains commenced with A.S.Genstar or Wade Tech but they were not involved in all the other 613. As Lewison J pointed out in **Livewire** paragraph 107 (see paragraph

27 above) there is no logical connection between those chains and the clean chains involving BSG; such connection as there is is an accounting connection. Why, asks counsel for BSG, should those transactions be allocated to the clean chain involving BSG rather than clean chains involving others? He submits that the connection on which HMRC relies is unreal and is inconsistent with the principles of legal certainty, fiscal neutrality, proportionality and freedom of movement.

41. As indicated in paragraph 37 of its original statement of case and reiterated by counsel before me, the connection on which HMRC relies is the fact that both clean chains originated with Infinity and a large number of dirty chains ended with Infinity. Thus the connection is through the involvement of Infinity in both and the VAT consequence that it can, indeed must, in the relevant accounting period set-off its input tax on the dirty chains against its output tax in the clean chains. HMRC accepted in paragraph 44 of their Statement of Case that, on this basis, all traders in a chain in which Infinity was involved must, necessarily, have been connected with the fraud. The difference in their treatment depends on the evidence as to their knowledge.
42. In both **Optigen** and **Kittel** the ECJ was concerned with carousel fraud, not contra-trading. In the former the principle was expressed in terms which confined its operation to transactions in the dirty chain and in terms which, if satisfied, excluded liability. By contrast in **Kittel** the principle was expressed in affirmative terms extending beyond transactions in the dirty chain. On that formulation all that is required is that the transaction in which the trader participated was "connected with fraudulent evasion of VAT". **Just Fabulous (UK) Ltd** also concerned a carousel fraud but was a strike out application not a consideration of how the concept of 'connection' is to be applied. The first reported case at the level of the ECJ or the High Court involving contra-trading is **Livewire**.
43. The question of 'connection' was considered by Lewison J primarily in relation to knowledge. At paragraphs 107 and 109 (see paragraph 27 above) he dealt with it on the basis that whether the clean and dirty chains were connected is a matter of fact to be proved by HMRC. It is, I think, clear from those paragraphs of his judgment in **Livewire** that he did not consider that there was an inevitable connection between the clean and dirty chains if C was the same entity. Equally I do not think that that was the basis of his decision in either appeal before him. He decided the appeals on the basis of the knowledge of the taxpayer thereby, seemingly, assuming the relevant connection.
44. There is force in the argument of counsel for BSG but I do not accept it. The nature of any particular necessary connection depends on its context, for example electrical, familial, physical or logical. The relevant context in this case is the scheme for charging and recovering VAT in the member states of the EU. The process of off-setting inputs against outputs in a particular period and accounting for the difference to the relevant revenue authority can connect two or more transactions or chains of transaction in which there is one common party whether or not the commodity sold is the same. If there is a connection in that sense it matters not which transaction or chain came first. Such a connection is entirely consistent with the dicta in **Optigen** and **Kittel** because such connection does not alter the nature of the individual transactions. Nor does it offend against any principle of legal certainty, fiscal neutrality, proportionality or freedom of movement because, by itself, it has no effect.
45. Given that the clean and dirty chains can be regarded as connected with one another, by the same token the clean chain is connected with any fraudulent evasion of VAT in the dirty chain because, in a case of contra-trading, the right to reclaim enjoyed by C (Infinity) in the dirty chain, which is the counterpart of the obligation of A to account for input tax paid by B, is transferred to E (BSG) in the clean chain. Such a transfer is apt, for the reasons given by the Tribunal in **Olympia** (paragraph 4 quoted in

paragraph 4 above), to conceal the fraud committed by A in the dirty chain in its failure to account for the input tax received from B.

46. Plainly not all persons involved in either chain, although connected, should be liable for any tax loss. The control mechanism lies in the need for either direct participation in the fraud or sufficient knowledge of it. It is important, as the Tribunal recognised in paragraph 131 of its decision, that such tax losses are only used once. Thus having used the tax losses attributable to A.S.Genstar and Wade Tech by allocation to the tax reclaimed by BSG they are no longer available to be allocated to other transactions or claims.

