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Case No: CH/2008/APP/0116
CH/2008/APP/0252

**IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
(ON APPEAL FROM THE VAT AND DUTIES TRIBUNAL)**

Royal Courts of Justice
Strand, London, WC2A 2LL

16 January 2009

Before:

THE HONOURABLE MR. JUSTICE LEWISON

Between:

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

- and -

LIVEWIRE TELECOM LIMITED **Respondent**

And Between:

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

- and -

OLYMPIA TECHNOLOGY LIMITED **Respondent**

Mr Rupert Anderson QC, Mr Philip Moser and Mr David Bedenham (instructed by The Solicitors for HMRC and Howes Percival LLP) for the Appellants.

Mr David Scorey, Mr Jern-Fei Ng (instructed by Malletts Solicitors) for the First Named Respondent.

Mr. Kieron Beal, Ms Eleni Mitrophanous (instructed by BDO Stoy Hayward) for the Second Named Respondent.

Hearing dates: 15,16,17,18 December 2008

HTML VERSION OF JUDGMENT

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Mr. Justice Lewison:

Introduction

1. VAT fraud is a serious problem for national taxing authorities throughout the European Union. VAT fraud can take a number of forms. The particular form of fraud with which these appeals is concerned is known generically as missing trader intra-community fraud or MTIC fraud. This is a description coined by HMRC, but is generally used by those who specialise in this area. Even this generic type of fraud can itself take different forms:
 - i) In its simplest form it is known as an acquisition fraud. A trader imports goods from another Member State. No VAT is payable on the import. He then sells on those goods to a domestic buyer and charges VAT. He dishonestly fails to account for the VAT to HMRC and disappears. The importer is labelled a "missing trader" or "defaulter".
 - ii) The next level of sophistication involves both an import and an export. A trader once again imports goods from another Member State. No VAT is payable on the import. Typically the goods are high value low volume goods, such as computer chips or mobile phones. He then sells on those goods to a domestic buyer and charges VAT. He dishonestly fails to account for the VAT to HMRC and disappears. The domestic buyer sells on to an exporter at a price which includes VAT. The exporter exports the goods to another Member State. The export is zero-rated. So the exporter is, in theory, entitled to deduct the VAT that he paid from what would otherwise be his liability to account to HMRC for VAT on his turnover. If he has no output tax to offset against his entitlement to deduct, he is, in theory, entitled to a payment from HMRC. Thus HMRC directly parts with money. Sometimes the exported goods are re-imported and the process begins again. In this variant the fraud is known as a carousel fraud. There may be many intermediaries between the original importer and the ultimate exporter. These intermediaries are known as "buffers". The ultimate exporter is labelled a "broker". A chain of transactions in which one or more of the transactions is dishonest has conveniently been labelled a "dirty chain". Where HMRC investigate and find a dirty chain they refuse to repay the amount reclaimed by the ultimate exporter.
 - iii) In order to disguise the existence of a dirty chain, fraudsters have become more sophisticated. They have conducted what HMRC call "contra-trading". The trader who would have been the exporter or broker at the end of a dirty chain, with a claim to repayment of input tax, himself imports goods (which may be different kinds of goods) from another Member State. Because this is an import he acquires the goods without having to pay VAT. This is the contra-trade. He sells on the newly acquired goods, charging VAT but this output tax is offset against his input tax, resulting in no payment (or only a small payment) to HMRC. The buyer of the newly acquired goods exports them and reclaims his own input tax from HMRC. Again there may be intermediaries or buffers between the contra-trader and the ultimate exporter. The fraudsters' hope is that if HMRC investigate the chain of transactions culminating in the export, they will find that all VAT has been properly accounted for. This chain of transactions has conveniently been called the "clean chain". Thus the theory is that an investigation of the clean chain will not find out about the dirty chain, with the result that HMRC will pay the reclaim of VAT on the export of the goods which have progressed through the clean chain. I should add that HMRC do not agree with the label "clean chain" because they say that both chains are part of an overall fraudulent scheme.
2. The present case concerns two appeals against decisions of the VAT and Duties Tribunal, in each case chaired by Dr John Avery Jones CBE. In each case the taxable person appealed against the refusal by HMRC to repay input tax reclaimed on an export of goods to another Member State. One of the appeals was that of Livewire Telecom Ltd ("Livewire") which was in the position of the ultimate exporter of goods in a clean chain. The other was that of Olympia Technology Ltd ("Olympia") which was in the position of the ultimate exporter in a dirty chain in relation to most of the exports and in the position of the ultimate exporter in a clean chain for three of

them. In each case the Tribunal allowed the taxable person's appeal. HMRC appeal to this court. The appeal is restricted to questions of law. The facts are for the Tribunal alone.

3. In essence the question of law is: in what circumstances may HMRC lawfully refuse to make a payment of input VAT to an exporter who is not himself dishonest and does not have actual knowledge of a scheme to defraud the Revenue? The question has to be put in that way because the Tribunal in each case found as a fact that the taxable person was not dishonest and had no actual knowledge of such a scheme. HMRC cannot appeal against that finding of fact.
4. There is, however, a prior question. Are HMRC entitled to raise this question at all in view of the way that their case was conducted before the Tribunal? *Livewire* and *Olympia* say that in each appeal the only case they had to meet was that they were dishonest co-conspirators in an elaborate tax fraud; and that having failed to establish that case HMRC cannot now seek to establish an entitlement to refuse to repay input tax on a different ground.

The domestic legislation

5. VAT is charged in accordance with the Value Added Tax Act 1994 ("VATA") and regulations made under it. The VATA gives effect to the Sixth VAT Directive (77/388/EEC). Section 1 of the VATA says that VAT is charged, in accordance with the provisions of the Act, on the supply of goods in the United Kingdom; on the acquisition in the United Kingdom from other Member States of any goods; and on the importation of goods from places outside the Member States. Section 1(2) says that liability to account for VAT on the supply of goods within the United Kingdom is that of the supplier. Section 4 of the VATA provides that VAT is charged on any taxable supply of goods made by a taxable person in the course or furtherance of a business carried on by him.
6. Section 24 of the Act defines input tax. It provides as follows:

"(1) Subject to the following provisions of this section, 'input tax', in relation to a taxable person, means the following tax, that is to say –

 - (a) VAT on the supply to him of any goods or services;
 - (b) VAT on the acquisition by him from another Member State of any goods; and
 - (c) VAT paid or payable by him on the importation of any goods from a place outside the Member States,

being (in each case) goods or services used or to be used for the purpose of any business carried on or to be carried on by him."
7. Section 25(1) sets out the obligation imposed on a taxable person to account for and pay VAT in respect of supplies made by him for each prescribed accounting period. Section 25 also provides:

"(2) Subject to the provisions of this section, he is entitled at the end of each prescribed accounting period to credit for so much of his input tax as is allowable under section 26, and then to deduct that amount from any output tax that is due from him.

(3) If either no output tax is due at the end of the period, or the amount of the credit exceeds that of the output tax then, subject to subsections (4) and (5) below, the

amount of the credit or, as the case may be, the amount of the excess shall be paid to the taxable person by the Commissioners; and an amount which is due under this subsection is referred to in this Act as a 'VAT credit'.

...

(6) A deduction under subsection (2) above and payment of a VAT credit shall not be made or paid except on a claim made in such manner and at such time as may be determined by or under regulations . ."

8. Section 26 provides:

"(1) The amount of input tax for which a taxable person is entitled to credit at the end of any period shall be so much of the input tax for the period (that is input tax on supplies, acquisitions and importations in the period) as is allowable by or under regulations as being attributable to supplies within subsection (2) below.

(2) The supplies within this subsection are the following supplies made or to be made by the taxable person in the course or furtherance of his business –

(a) taxable supplies;

(b) supplies outside the United Kingdom which would be taxable supplies if made in the United Kingdom."

9. Section 30(8) provides:

"Regulations may provide for the zero-rating of supplies of goods, or of such goods as may be specified in the regulations, in cases where:-

(a) The Commissioners are satisfied that the goods have been or are to be exported to a place outside the Member States or that the supply in question involves both -

(i) the removal of the goods from the United Kingdom; and

(ii) their acquisition in another Member State by a person who is liable for VAT on the acquisition in accordance with the provisions of the law of that Member State corresponding, in relation to that Member State, to the provisions of section 10; and

(b) Such other conditions, if any, as may be specified in the regulations or the Commissioners may impose are fulfilled."

10. The regulations in question are the VAT Regulations 1995. The regulations provide for the filing of VAT returns and for a claim to a deduction to be made on such a return. Regulation 134 of the VAT Regulations provides:

"Where the Commissioners are satisfied that —

(a) a supply of goods by a taxable person involves their removal from the United Kingdom,

(b) the supply is to a person taxable in another Member State,

(c) the goods have been removed to another Member State,

(d) the goods are not goods in relation to whose supply the taxable person has opted, pursuant to section 50A of the Act, for VAT to be charged by reference to the profit margin on the supply,

the supply, subject to such conditions as they may impose, shall be zero-rated."

11. On the face of it, if a taxable person satisfies the terms of section 25 (3) then HMRC have a statutory obligation to pay a VAT credit to the taxable person. However, it is common ground that, despite this apparently mandatory obligation, HMRC are in some circumstances entitled to withhold payment on grounds derived from European law.

The European dimension

12. As mentioned the VATA is intended to give effect to the Sixth VAT Directive. Article 17 of the Directive contains the right to deduct input tax. Article 17(1) confers on taxable persons a right to deduct deductible tax at the time that it becomes chargeable. Article 17(2) provides:

"(2) In so far as the goods and services are used for the purposes of his taxable transactions, the taxable person shall be entitled to deduct from the tax he is liable to pay:

(a) value added tax due or paid within the territory of the country in respect of goods or services supplied or to be supplied to him by another taxable person;

(b) value added tax due or paid in respect of imported goods within the territory of the country. ."

13. Article 22(8) provides:

"Member States may impose other obligations which they deem necessary for the correct collection of the tax and for the prevention of evasion, subject to the requirement of equal treatment for domestic transactions and transactions carried out between Member States by taxable persons and provided that such obligations do not, in trade between Member States, give rise to formalities connected with the crossing of frontiers.

The option provided for in the first sub-paragraph cannot be used to impose additional obligations over and above those laid down in paragraph 3."

14. Article 28a(1) of the Sixth Directive makes subject to VAT the intra-Community acquisition of goods for consideration within the territory of the country by a taxable person acting as such where the vendor is a taxable person acting as such. Article 28a(3) defines the intra-Community acquisition of goods as "acquisition of the right to dispose as owner of movable tangible property dispatched or transported to the person acquiring the goods by on behalf of the vendor or the person acquiring the goods to a Member State other than that from which the goods are despatched or transported." The corollary of these provisions is that the Sixth Directive exempts from VAT the supply of goods to a trader in another Member State in certain circumstances. Article 28c(A) states:

"Without prejudice to other Community provisions and subject to conditions which they shall lay down for the purpose of ensuring the correct and straightforward application of the exemptions provided for below and preventing any evasion, avoidance or abuse, Member States shall exempt:

(a) supplies of goods [as defined in Article 5] dispatched or transported by or on behalf of the vendor or the person acquiring the goods out of the territory referred to in Article 3 but within the Community, effected for another taxable person or a non-taxable legal person acting as such in a Member State other than that of the departure of the dispatch or transport of the goods."

15. At first sight the provisions of the Directive appear to envisage that it is for the Member States themselves to "impose other obligations which they deem necessary for ... for the prevention of evasion" or to "lay down [conditions] for the purpose of ... preventing any evasion, avoidance or abuse". It is common ground that the United Kingdom has not imposed or laid down obligations or conditions relevant to these appeals. However, it is also common ground that if the facts fall within the legal principle stated by the ECJ in a number of cases, and in particular *Kittel v Belgium* [2008] STC 1537, then HMRC are entitled to withhold payment.
16. I will return to *Kittel* in more detail later, but at this stage it is sufficient to quote its formal ruling that:

"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 value added tax, it is for the national court to refuse that taxable person entitlement to the right to deduct."

Change of case on appeal: the principle

17. May LJ stated the principle in *Jones v. MBNA International Bank (CA)* (30th June 2000) which was applied by the Court of Appeal in *McDonald v. Coys of Kensington* [2004] EWCA Civ 47 and *Petromec Inc v Petroleo Brasileiro SA Petrobas* [2006] 1 Lloyd's Rep 121. His formulation of the principle was as follows:

"..... a party cannot normally seek to appeal a trial judge's decision on the basis that a claim, which could have been brought before the trial judge, but was not, would have succeeded if it had been brought. The justice of this as [a] general principle is obvious. Parties to litigation are entitled to know where they stand. The parties are entitled, and the court requires, to know what the issues are. Upon this depends a variety of decisions, including, by the parties, what evidence to call, how much effort and money it is appropriate to invest in the case, and generally how to conduct the case; and, by the court, what case management and administrative decisions to make and give, and the substantive decision of the case itself. Litigation should be resolved once and for all, and it is not, generally speaking, just if a party who successfully contested a case advanced on one basis should be expected to face on appeal, not a challenge to the original decision, but a new case advanced on a different basis. There may be exceptional cases in which the court would not apply the general principle which I have expressed."

18. The principle was not, and could not have been, in dispute. Livewire and Olympia say that having advanced a case below on the first limb of the *Kittel* ruling only (i.e. that the taxable persons *knew* that by their purchases they were participating in a transaction connected with the fraudulent evasion of VAT) and having failed on the facts HMRC cannot now advance a case based on the second limb of that ruling (i.e. that the taxable persons *should have known* that they were participating in such a transaction). HMRC's response is that the case below was (in each case) advanced on the basis of both limbs of *Kittel*.

The case below: Livewire

19. As I have said, in Livewire's case it was alleged to be in the position of the broker at the end of a clean chain. The contra-traders who, according to HMRC, connected the clean chain with the dirty chains were two companies called Uni-Brand and Sygnet. HMRC served a statement of case as required by the relevant procedural rules. Paragraph 29 appeared in a section headed "Knew or should have known". The paragraph itself stated:

"[HMRC] rely on three main grounds for averring that the [taxable person] knew or should have known that its transactions were connected to fraud."

20. It then set out the three factors. Paragraph 41 concluded:

"Given all of the above factors, [HMRC] properly concluded that the [taxable person] knew or should have known that the transactions were connected with fraud."

21. In addition to the statement of case, counsel then appearing for HMRC prepared outline written submissions in opening the appeal. Paragraph 25 said that it was HMRC's case that the taxable person had "knowledge" or the "means of knowing" that the assessed transactions were part of transaction chains which were connected with fraud." The submission concluded by asserting that the available evidence enabled the Tribunal to be satisfied that the relevant deals formed part of transaction chains connected to fraud and:

"The [taxable person] knew or ought to have known of that fact."

22. Thus far it seems to me that HMRC were advancing the case on both limbs of *Kittel*. That is how Livewire understood it too. Livewire's skeleton argument prepared at the start of the appeal defined the issues. One of the issues labelled "the Knowledge Issue" was described thus:

"... did Livewire actually know of the fraudulent evasions of VAT and of their connexion with the transactions which Livewire had entered into in April 2006? Alternatively should Livewire have known of these matters?"

23. Clearly, this refers to an alternative case. Paragraph 89 of Livewire's skeleton dealt with actual knowledge. Paragraphs 91 to 95 dealt with whether Livewire had the means of knowledge or should have known. It seems clear that Livewire was responding to a case based on both limbs of *Kittel*. Livewire's written closing after the evidence had been heard described the Knowledge Issue in exactly the same way that it had been described in its opening skeleton argument. Paragraph 105 dealt with knowledge. It divided the issue into three sub-issues, one of which was:

"Thirdly, and alternatively, have [HMRC] satisfied the Tribunal that Livewire ought to have known of the said fraud ("constructive knowledge sub-issue")."

24. That sub-issue was elaborated in paragraphs 128 to 161 of the written submission. Again it seems to me that Livewire were responding to a case based on both limbs of *Kittel*.

25. However, in HMRC's written closing it was said that:

"The overall scheme to defraud described above can only work if the broker trader in the second chain (i.e. Livewire) is complicit (whether by actually knowing of it or by acting on the instructions of a controlling hand [in which case, at the very least, they ought to have known of it]). The trader in Livewire's position is necessarily complicit because it is only if they achieve a repayment from HMRC that the fraud makes its profit. If the trader was not complicit there would be no way for the spoils of the fraud to be divided between the participants."

26. Mr Scorey, appearing for Livewire, relies heavily on this part of HMRC's closing which, he says, shows that by the end of the case HMRC had confined their case on the facts to an allegation of actual knowledge. It is, I think, also necessary to examine how the Tribunal understood the case that was being advanced by HMRC. The following parts of their decision set out how they understood HMRC to be putting their case:

"In the end Customs conducted the appeal on the basis that both chains were a fraud in which the Appellant was involved, which must imply knowingly involved." (§ 11)

"Mr Benson [counsel for HMRC] puts forward all the transactions in the dirty and clean chains and asks the Tribunal to conclude that everyone is participating in a fraud, which therefore includes the missing traders and necessarily the contra-traders, Sygnet and Uni-Brand. ... He accepts that if the contra-traders are not part of the fraud then it will be extremely unlikely that the Appellant [knew] or ought to have known about the missing traders in the dirty chain, although the question still has to be asked." (§ 16)

"In view of the decision above, the Appellant could not have known of the fraud, which is the fraud by the missing traders in the dirty chains. As Mr Scorey pointed out, "ought to have known" is inconsistent with Customs' case that both chains were part of a fraud, which, if true (which we have found it is not), must mean that the Appellant had actual knowledge. However, we set out the rival contentions and our views." (§ 33)

"Indeed, even if we had found that Sygnet and Uni-Brand were involved in the fraud (which we have not) we would not have decided that the above points showed that Appellant either knew, or had the means of knowledge, of such fraud." (§ 36)

"Accordingly our decision is that the fraud carried out by the missing traders only; that Uni-Brand and Sygnet are not parties to any fraud; and that the Appellant neither knew nor ought to have known about the fraud, and we allow the appeal." (§ 37)

27. In my judgment the written submissions show that both sides understood that, at least in formal terms, HMRC's case was being advanced on the basis of both limbs of *Kittel*. I do not regard HMRC as having abandoned reliance on the second limb. That is why the Tribunal said in paragraph 16 that the question still had to be asked. It is also why the Tribunal answered the question and why, when recording its decision, it did so by reference to both limbs of *Kittel*. I have concluded, therefore, that HMRC are not precluded from advancing their grounds of appeal by the way in which the case was presented below.

The case below: Olympia

28. As I have said, in Olympia's case it was alleged, in relation to most of the transactions, to have been in the position of the broker at the end of a dirty chain; but in three cases it was alleged to have been the broker at the end of a clean chain, connected to a dirty chain by a contra-trader. In Olympia's case the alleged contra-trader was a company called Topnotch. Again HMRC served a Statement of Case. Paragraph 39 described the issues as whether the assessed transactions were connected to fraud and whether:

"the Appellant taxpayer "knew or should have known" of that fact."

29. After setting out a number of factual allegations, paragraph 58 stated:

"[HMRC] will contend that the Appellant's conduct set out above is reckless. The Appellant knew or should have known that the transactions were connected with fraud."

30. The statement of case then made further factual allegations and stated (§ 60):

"Given all the above factors [HMRC] properly concluded that the Appellant knew or should have known that the transactions were connected with fraud."