Knowledge

47. As I recorded in paragraph 2 above there is no suggestion that BSG knew of any fraudulent evasion of VAT. Further the Tribunal rejected the suggestions either that BSG had been controlled or manipulated as part of some wider conspiracy or that its controlling director, Mr Peters had 'turned a blind eye' to the various elements of the transactions, see paragraph 38 above. So, given that the clean chains are, through Infinity, connected with the dirty chains, the question is, in terms of paragraph 59 of the judgment of the ECJ in **Kittel**, whether "having regard to objective factors,...[BSG]... should have known that, by [its] purchase, [it] was participating in a transaction connected with fraudulent evasion of VAT".
48. As Lewison J pointed out in **Livewire** (see paragraph 26 above), in alleged contra-trading cases there are, at least, two potential frauds (1) the dishonest failure to account for VAT by the defaulter or missing trader (A) in the dirty chain, namely A.S.Genstar and Wade Tech, and (2) the dishonest cover-up of that fraud by the contra-trader (C), namely Infinity. In this case the Tribunal rejected the contention of HMRC that Infinity had itself been fraudulent even though it must have known or have had reason to suspect that within its transaction chains there were missing, hijacked or otherwise defaulting traders, see paragraph 141. Accordingly for the purpose of applying the **Kittel** test the only relevant fraud is that of A.S.Genstar and Wade Tech.
49. Counsel for BSG submits that the Tribunal was wrong to have concluded, as they did in paragraph 228, that BSG ought to have known that, by its purchases, it was participating in transactions connected with fraudulent evasion of VAT. First, neither the fraudulent evasion nor the relevant connection had by then occurred. Second, the "sufficient to protect" test adopted by the Tribunal in assessing the adequacy of the due diligence carried out by BSG was too strict. Third, given the Tribunal's conclusions in relation to Infinity, the perceived inadequacies of BSG's due diligence did not justify the conclusion that BSG ought to have known of the relevant fact.
50. Counsel for HMRC seeks to uphold the conclusions of the Tribunal on the footing that, given there was the connection, through Infinity, between BSG's transactions in the clean chain and the fraudulent evasions of A.S.Genstar and Wade Tech in the dirty chains, BSG ought to have known of that connection. She relies on a number of detailed acts or omissions by Mr Peters in relation to Universal, Allimpex and Infinity recounted by the Tribunal in particular paragraphs of its decision. She emphasises the unusual or uncommercial features of the transactions effected by BSG with one or other of the three parties involved. She refers to the Tribunal's own summary in paragraph 228 which I have quoted in paragraph 38 above.
51. I start by considering the second objection of counsel for BSG, namely that the "sufficient to protect" test adopted by the Tribunal was too high. No doubt it is derived from **Kittel** paragraph 51, **Teleos** paragraph 68 and **Netto** paragraphs 24 and 25. It first appeared in paragraph 162 of the Tribunal's decision. Having considered in some detail the extent of the enquiries made by Mr Peters in relation to Universal they concluded:

"We consider that the due diligence exercise relating to Universal was inadequate, as was the failure to follow up outstanding questions where matters did not appear to be in satisfactory order. The exercise was not sufficient to protect BSG from the risk of involvement in transactions which might turn out to have undesirable associations."

The same test was applied in paragraph 223 of the Tribunal's judgment, quoted in paragraph 37 above.

52. In my view, this test is misleading for two reasons. First the burden is on HMRC to prove that BSG ought to have known that by its purchases it was participating in transactions connected with fraudulent evasion of VAT. It is not for BSG to prove that it ought not. Second, it is not sufficient to demonstrate that BSG was involved in transactions which "might" turn out to have undesirable associations. The relevant knowledge is that BSG ought to have known that by its purchases it was participating in transactions which were connected with the fraudulent evasion of VAT; that such transactions might be so connected is not enough.
53. Similar considerations apply to the formulation of the case for HMRC. The contention is that BSG ought to have known of the connection, through Infinity, between its transactions and the fraudulent evasion of VAT by the defaulting traders in the dirty chain. This formulation involves two separate questions, knowledge of the connection and knowledge that the connection was with the fraudulent evasion of VAT. Clearly BSG would have known that its transactions would, for the purposes of VAT, be connected with other transactions with which Infinity was concerned in the sense that Infinity's output tax, paid by BSG, would have to be set against input tax payable by Infinity in respect of other transactions. But that is not enough. HMRC must also prove that BSG ought to have known that those other transactions involved the fraudulent evasion of VAT.
54. The Tribunal rejected any allegation of conspiracy involving BSG or Infinity. It rejected the suggestion that BSG had been manipulated. It acquitted Infinity of fraud. If Infinity did not know of the fraud when it happened and was not party to any arrangement that it should happen, how could BSG have known of any fraud before it happened? No amount of due diligence undertaken in respect of Infinity, Universal or Allimpex could have revealed it. And if BSG could not have known, how could there be circumstances from which it could properly be concluded that BSG ought to have known?
55. In my view it is an inescapable consequence of contra-trading that for HMRC to refuse a reclaim by E it must be in a position to prove that C was party to a conspiracy also involving A. Although the fact that C is party to both the clean chain with E and dirty chain with A constitutes a sufficient connection it is not enough to show that E ought to have known of the fraudulent evasion of VAT involved in the subsequent dirty chain. At the time he entered into the clean chain there was no such dirty chain of which he could have known, nor was the occurrence of such dirty chain inevitable in the sense of being pre-planned.
56. In my view the Tribunal was wrong to have concluded that BSG ought to have known that by its purchases from Infinity it was participating in transactions connected with fraudulent evasion of VAT. For that reason I would allow this appeal.