31. Once again HMRC prepared a written opening. Paragraph 9 introduced the question of "knowledge and means of knowledge". Paragraph 16 alleged that certain transactions were connected with the fraudulent evasion of VAT and that "Olympia knew or should have known that it was participating in transactions of such a character". Paragraphs 18 to 30 discussed the legal test. In paragraph 26 HMRC said:

"For the avoidance of doubt [HMRC] do not read the decision of Chairman Bishopp in *Calltel* as requiring mere "negligence" to be established. For the same reason, [HMRC] have no difficulty in seeing the test for "means of knowledge" as akin to e.g. a variety of "Nelsonian blindness"."

32. This, however, was qualified by paragraph 27 in which HMRC said that:

"Consistent with the traders' EU law obligations ... an appropriate form of "Nelsonian blindness" (whereby "blind-eye" knowledge equates to knowledge) in the present context would be along the lines of, e.g. "a decision by a trader to refrain from taking all reasonable steps to satisfy himself that his transaction was not connected with fraud."

33. In paragraph 28 HMRC said:

"In fact there appears to be little of substance between the parties on this point: it is agreed that something more than (by definition unwitting) "negligence" is required; it is further agreed that the nature of the (minimum) conduct required is instead akin to recklessness...."

34. This formulation was repeated in paragraph 13 of HMRC's written closing at the conclusion of the hearing. Paragraphs 36 to 59 of that document dealt with both what Olympia knew and also what it should have known. The conclusion advanced in paragraph 59 was that given Olympia's actual knowledge it should have known that its transactions were almost certain to be connected with fraud and:

"Further or alternatively, given its actual knowledge of its own business, Olympia should have taken certain further reasonable steps to investigate its deal chains. If it had done so, it would have discovered that its transactions were almost certain (alternatively more likely than not) to be connected with fraud. Therefore Olympia had the knowledge or means of knowledge and its appeals in relation to the 15 "straight" MTIC deals must fail."

35. So far as the contra-trading was concerned, HMRC dealt with this in paragraphs 60 to 68. They made it clear in paragraph 60 (d) that they alleged that Topnotch (the alleged contra-trader) "knew that VAT was likely to be withheld and contrived to offset input tax with an ostensibly "clean" chain via Olympia." Having set out certain factual allegations HMRC stated (§ 66):

"From all the above Olympia should have been put on inquiry and checked properly the bona fides of Topnotch ...thus declining to do the deals... Further and in any event Olympia – from its knowledge of the market and the fraud in it – should have

suspected that it was being used and that it was more likely than not that such a lucrative deal that had apparently "fallen into its lap" was too good to be true and thus connected with MTIC fraud."

36. It seems to me that HMRC clearly based their case on the second limb of *Kittel*. That the Tribunal also took the same view is apparent from their description of the issue in the appeal (§ 2):

"The decisions appealed against are to the effect that the Appellant ought to have known it was involved in MTIC [Missing Trader Intra-Community (fraud)] transactions. The issue in this appeal is whether those decisions are correct."

37. In addition, the Tribunal recorded Mr Beal's understanding of HMRC's case as follows (§ 8):

"Mr Beal characterised Mr Moser's case as involving the following syllogism:

(1) The wholesale market in mobile phones in the UK is beset by fraud;

(2) The Appellant knew that (1) was the case;

(3) The Appellant knew that it had to take certain reasonable steps to avoid becoming unwittingly caught up in fraud;

(4) The Appellant either failed to take reasonable steps, or failed to take heed of the results arising from the reasonable steps it did take;

(5) The Appellant accordingly ought to have known that its transactions were part of a fraud."

38. It is clear from this summary that the case was put on the basis that Olympia "ought to have known" of the fraud.

39. I conclude that HMRC are not precluded from advancing their grounds of appeal by the way in which the case was presented below.

The principle in *Kittel*

The European cases

40. The scope of the principle in *Kittel* depends on a series of cases in the ECJ. Discerning shifts of emphasis in successive decisions of the ECJ sometimes resembles the finer points of Kremlinology at the height of the Cold War; and the subject of VAT is no exception.
41. HMRC (and no doubt other national taxing authorities) have long been concerned to combat fraudulent evasion of VAT. Thus Belgium introduced powers to withhold refundable amounts of VAT where there were grounds for suspecting tax evasion. The legality of these powers was challenged in *Garage Molenheide BVBA v Belgium* [1998] STC 126. For present purposes, the important statement by the ECJ was that the principle of proportionality applies to measures adopted to combat VAT fraud and that (§ 52):

"It must therefore be held that an irrebuttable presumption, as opposed to an ordinary presumption, would go further than is necessary in order to ensure effective recovery and would be contrary to the principle of proportionality in that it would not enable the

taxable person to adduce evidence in rebuttal for consideration by the judge hearing attachment proceedings."

42. As the House of Lords European Union Committee pointed out in its report on "Stopping the Carousel" (House of Lords Paper 101), MTIC fraud occurs because of a fundamental flaw in the VAT system, which is that since the seller of an item is collecting the tax on behalf of the taxing authority there is an additional link in the chain which makes fraudulent evasion easier.
43. HMRC's first line of attack on the general problem of MTIC fraud was the argument that transactions in a chain involving MTIC fraud were not genuine economic activities at all, because their purpose was not to release goods onto the market for consumption but to misappropriate VAT. Thus there was no basis for the recovery of VAT. This argument was considered and rejected by the ECJ in *Optigen Ltd v Customs and Excise Commissioners* [\[2006\] STC 419](#). Optigen was in the position of the broker at the end of a dirty chain. The series of transactions in which it was involved were a carousel fraud, but the assumed facts were that Optigen was an innocent buyer of the goods who had no knowledge or reason to have knowledge of a defaulter at an earlier link in the chain. A conjoined appeal, that of Bond House, also involved MTIC fraud and the assumed facts were that Bond House did not know of the fraud and did not act recklessly. The ECJ held that each transaction in the chain had to be examined on its own merits and that a transaction that was not itself vitiated by VAT fraud constituted a supply of goods or services effected by a taxable person acting as such and an economic activity:

"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." (§ 51)

"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." (§ 52)

44. It was this decision that introduced the phrase "no knowledge or means of knowledge". It is HMRC's belief that by concentrating attention on each individual transaction in a chain rather than on the totality of the chain the ECJ gave, if not the green light, then at least the flashing amber light to MTIC fraud, which increased in prevalence thereafter.
45. As noted, the Sixth Directive authorised Member States to introduce certain measures to combat VAT evasion. The UK introduced section 77A of the VATA which imposes joint and several liability for VAT in certain cases. The applicable mental state for the application of section 77A is that the taxable person to whom goods had been supplied "knew or had reasonable grounds to suspect" that some or all of the VAT payable in respect of that supply, or on any previous or subsequent supply of those goods, would go unpaid. Section 77A also introduced a rebuttable presumption that a person had reasonable grounds to suspect if (among other things) the price of the goods was below market value. The legality of section 77A was challenged by the Federation of Technological Industries; and that challenge was considered by the ECJ in *Customs and Excise Commissioners v Federation of Technological Industries* [\[2006\] STC 1483](#) ("*FTI*"). The Advocate General (Poiares Maduro A-G) delivered an opinion in which he said:

"27. In my opinion, Member States may, under the Sixth Directive, hold a person liable for payment of VAT when, at the time he effected the transaction, he knew or

reasonably ought to have known that VAT would go unpaid in the supply chain. In this respect, the national tax authorities may rely on presumptions of such knowledge. Nevertheless, those presumptions must not de facto bring about a system of strict liability.

28. It follows that presumptions of VAT fraud must arise from circumstances, indicative of VAT fraud, of which traders may reasonably be expected to have acquired knowledge. Member states may impose a duty on traders to be vigilant and to inform themselves as to the background of the goods in which they are trading. However, this duty must not place too heavy a burden on traders who take the necessary precautions to ensure that they are trading in good faith.

29. In addition, the presumptions must be rebuttable, without demanding evidence of facts that are excessively difficult for traders to ascertain."

30. If these requirements are not fulfilled, the application of presumptions would effectively undermine the imperative that a person can only be held liable for payment of VAT when he knew or reasonably ought to have known that VAT would go unpaid. That would be tantamount to introducing strict liability through the backdoor."

46. The ECJ agreed with the Advocate General. As they put it (§ 32):

"While art 21(3) of the Sixth Directive allows a Member State to make a person jointly and severally liable for the payment of VAT if, at the time of the supply, that person knew or had reasonable grounds to suspect that the VAT payable in respect of that supply, or of any previous or subsequent supply, would go unpaid, and to rely on presumptions in that regard, it is none the less true that such presumptions may not be formulated in such a way as to make it practically impossible or excessively difficult for the taxable person to rebut them with evidence to the contrary. As the Advocate General observed in para 27 of his opinion, those presumptions would, de facto, bring about a system of strict liability, going beyond what is necessary to preserve the public exchequer's rights."

47. They added (§ 33):

"Traders who take every precaution which could reasonably be required of them to ensure that their transactions do not form part of a chain which includes a transaction vitiated by VAT fraud must be able to rely on the legality of those transactions without the risk of being made jointly and severally liable to pay the VAT due from another taxable person (see, to that effect, *Optigen Ltd v Customs and Excise Comrs* (Joined cases C-354/03, C-355/03 and C-484/03) [\[2006\] STC 419](#), [\[2006\] 2 WLR 456](#), para 52)."

48. There are a number of points which I should make about this paragraph. First, it is plainly dealing with traders who do not actually know that a transaction in the chain is vitiated by VAT fraud. It is therefore concerned, not with knowledge, but with means of knowledge. Second, the notion of "reasonable precautions" does not appear in the paragraph of *Optigen* to which the ECJ referred. Accordingly, in my judgment it is a fair inference that in deciding whether a person had the "means of knowledge" of VAT fraud, the ECJ was saying that a trader who took all reasonable precautions and did not discover the fraud was to be equated with a person who did not have the means of knowledge. Third, the reasonable precautions to which the ECJ referred were not limited to enquiries of the taxable person's immediate counterparties, because of the express reference to a "chain" of transactions. Fourth, the precautions to which the ECJ were referring were precautions to ensure that the chain in which the trader found himself did not include a transaction which was vitiated by fraud. They said nothing about investigating the legality of some different chain. Fifth, it is necessarily implicit in this paragraph that, having taken the precautions, the trader did not realise

that his transaction was part of a chain which included a transaction vitiated by VAT fraud. Sixth, the ECJ were not dealing with the case of a person who had not taken all reasonable precautions. It would be reading too much into the judgment to interpret it as saying that a person who had not taken all reasonable precautions was automatically unable to rely on the legality of his own transactions. Indeed to read this into the judgment would conflict with the court's rejection of irrebuttable presumptions. But the court did uphold legislation imposing liability not only on the dishonest trader, but also on the honest trader who had no more than reasonable grounds for suspicion. It is also notable that Poiares Maduro A-G described the "imperative" (§ 30) as being that a person could be held liable for VAT if he knew "or reasonably ought to have known" that VAT would go unpaid.

49. A few months later the ECJ delivered its decision in *Kittel v Belgium* [2008] STC 1537. This was one of two conjoined references. In the first of the references (*Kittel*) a company called Computime was knowingly part of a carousel fraud (§ 10). In the second reference (*Recolta*) a Mr Alliaud sold cars to Recolta which in turn sold them to Auto Mail for export. In fact the cars never were exported. Mr Alliaud and Auto Mail were co-conspirators in a VAT fraud. However, the national court found that there was nothing to suggest that Recolta "knew or had any suspicion that they were involved in a major fraud scheme" (§ 17). The national taxing authorities refused repayment of VAT in both cases, relying on a provision of the Belgian Civil Code which provided that an obligation with no basis or with a false or unlawful basis can give rise to no effect whatsoever.

50. The ECJ began by reformulating the questions that it was asked to decide. The questions that it posed itself were:

"whether, where a recipient of a supply of goods is a taxable person who did not and could not know that the transaction concerned was part of a fraud committed by the seller, art 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 the contract incurably void as contrary to public policy for unlawful basis of the contract attributable to the seller, causes that taxable person to lose his right to deduct that tax...

whether the answer to that question is different where the contract is incurably void for fraudulent evasion of VAT...

whether the answer to that question is different where the taxable person knew or should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of VAT."

51. In considering its answers to those questions, the ECJ referred to its previous decisions in *Optigen*, and in particular to paragraphs 51 and 52 (already quoted in § 43), and continued:

"51. In the light of the foregoing, it is apparent that 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 (see, to that effect, *Customs and Excise Comrs v Federation of Technological Industries* (Case C-384/04) [2006] STC 1483, para 33).

52. It follows 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, art 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.

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 *Halifax plc v Customs and Excise Comrs* (Case C-255/02) [\[2006\] STC 919](#), [\[2006\] Ch 387](#), para 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 *Gemeente Leusden v Staatssecretaris van Financiën* (Cases C-487/01 and C-7/02) [\[2007\] STC 776](#), [\[2004\] ECR I-5337](#), para 76). Community law cannot be relied on for abusive or fraudulent ends (see, inter alia, *Kefalas v Greece and OAE* (Case C-367/96) [\[1998\] ECR I-2843](#), para 20; Case *Diamantis v Greece* (Case C-373/97) [\[2000\] ECR I-1705](#), para 33; and *I/S Fini H v Skatteministeriet* (Case C-32/03) [\[2005\] STC 903](#), [\[2005\] ECR I-1599](#), para 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, *Rompelman v Minister van Financiën* (Case 268/83) [\[1985\] ECR 655](#), para 24; *Intercommunale voor Zeewaterontziltling (in liquidation) v Belgium* (Case C-110/94) [\[1996\] STC 569](#), [\[1996\] ECR I-857](#), para 24; and *Gabalfrisa* (para 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* (para 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, art 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."
52. Paragraph 51 refers to paragraph 33 of the Court's judgment in *FTI*. However, there are differences between the referenced paragraph in *FTI* and the reformulation in *Kittel*. First, whereas *FTI* referred to taking precautions to ensure that the taxpayer's transaction was not part "of a chain which includes a transaction vitiated by VAT fraud", this paragraph of *Kittel* broadens the language to say that
- i) The precautions are precautions to ensure that their transactions are not connected with fraud (i.e. the fraud is not necessarily restricted to the particular chain in which the taxpayer finds himself); and
 - ii) The fraud can be the fraudulent evasion of VAT or other fraud (i.e. the fraud is not limited to VAT fraud).
53. I will come back to the phrase "connected with" fraud. However, the Court does not, in this paragraph, spell out the consequences of failing to take the precautions which it described. Nor does it explain the rationale for the reformulation. But it seems probable that the reference to "other fraud" was prompted by the particular form of Belgian domestic law that was under challenge and in subsequent cases reformulations of the test by the ECJ have not included this part of *Kittel*.
54. Paragraph 52 takes as its assumption a person who did not and could not know that the transaction concerned was connected with a fraud committed by the seller. There are two points to be made at this stage. First, this paragraph is not considering the case of a person who did not know but could have known. Second, the fraud under consideration is fraud committed by the seller and not a fraud committed by someone more remote in a chain of transactions. There is, as it seems to me, a tension between this narrower consideration of fraud and the broader description of the precautions in the immediately preceding paragraph. There is also a tension between this formulation (which refers to a fraud committed by the seller) and the broader description of the fraud in paragraph 33 of *FTI*. It seems probable that this was because of the facts of the particular cases under consideration. Paragraph 52 is also concentrating on the validity of a rule of national law, specifically the Belgian Civil Code. That is why the last sentence of the paragraph says that it is irrelevant whether the reason why the contract is invalid is the existence of VAT fraud or "other fraud".
55. Paragraph 53 is the immediate contrast with the situation envisaged by paragraph 52. That is the case where the tax is evaded by the taxable person *himself*. Again this paragraph is not concerned with a person who is not himself evading tax, but where the tax has been or will be evaded by someone else in a chain of transactions. Paragraph 54 seems to me to be the justification for paragraph 53, namely that community rights (including the right to deduct VAT) cannot be relied on for abusive or fraudulent ends.
56. When the court embarks on paragraph 55 it is amplifying paragraph 54. The only case mentioned is where the right to deduct is exercised fraudulently. A fraudulent exercise of the right to deduct would most naturally be the fraud of the person claiming to exercise that right. That was the situation that the ECJ were considering in the previous cases referred to in paragraph 55.
57. Paragraphs 56 and 57 are the nub of the decision on which HMRC particularly rely. As noted, *Kittel* was a reference from Belgium and the language of the case was French. The French version of these paragraphs reads:

"56 De même, un assujetti qui savait ou aurait dû savoir que, par son acquisition, il participait à une opération impliquée dans une fraude à la TVA, doit, pour les besoins de la sixième directive, être considéré comme participant à cette fraude, et ceci indépendamment de la question de savoir s'il tire ou non un bénéfice de la revente des biens.

57 En effet, dans une telle situation, l'assujetti prête la main aux auteurs de la fraude et devient complice de celle-ci."

58. There are points at which the translation from the French may communicate different nuances from the French text itself:

i) Whereas the English translation speaks of a transaction "connected with" fraudulent evasion of VAT the French text speaks of an operation "impliquée dans" a VAT fraud. This is true both of paragraph 56 and also of paragraph 51. The word "impliquée" may suggest rather closer involvement than the more general "connected with".

ii) Paragraph 57 in the French text begins with the words "En effet". The English translation, "That is because", is a possible translation of the French phrase, but it is one that emphasises the theoretical rather than the practical link between paragraph 56 and paragraph 57. Other translations might have been "In effect" or "In fact" or "Indeed" which would have emphasised the practical link.

iii) The French "prête la main" suggests a more active help than the more neutral "aids" in the English translation.

iv) Whereas the English translation speaks of the taxpayer becoming "their accomplice" (i.e. the fraudsters' accomplice) the French text ends with the phrase "complice de celle-ci", where "celle-ci" must refer back to "la fraude". In other words according to the French text the taxpayer is complicit in the fraud itself.

59. The ECJ then summarised its conclusions in paragraph 59 which, in the French text, reads:

"Dès lors, il appartient à la juridiction nationale de refuser le bénéfice du droit à déduction s'il est établi, au vu des éléments objectifs, que l'assujetti savait ou aurait dû savoir que, par son acquisition, il participait à une opération impliquée dans une fraude à la TVA et ceci même si l'opération en cause satisfait aux critères objectifs sur lesquels sont fondées les notions de livraisons de biens effectuées par un assujetti agissant en tant que tel et d'activité économique."

60. The key additional phrase here, which did not appear in paragraphs 55 or 56, is "au vu des éléments objectifs". This is translated as "having regard to objective factors". The word "factors" is a possible translation of "éléments", but it could also be rendered as "facts". Indeed in paragraph 55, where the same word appears, it is rendered as "evidence".

61. Overall, it is arguable that these nuances in the English translation convey the impression of a rather less intimate involvement in the fraud than the French text seems to require. However this was not fully argued, so I proceed on the basis that the translation is accurate.

62. Nevertheless, *Kittel* is not the last word on the subject. In *R (on the application of Teleos plc and others) v Revenue and Customs Commissioners* [2008] STC 706 ("*Teleos*") Teleos sold mobile telephones to a Spanish company on an ex works basis. According to the sales contracts, the destination of the goods was France or, in certain cases, Spain. The ex works nature of the contracts meant that the claimants were required by the contract only to place the goods at the customer's disposal at a

bonded warehouse in the United Kingdom. The customer was responsible for arranging the transport of the goods to their destination. For each transaction, the relevant claimants received from the customer, a few days after the sale, the stamped and original of the consignment note issued under the Convention on the Contract for the International Carriage of Goods by Road. Initially, HMRC accepted the CMR consignment notes as evidence that the goods had been exported from the United Kingdom, so that those supplies were exempt from VAT. Subsequently, however, HMRC discovered that the consignment notes were false and that the goods had not been exported. They claimed to recover VAT from Teleos. The underlying facts were that Teleos had no reason to doubt the authenticity or veracity of the consignment notes, they were not party to any fraud and were unaware that the goods had not left the United Kingdom. One of the questions referred to the ECJ was whether HMRC were entitled to recover VAT in those circumstances.

63. The Advocate-General (Kokott A-G) said:

"75. Certainly the supplier is under an obligation to do all in his power to ensure that the intra-Community supply is properly carried out. If, by contract, he leaves the transport of the goods to another Member State to the acquirer, he must—as stated in the explanations accompanying the first question—in certain circumstances bear the consequences of non-performance of that obligation by the acquirer.

76. The seller must also satisfy himself of the seriousness of his business partner. The objective of preventing tax evasion justifies heavy requirements being involved in fulfilling that obligation. It is for the national court to decide whether the supplier has fulfilled it. According to the information which it has supplied in the reference, it appears that Teleos and others exhausted all the possibilities at their disposal in scrutinising TT.

77. It would, on the other hand, be excessive to go so far as to hold the supplier liable for criminal conduct of his business partner, against which he cannot protect himself."

64. The footnote to the quoted sentence in paragraph 77 of the Advocate-General's opinion reads:

"The idea that, in the levying of VAT, a careful and honest taxable person should not have to assume liability for the fraudulent conduct of others, is expressed in a series of decisions on carousel frauds (see in particular *Federation of Technological Industries* (para 33), *Optigen* (para 52 et seq), and *Kittel and Ricolta* (para 45 et seq))."

65. The ECJ made the points that, although Member States are entitled to combat fraud, the measures they adopt must not infringe the principles of legal certainty and proportionality and must not undermine the fiscal neutrality of VAT (§§ 45 and 46). The court continued that:

"... it would be contrary to the principle of legal certainty if a Member State which has laid down the conditions for the application of the exemption of intra-Community supplies by prescribing, among other things, a list of the documents to be presented to the competent authorities, and which has accepted, initially, the documents presented by the supplier as evidence establishing entitlement to the exemption, could subsequently require that supplier to account for the VAT on that supply, where it transpires that, because of the purchaser's fraud, of which the supplier had and could have had no knowledge, the goods concerned did not actually leave the territory of the Member State of supply."

66. The UK government argued that:

"the case law according to which it is neither disproportionate nor contrary to the general principles of law which the court is required to uphold to require an importer who has acted in good faith to pay customs duties payable on the importation of goods in respect of which the exporter has committed a customs offence, where the importer has played no part in that offence, is applicable to this case."

67. The ECJ rejected that argument. They made the important point that the intra-community VAT regime involved a division of powers between Member States and allowed the Member States to have recourse both to the supplier and the purchaser to obtain payment of VAT. They said (§ 58):

"Admittedly, the objective of preventing tax evasion sometimes justifies stringent requirements as regards suppliers' obligations. However, any sharing of the risk between the supplier and the tax authorities, following fraud committed by a third party, must be compatible with the principle of proportionality. Furthermore, rather than preventing tax evasion, a regime imposing the entire responsibility for the payment of VAT on suppliers, regardless of whether or not they were involved in the fraud, does not necessarily safeguard the harmonised VAT system from evasion and abuse by purchasers. The latter, were they exempted from all responsibility, could, in effect, be encouraged not to dispatch or not to transport the goods out of the Member State of supply and not to declare the goods for VAT purposes in the envisaged Member States of destination."

68. In this paragraph it seems to me that the ECJ were deciding that a system that imposed the responsibility for payment of VAT on a supplier who was not "involved in the fraud" would offend the principle of proportionality. The phrase "involved in" the fraud suggests a closer link than "connected with". Commenting on *Kittel* (among other cases) the court said (§ 65):

"Moreover, according to the court's settled case law, 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* (para 33) and *Kittel and Recolta Recycling* (para 51))."

69. It is notable that in summarising *FTI* and *Kittel*, described as "settled case law", the ECJ refers to "participation in tax evasion" rather than the looser expression "connected with fraud" which was the phrase actually used in the referenced paragraph of *Kittel*. On the other hand, whereas the referenced paragraphs in *FTI* and *Kittel* refer to a supplier who *had* taken all reasonable precautions, in *Teleos* the court wrote of a *requirement* to take such precautions. It continued (§ 66):

"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."

70. The way that this paragraph is written suggests that the three factors are cumulative rather than alternative. In the light of that discussion the ECJ answered the referred question as follows (§ 68):

"The reply to the third question referred must therefore be that the first subparagraph of art 28c(A)(a) of the Sixth Directive is to be interpreted as precluding the competent authorities of the Member State of supply from requiring a supplier, who acted in good faith and submitted evidence establishing, at first sight, his right to the exemption of an intra-Community supply of goods, subsequently to account for VAT on those goods where that evidence is found to be false, without, however, the

supplier's involvement in the tax evasion being established, provided 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."

71. Again it is notable that the ECJ refers to "involvement in the tax evasion" in the sense of actual and direct involvement; and to precautions to ensure that his transaction did not lead to his "participation" in such evasion. On the other hand it is also notable that the ECJ did not simply say that a supplier who acted in good faith cannot be deprived of the right to deduct: they added the proviso that he must have taken every reasonable measure to ensure that his supply did not lead to his participation in VAT evasion. This underscores the impression given by paragraph 66 that the factors mentioned in that paragraph are cumulative.

72. In *Netto Supermarkt GmbH & Co OHG v Finanzamt Malchin* [\[2008\] STC 3280](#) ("*Netto*") Netto, the supermarket operator, had refunded VAT to customers on presentation of documentation duly stamped by the relevant customs authorities. It later transpired that the documentation had been forged. The question was whether Netto could be assessed to pay the VAT which it had wrongly refunded to its customers. The case was argued on the footing that Netto were unable to recognise that the conditions for exemption from VAT were not met, even by exercising due commercial care. The Advocate-General (Mazák A-G) said:

"45. Viewed against that background, it would to my mind clearly be disproportionate to hold, in circumstances such as those in the main proceedings, a taxable person liable for the shortfall in tax revenues caused by fraudulent acts of third parties. A taxable person can certainly be expected to assume the task attributed to him under the common system of VAT with all due diligence and care and be held responsible for any shortcomings in that regard. But it falls, as regards shortcomings outside the sphere of influence of the taxable person, to the Member State to ensure—in the interest of the public purse—the overall functioning of the system and to prevent any evasion, avoidance or abuse. The corresponding risks should therefore also be borne by the Member State.

46. That view is supported by a number of decisions of the court, from which—in spite of certain differences regarding the factual circumstances—it appears clearly that a taxable person acting in good faith, that is, more particularly, on condition that he had no part in the irregularities and took every precaution reasonably required, should not have to assume liability for the fraudulent conduct of others."

73. He referred to *Optigen* and *Kittel* and continued:

"49. A supplier such as the one at issue in the main proceedings, who is, as the referring court established, unable even by exercising due commercial care, to recognise that the conditions for exemption were in reality not met, certainly meets the standards of acting in good faith and of diligence as envisaged by the above-mentioned case law. It may be added in that regard that it appears from the order for reference that even the customs authorities contacted by Netto Supermarkt were unable, without more, to see at first sight that the documents produced were falsified."

74. The ECJ agreed with the Advocate General, and in particular with paragraph 45 of his opinion. It said (§ 23):

"As the Advocate General has pointed out in para 45 of his opinion, 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.

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* (para 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* (para 66))."

75. It is striking that although the Advocate General referred in his opinion to *Kittel*, the ECJ did not refer to it at all, but cited the explanation or reformulation of *Kittel* found in *Teleos*.

76. I would summarise the current state of the jurisprudence of the ECJ on this subject as follows:

i) The objective of preventing evasion of VAT is an objective encouraged by the Sixth Directive (*Kittel* § 54);

ii) This objective precludes the recovery of input tax where the tax is evaded by the taxable person himself (*Kittel* § 53). In such cases where the right to deduct has been exercised fraudulently the deduction may be retrospectively disallowed (*Kittel* § 55);

iii) This objective sometimes justifies stringent requirements as regards suppliers' obligations, but any sharing of risk must be compatible with the principle of proportionality (*Teleos* § 58);

iv) It is disproportionate and contrary to Community law to require a person who is a careful and honest trader to assume liability for the frauds of others (*Teleos A-G's* opinion § 77, footnote);

v) It is also disproportionate to hold a taxable person liable for fraudulent acts of third parties over whom he has no influence (*Netto* § 23):

vi) A trader who does take every precaution that could reasonably be required of him, and does not realise that he is participating in VAT fraud must be entitled to rely on the legality of his own transaction (*FTI* § 33);

vii) A person who knew or should have known that by his purchase he was taking part in a transaction connected with the fraudulent evasion of VAT is to be treated in the same way as a person who fraudulently exercises the right to deduct (*Kittel* §§ 55, 56);

viii) It is not contrary to Community law to require a supplier to take every step that could reasonably be required of him to satisfy himself that the transaction which he is effecting does not result in his participant in tax evasion (*Teleos* § 65; *Netto* § 24);

ix) Likewise a taxable person can be expected to act with all due diligence and care (*Netto A-G's* opinion § 45);

x) Whether a taxable person knew or should have known that he was participating in a transaction connected with the fraudulent evasion of VAT must be determined having regard to objective facts or factors (*Kittel* § 59);

xi) Community law does not prohibit presumptions, but presumptions must be rebuttable by evidence (*Garage Molenheide* § 52; *FTI* § 32).

Domestic case-law

77. There are a number of domestic cases that have considered *Kittel*. The most important of these is *R (on the application of Just Fabulous (UK) Ltd) v Revenue and Customs Commissioners* [2008] STC 2123, a decision of Burton J. In considering that decision it is critical to appreciate that it was decided on assumed facts. The judge described the assumed facts as follows (my comments are in square brackets):

"The case that must be assumed is that Blackstar [the broker] is dishonestly involved in the defaulter chain [i.e. the dirty chain] and knows that, if it puts forward a VAT return to the Revenue claiming back its input tax in respect of the mobile phones which have gone round the defaulter chain, it will not receive that money because the Revenue will refuse to pay. Hence, it is to be assumed, it persuades Evolution [the contra-trader] to enter knowingly into and/or to execute a 'contra-trading' transaction in respect of cameras which will be or are being imported. Evolution must be assumed to know of, and thus participate in, Blackstar's dishonest purpose. In this regard, it would not matter whether Evolution is already intending to acquire cameras by import and is prepared to use that transaction for the dishonest set off, or whether the import of the cameras is constructed solely for the purpose of establishing the transaction. Evolution then knowingly agrees to buy the cameras from or through Blackstar, pays Blackstar VAT which thus allows Blackstar dishonestly to recover off-set VAT which it would not have received direct from the Revenue, and then claims back what it has paid to Blackstar in its own VAT return on exporting the cameras. The contra-trading chain is likely to be relatively short. Indeed Brayfal, for example, in the March 2006 accounting period purchased stock from only one supplier, Future, and sold to only one customer, in Austria."

78. Thus the assumed facts were that two dishonest traders entered into a conspiracy to defraud the revenue. In the way that juries are directed in the case of joint enterprise, "they were in it together". On the basis of those assumed facts, the question for decision was whether the *Kittel* test was capable of applying to contra-trading, or whether it was restricted to a "dirty" chain alone. The judge described the rival arguments and the issue (§ 24):

"On the basis of the assumed facts, whether or not Evolution knew of the precise nature of the defaulter chain or of the goods purportedly dealt with in that chain or the identities of the participants in that chain, Evolution knew of the fraudulent aim of Blackstar in acquiring, through the off-set on the contra-trading transaction, the opportunity to receive, by such off-set, VAT which it would not be able to recover direct from the Revenue. The Revenue asserts, relying on *Kittel*, that it is entitled to refuse the input tax when Evolution exports the cameras it has acquired from Blackstar, and enters into its return, as input tax, the VAT it has paid to Blackstar. The claimants' case is that *Kittel* only legitimises a refusal by the Revenue to pay VAT due in respect of the *goods* the subject matter of the *defaulter chain*. That is the issue which I am asked to decide." (Emphasis in original)

79. Mr Anderson QC appearing then (as now) for HMRC submitted that:

"The words which record these definitive statements [in paragraphs 55, 56 and 61 of *Kittel*] are untrammelled by any reference to the need for establishing that the taxable person must be a member of a defaulter chain, or that he must be dealing in the same goods as had been the subject of a defaulter chain. The only such references in the judgment are for the purpose of differentiating the result in relation to *Kittel* from that with regard to *Recolta*, where the taxable person was innocent but was said to be rendered liable to sanctions by the Revenue because of his participation in the defaulter chain in relation to the same goods."

80. He went on to find that:

"In those circumstances there is no question of any need for an extension, but the Revenue is inviting me here simply to follow the European Court in *Kittel*. If however it is necessary to extend *Kittel*, by applying those principles for the first time in relation to a participant in a contra-trade chain deliberately assisting in the fraudulent recovery of VAT reclaimed at the end of the defaulter chain, then Mr Anderson submits that such is a natural and inevitable extension."

81. Burton J said that he was "wholly persuaded" by these submissions. I respectfully agree that HMRC are plainly entitled to refuse to repay a reclaim of input tax made by a dishonest co-conspirator.

82. But on the basis of the Tribunals' findings, I am not concerned with dishonest co-conspirators. Earlier in his judgment Burton J presciently said (§ 29):

"Further, there are bound to be evidential difficulties with regard to precisely what needs to be proved in respect of what might be loosely described as *mens rea*—'knew or should have known' (see *Kittel* [2008] STC 1537, [2006] ECR I-6161, para 56 of the judgment), as contrasted with having 'no knowledge and no means of knowledge' (see *Bond House* [2006] STC 419, [2006] Ch 218, para 46 of the judgment)—and the extent to which such *mens rea* must be proved."

83. He returned to this question at the end of his judgment, saying (§ 55):

"The assumed facts, upon which I have been satisfied, put the case at the highest against these claimants; but of course there may well be gradations of knowledge which would need to be considered by the tribunal ..."

Discussion

84. Both Mr Scorey (for Livewire) and Mr Beal (for Olympia) submitted that the ECJ was laying down a test of dishonesty. They buttressed this submission by reference to the principle of equivalence, and submitted that the nearest equivalent domestic concept was that of dishonest assistance in a breach of trust, for which dishonesty is a necessary condition. This was not a question that arose in *Just Fabulous*, because on the assumed facts the taxable persons were dishonest. In addition they submitted that the right to deduct was an essential part of the VAT scheme and that any restriction on that right was a derogation that must be strictly applied.

85. I do not accept these submissions. First, the very nature of the fraud under consideration is an intra-community fraud (i.e. it is a fraud in which the crossing of national frontiers is inextricably involved). It is very unlikely that the ECJ was laying down a principle that might be differently applied in different Member States to the same chain of transactions. Second, it seems to me that the ECJ was at pains to stress that the test was not one of dishonesty. This comes out most clearly from the ECJ's answer to the question posed in *Teleos*, where good faith is not enough on its own (§ 68). The supplier must, in addition to being of good faith, have taken every reasonable measure to ensure that his supply was not participating in VAT evasion. But it is also evident from the court's statement that a Member State may lawfully impose a requirement on suppliers to take all reasonable precautions in order to preserve their right to deduct (*Teleos* § 65). A requirement to take all reasonable precautions (or to act with all due diligence *and care* (*Netto* A-G § 45)) is incompatible with a simple test of dishonesty. The policy is that an honest *and careful* trader should not be liable for the frauds of others (*Teleos* A-G § 77 fn). In addition, it seems to me that the proposition that whether a person knew or should have known is to be tested by objective facts or factors (*Kittel* § 59) is also inconsistent with a simple test of dishonesty. Moreover, if dishonesty were the only test, it is difficult to see why the court in *Kittel* would have thought that their interpretation would make it more difficult to carry out fraudulent transactions (*Kittel* § 58). Third, the objective of preventing

VAT evasion is positively encouraged by the Sixth Directive, and consequently measures taken in that respect are not a derogation. As Burton J put it in *Just Fabulous* (§ 45):

"The principle of legal certainty must be trumped by the 'objective recognised and encouraged by the Sixth Directive'."

86. In so far as a domestic analogy is appropriate, I agree with Mr Anderson that the appropriate analogy is that of constructive knowledge or constructive notice. This was described by Denning J in *Nelson v Larholt* [1948] 1 KB 339, 343 as follows:

"He must, I think, be taken to have known what a reasonable man would have known. If, therefore, he knew or is to be taken to have known of the want of authority, as, for instance, if the circumstances were such as to put a reasonable man on inquiry, and he made none, or if he was put off by an answer that would not have satisfied a reasonable man, or, in other words, if he was negligent in not perceiving the want of authority, then he is taken to have notice of it."

87. The taking of every reasonable precaution has sometimes been referred to as a "positive duty". This is, I think, potentially misleading. The taxable person does not owe a "duty" to take precautions (unless it is a duty to himself). The taking of all reasonable precautions (and acting on the basis of what he discovers as a result of taking those precautions) provides him with an impenetrable shield against any attack by HMRC. The taking of every reasonable proportion is only a "duty" in the sense that the so-called "duty to mitigate" is a duty applicable to the recovery of damages.

88. At one stage, by reference to this supposed "duty", Mr Anderson seemed to me to be submitting that if a taxable person failed to take every precaution that could reasonably be expected, he would automatically be deemed to be a participant in fraud and would forfeit his right to deduct input tax. This, he said, followed from the phraseology in paragraph 56 of *Kittel* ("a person ... *must* be regarded as a participant in the fraud"). However, as noted, an irrebuttable presumption imposing liability to VAT would fall foul of the principle of proportionality. In my judgment (as I think Mr Anderson in the end accepted) if a taxable person has not taken every precaution that could reasonably be expected of him, he will still not forfeit his right to deduct input tax in a case where he would not have discovered the connection with fraud even if he had taken those precautions.

Identifying the fraud and the connection with fraud

89. 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.
90. The *Kittel* test, even in its original form, requires that the taxable person "knew or should have known" something. It is therefore necessary to identify what it is that he knew or should have known.
91. In cases (such as the present) where the taxable person is not a co-conspirator in an overall scheme to defraud the revenue by the fraudulent evasion of VAT it is, I think, necessary to identify the fraud with which the taxable person's transaction is alleged to be connected, and of which he should have known. Mr Anderson asserted several times that the fraud in question was a fraud to defraud the revenue through a series of transactions designed to extract money from the Exchequer by means of defaulting chains and contra-trading. The contra-trading deals, he said, were designed to displace claims for repayment of input tax. The ultimate intra-community export of

goods was critical in order to extract money from the Exchequer, which was the purpose of the whole scheme. That, he said was the fraud. Assuming, for the moment, that the trader who makes his claim for repayment of input tax is not himself a dishonest co-conspirator, I had difficulty in understanding how this differed from saying that the fraud was the fraud of the missing trader in the dirty chain. The honest trader knows that he has bought goods on which he has paid VAT. He knows that he will export those goods and reclaim the VAT from HMRC. Unless there is a missing trader somewhere further down the chain (or in a parallel chain) there is no fraud. I accept that the honest trader need not know the identity of the missing trader but unless he knows or should have known that there was (or was likely to be) a missing trader somewhere in the dirty chain, I do not see how it can be said that he knew or should have known that his transaction was connected with fraud. In fact, in the case of a "straight" MTIC fraud the missing trader will always be the importer of the goods, so his position in the chain (if not his identity) will be a fact which can be known. Mr Anderson referred several times to facts alleged to be indicia of fraud. But, as it seems to me, those indicia are facts or evidence from which a conclusion is (or should be) drawn. They are not the conclusion itself.

92. Mr Anderson also said that a fraud could be committed if there were a series of orchestrated transactions and, as I understood him, in a contra-trading fraud it was an essential ingredient that the transactions were orchestrated. Mr Anderson said that it did not matter that the honest trader did not know who the orchestrator was. That seems to me to be right. But Mr Anderson also said that it was not necessary for the honest trader to know that he was taking part in a series of orchestrated transactions. If the honest trader does not know that his transaction is part of an orchestrated series of transactions, and does not know that there is a defaulter in the dirty chain, I had difficulty in understanding what Mr Anderson said that the honest trader should have known. Mr Anderson simply repeated the statement in *Kittel*, namely that he should have known that his transaction was connected with fraud. But that does not, with respect, answer the question: what is the fact in the real world that the trader should have known?

93. There have been some observations on this subject in the case-law.

94. In *Optigen Poiares Maduro A-G* referred to the Tribunal's description of a carousel fraud and said (§ 8):

"Endless variations on the chain of transactions are imaginable, considerably more complicated than the one described above, and in reality the same goods may be 'sent around' several different chains. *Still, the problem fundamentally remains the same: a trader collects an amount paid to him as VAT but does not account for it to the tax authorities.* The defaulting trader may use a 'hijacked' VAT number or it may register itself for VAT and simply disappear before the tax authorities take action." (emphasis added)

95. In *FTI* the same Advocate-General said (§ 9):

"A company ('B') established in the United Kingdom, buys goods from a company ('A') in another Member State. No VAT is due from A in respect of the acquisition, but B is required to account for VAT in respect of its onward sales in the United Kingdom. B sells the goods, usually at a discount, to a third company ('C') also established in the United Kingdom, but fails to account for VAT. C is called a 'buffer company'. It sells the goods to another company in the United Kingdom at a small profit, accounting for VAT on the sale, but reclaiming input VAT. There may be a series of further sales, but eventually the goods reach a company which sells them to a VAT registered trader in another Member State. This sale is exempt from VAT, but the seller is entitled to recover input tax and accordingly seeks to recover from the Commissioners the VAT which it paid on its purchase of the goods from the last buffer company. If such repayment is made, the Commissioners pay to this company the VAT charged on the

sale by the last buffer company and yet do not receive the amount charged as VAT by B. The hallmark of a true carousel fraud is that the goods are ultimately sold back to the original seller, company A. The cycle can then start again. *On each circuit of the carousel the amount paid as VAT to B is extracted from the public revenue.*" (Emphasis added)

96. Thus what is extracted from the public revenue is not the repayment of VAT at the end of the chain, but the VAT for which the defaulter should have accounted but did not. In the same case he described:

"the imperative that a person can only be held liable for payment of VAT when he knew or reasonably ought to have known *that VAT would go unpaid.*" (Emphasis added)

97. In *Kittel* itself Ruiz-Jarabo Colomer A-G agreed with this. He said (§ 35):

"In reality, the methods used are as fanciful and complicated as the imaginations of the people who think them up. I therefore agree with Advocate General Poiares Maduro who, in para 8 of his opinion in *Optigen* [\[2006\] STC 419](#), finds that in every case the bottom line is that an amount received in respect of VAT is not declared."

98. Likewise in *Just Fabulous* Burton J said of an MTIC carousel fraud (§ 7):

"The fraud is plainly committed, if the participants in such chain are dishonest, at the stage of the *missing trader*, although the loss may not crystallise until the Revenue has to pay out in full in respect of the return filed by the exporter." (Emphasis in original)

99. All these observations were directed to "straight" MTIC frauds rather than a contra-trading fraud. In the case of a "straight" MTIC fraud it seems to me that a taxable person who is not himself a dishonest co-conspirator will not be deprived of his right to reclaim payment of input tax unless he knew or should have known of a connection between his own transaction and the fraud of the missing trader.

100. Burton J considered a contra-trading fraud later in his judgment. He said (§ 52):

"... on the assumed facts ... Evolution is 'a taxable person who knew ... that by his purchase, he was taking part in a transaction connected with fraudulent evasion of VAT'. In those circumstances, I am satisfied that the Revenue would have the right to refuse to pay the input claimed, and my concluded view is the same as was the untutored response of Charles J in *Megantic*: and the same as the provisional view of Mr Bishopp in *Calltell* (see [\[2007\] UKVAT V20266](#), para 18) that:

'18. ... if the Respondents can show that the transactions were what they claim them to be ... they have at least an arguable case that a trader who, knowingly or with means of knowledge, engages in conduct designed to conceal, or avoid the consequences of discovery of, a fraud should be in no better position than the perpetrator of the fraud.'

101. In the case of contra-trading, therefore, the fraudulent conduct extends to conduct "designed" to conceal or avoid the discovery of a fraud. In other words the cover up is part of an overarching scheme, and is part of an overall fraud. But whether this is a correct description of the overall fraud depends on the facts. Underlying Mr Anderson's description of the fraud is the *assumption* that there is an overarching scheme. But whether there is such a scheme is for the Tribunal to decide. Mr Anderson's formulation assumes that which it is necessary for HMRC to prove.

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. As Millett J put it in *Agip (Africa) Ltd v Jackson* [1990] Ch. 265, 295 (in the context of dishonest assistance in a breach of trust):

"In my judgment, however, it is no answer for a man charged with having knowingly assisted in a fraudulent and dishonest scheme to say that he thought that it was "only" a breach of exchange control or "only" a case of tax evasion. It is not necessary that he should have been aware of the precise nature of the fraud or even of the identity of its victim. A man who consciously assists others by making arrangements which he knows are calculated to conceal what is happening from a third party, takes the risk that they are part of a fraud practised on that party."

104. This conclusion is, I think, consistent with what Burton J said in *Just Fabulous* (§ 24):

"*whether or not* Evolution knew of the precise nature of the defaulter chain or of the goods purportedly dealt with in that chain or the identities of the participants in that chain, Evolution *knew of the fraudulent aim of Blackstar* in acquiring, through the off-set on the contra-trading transaction, the opportunity to receive, by such off-set, VAT which it would not be able to recover direct from the Revenue." (Emphasis added)

105. In other words, if the taxable person knew of the fraudulent purpose of the contra-trader, whether he had knowledge of the dirty chain does not matter.

106. However, if the contra-trader is not himself dishonest, then there will only have been one fraud, namely the dishonest failure to account for VAT by the defaulter in the dirty chain. In that situation, the taxable person will not, in my judgment, be deprived of his right to reclaim input tax unless he knew or should have known of that fraud. But if the taxable person knew or ought to have known of that fraud, then he will be deprived of his right to reclaim input tax, even if the contra-trader is wholly innocent (as, for instance, where the missing trader and the taxable person between them dishonestly orchestrate a sale to and purchase from an innocent intermediary, which appears to have happened in *Recolta*).

107. As the Tribunal pointed out in *Livewire* 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. They noted (§ 6) that the problem in real life is that there is no logical connection between the clean and dirty chains. As Mr Scorey 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. The Tribunal went on to say (§ 11):

"... conceptually there is therefore a problem in understanding what is the fraud about which the Appellant is said to know or ought to have known. If it be the case that Sygnet and Uni-Brand are involved in a fraud in the sense of helping to cover up the missing traders' defaults by arranging for a reduced repayment (Sygnet) or no repayment (Uni-Brand), at least they were a participant in the chain that included the Appellant. But if Sygnet and Uni-Brand were not so involved and the only fraudsters are the missing traders, such missing traders were not involved in any chain that has a logical connection with the chains in which the Appellant is a party, and in any event the tax that was not paid by the missing traders was in most cases due only after the Appellant's deals."

108. Similarly in *Calltel Telecom Ltd v HMRC* [\[2007\] UKVAT V20266](#), discussing the question of knowledge, the Tribunal (Chairman Colin Bishopp) said (§ 52):

"It is difficult to see how a trader, entering into a chain of transactions in which every trader accounts correctly for VAT (and which is not tainted for some other reason) could have the means of knowing that it is a device for concealing, or avoiding the consequences of discovery of, another, fraudulent, chain of transactions. Nevertheless it is, we think, possible that a trader could have the means of knowing that, by his participation, he is assisting a fraud. Much will depend on the facts, but an obvious example might be the offer of an easy purchase and sale generating a conspicuously generous profit for no evident reason. A trader receiving such an offer would be well advised to ask why it had been made; if he did not he would be likely to fail the test set out at paragraph 51 of the judgment in *Kittel*."

109. Mr Anderson's response was to assert that the clean chain and the dirty chain were indeed part of an overall scheme to defraud the revenue. Indeed it seems to me that the whole concept of contra-trading (which is HMRC's own coinage) necessarily assumes that to be so. But that assertion is the assertion of a factual conclusion which HMRC is required to prove on the facts of an individual case. As Mr Bishopp said, much will depend on the facts. There is, in my judgment, no legal flaw in what the Tribunal said in this respect in the present cases.

The Tribunal's identification of the fraud

Livewire

110. HMRC's case was summarised in two paragraphs of an agreed statement of facts from which the Tribunal quoted:

"(14) It is Customs' case that the purported scheme to defraud the Revenue relates to the fraudulent evasions of VAT which are said to have taken place in other supply chains of which the Appellant was not a part, and in relation to contra-trading or "offset" transactions which are said to have been carried out by two traders, Uni-Brand (Europe) Ltd ("Uni-Brand") and Sygnet Computing Ltd ("Sygnet").

(15) It is Customs' case that the fraud is alleged to have involved a number of allegedly missing or defaulting traders in other supply chains which Customs say are connected to the Appellant's direct supply chains because those chains form part of an overall scheme to defraud."

111. The Tribunal considered the evidence and rejected the case of an overall scheme to defraud. That was a finding of fact. So far as the frauds were concerned the Tribunal said:

"We find that such evidence falls far short of cogent evidence and accordingly find that neither Sygnet nor Uni-Brand were knowingly parties to a fraud and accordingly the only fraud is that committed by the missing traders."

Olympia

112. In *Olympia* the Tribunal found fraud proved in each of the dirty chains. They also found that the alleged contra-trader was not knowingly involved in any dishonest cover up. Those too were findings of fact.

The Tribunal's formulation of the test of knowledge

Livewire

113. The Tribunal described the nature of contra-trading and the test of knowledge as follows (§ 5):

"In contra-trading there are, in its simplest theoretical form, two chains of transactions. First, the "dirty chain," in which there is a missing trader, defaulting trader, or trader using a hijacked VAT number ("missing trader" for short), comprising A (the missing trader) who is the importer of goods into the UK, who sells them to B, 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,"¹ in which there are no missing traders, comprising C, who is this time the importer, who sells to D, who sells to E, the exporter (the Appellant in this appeal is in the position of E). 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 benefit to C in this as C has paid the input tax to B, and therefore C could be a trader who happens to carry out both import and export transactions unconnected with any fraud, or C could be a trader who is controlled by a "puppet master" to enter into the cancelling transactions to disguise A's involvement in a 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 possibly of C's involvement.* Since, as we have demonstrated in our example in paragraph 4 above, the only gain from A's fraud is the recovery of input tax by E this must imply that E is a participant in the fraud and, unless he is the puppet-master, is presumably sharing the tax recovered with someone else. As Mr Scorey pointed out it is difficult to see how a case of E having means of knowledge, rather than actual knowledge, can arise." (Emphasis added)

Olympia

114. In *Olympia* the Tribunal described contra-trading in exactly the same way and concluded:

"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."

115. This is almost the same test as that which the Tribunal applied in *Livewire*; but the word "possibly" has been omitted. Thus the Tribunal held in *Olympia* that HMRC must show that the taxable person must know (or ought to have known) of both the missing trader's fraud and also the contra-trader's involvement in that fraud.

Conclusion

116. For the reasons I have given, I consider that this was too high a legal test. In the case where the contra-trader is himself a dishonest co-conspirator it need not be shown that the taxable person knew or ought to have known of the missing trader's default. It is sufficient if he knew or ought to have known of the contra-trader's dishonesty. In a case where the contra-trader was not dishonest, it is sufficient if the taxable person knew or ought to have known of the missing trader's default.

Does it make any difference?

117. In *Livewire* the Tribunal found as a fact that the alleged contra-traders (Sygnet and Uni-Brand) were not involved in or knowingly party to a fraud (§ 31). Thus *Livewire* was a case where there was only one fraud, namely a missing trader fraud in a dirty chain. Thus in my judgment on the facts as found, the Tribunal's mis-statement of the legal test had no impact on the eventual result.

118. In *Olympia* most of the impugned deals were part of "straight" MTIC chains, in which the fraud is that of a missing trader. In three cases there was an alleged contra-trader (Topnotch) but the Tribunal found as a fact that Topnotch was not a knowing party to a fraud. Again, therefore, the mis-statement of the legal test had no impact on the eventual result.

119. It would not, therefore, be right to allow HMRC's appeals on that ground.

Should have known: the Tribunal's test

Livewire

120. In *Livewire*'s case the Tribunal did not discuss the legal test of "should have known". There is no indication that it applied the wrong test. In its findings of fact it concluded (§ 34):

"We quite agree that the due diligence was flawed and we are surprised that the Appellant did not take this more seriously, particularly as they had already been victims of a fraud. We suspect that much of the due diligence was carried out because Customs asked to see it on their monthly visits, rather than because the Appellant thought it assisted them. ... It is worth pointing out that even if the Appellant had conducted perfect due diligence on its suppliers and customers it could not have indicated the fraud by the missing traders in the dirty chain."

121. Mr Anderson criticised this conclusion because, he said, it concentrated too narrowly on the missing traders in the dirty chain. However, in the first place, on the basis of the Tribunal's findings the only proven fraud was that of the missing traders in the dirty chain, so it was with that fraud that any connection was relevant. Second, Mr Anderson was unable to suggest any precautions that *Livewire* ought to have taken apart from investigating its own supply chain. Thus I cannot see that in reaching its conclusion in *Livewire*'s case, the Tribunal was guilty of any legal error. The finding of fact by the Tribunal in the third of the quoted sentences is, in my judgment, fatal to HMRC's appeal.

Olympia

122. The Tribunal (in my judgment rightly) rejected Mr Beal's submission that the test of "ought to have known" required HMRC to prove that the taxable person turned a blind eye, which involved knowing that there was something there to see (§ 15). They continued (§ 16):

"We consider that on its ordinary wording "ought to have known" is a factual test comprising two limbs. First, one should start with all the facts (a) actually known to

the person and ask whether in the light of those facts a reasonable businessman would have known that the transaction in question was connected with fraud. Secondly, it would include (b) those facts that would have been known to the person if he had taken some action to discover them that the reasonable businessman would have taken in the circumstances (*which is not necessarily the same as every precaution reasonably required*), but which the person did not. Both of these require one to determine the degree of experience of the reasonable businessman, for which we draw by analogy on the contrast made in s 214 of the Insolvency Act 1986:

"(4) For the purposes of subsections (2) and (3) [which includes that that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation], the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both-

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and

(b) the general knowledge, skill and experience that that director has."

In favour of a test on the lines of subs (4)(a) (or a combination of both tests) is that this is consistent with the director's duty to the company and its creditors, who can expect a director to have a reasonable standard of experience. In favour of a test on the lines of subs (4)(b) is the argument that taking the director's actual experience into account is more relevant to what the particular person ought to have known. The parties did not make any submissions on this point. On balance, while we see the merits of the former for consistency, we consider that this is too high a test in the present circumstances which are far removed from a director's personal liability to creditors and concerns whether Customs can decline to pay input tax to which the company is in principle entitled. *The test that we apply is accordingly whether a person with the knowledge, skill and experience of the director concerned would have known that the transactions were connected with fraud.* This appeal does not depend on the Appellant failing to take precautions, but more on whether it should have acted differently on information that it had obtained. Something on which both counsel were agreed was that "they jolly well ought to have known" conveyed the right approach." (emphasis supplied)

123. It is common ground that the supposed analogy with section 214 of the Insolvency Act 1986 is at best unhelpful and at worst positively misleading. First, section 214 requires the court to take into account *both* (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company *and also* (b) the general knowledge, skill and experience that that director has. In other words (b) is knowledge over and above the minimum to be expected of an ordinarily competent director. It does not allow a lower standard to be adopted. Second, the *Kittel* test applies to the taxable person. The taxable person was Olympia (the company). The question therefore for the Tribunal was not what a director of Olympia knew or ought to have known, but what the company itself knew or ought to have known. The knowledge of a director of the company may, to be sure, be attributed to a company, but there may be other knowledge (for example that of a senior employee) which, on the facts ought also to be attributed to the company: *Meridian Global Funds Management Asia Ltd v Securities Commission* [1985] AC 500. Accordingly, in applying the test of what ought to have been known by a director with the knowledge, skill and experience of the particular director concerned the Tribunal, in my judgment, fell into a legal error. To the extent that a domestic analogy is appropriate, the Tribunal applied a lower standard than that which would have been appropriate to support a finding of constructive knowledge. Third, I consider that the

Tribunal was wrong to water down the requirement that the taxable person must take every precaution reasonably required. The test does not require the taxable person to take every possible precaution: merely every precaution reasonably required. This test gives the Tribunal sufficient flexibility to decide, on particular facts, that a suggested precaution would have gone beyond what could reasonably have been expected.

124. These errors did feed into the Tribunal's ultimate conclusions. The director on whom the Tribunal concentrated was Mr Habib. Having dealt with a number of the precautions that Olympia did take the Tribunal concluded (§ 56):

"Weighing up all these factors, we consider that Mr Habib was, on account of his inexperience, naïve and gullible. Had we decided that the test of "ought to have known" should be based on an ordinarily competent director we might well have decided that such a person ought at least to have made further enquiries, but we have based the test on the experience of the particular director, Mr Habib. He was the ideal person for a "puppet master" to involve in fraud without his knowing. On balance, we believe that a person with his experience would not have known that there was fraud in the deal chains. Accordingly we conclude that it cannot be said that he, and accordingly the Appellant, ought to have known about the fraud in the deal chains."

125. Quite apart from the difficulty of imagining a naïve and gullible *company*, the Tribunal expressly adopted a legal test that required fewer precautions (or a lower level of understanding) than would have been required of a director of ordinary competence. The Tribunal does not positively find that it would have decided that an ordinarily competent director would have made further enquiries, but in my judgment the fact that the Tribunal considered that it "might well" have done so indicates that the application of the correct legal test might alter the outcome. In applying the correct legal test, the Tribunal must consider not only the knowledge that should be attributed to the company via its directors, but also the knowledge that should be attributed to the company via its senior employees. In this context, knowledge includes both knowledge of facts and the ability to evaluate those facts and to draw appropriate conclusions from them.

126. I can see no alternative to allowing HMRC's appeal on this ground. This ground applies only to the "straight" MTIC chains.

Result

127. HMRC's appeal in *Livewire* must be dismissed.

128. HMRC's appeal in *Olympia* must be allowed and the case must be remitted to the Tribunal for it to determine on the facts what Olympia ought to have known, applying the correct legal test.