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Mobilx Ltd (In Administration) and others v HMRC **[2010] EWCA Civ 517; [2010] S.T.I. 1589**

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Introduction

On 12 May 2010, the Court of Appeal gave judgment on three joined appeals from the High Court in relation to missing trader intra-Community (“MTIC” or “carousel”) fraud.

The principal question before the Court of Appeal was, as Moses LJ put it, whether HMRC was entitled under European Union law to refuse the input VAT claims of the appellant and respondent traders on the basis that those traders knew or should have known that the transactions in respect of which they claimed the VAT were or were likely to be connected with fraud.

The Court of Appeal was asked to rule on what conditions must be met before HMRC can refuse an input VAT claim from a trader in a chain of transactions in which there has been identified a tax loss resulting from MTIC fraud. This meant their Lordships addressing for the first time a number of inconsistent High Court and tribunal decisions, and being asked to provide the clarity of a single authoritative statement of the law from a higher court.

Background

The estimates before the Court of Appeal put the potential tax losses as a result of MTIC fraud as being £5.5 billion in 2005-2006 and, more recently, £2.5 billion in 2008-2009. It was also made clear to the Court that there were waiting behind this case more than eight hundred live appeals involving £2 billion of VAT. The Court was not in the dark as to the expected significance of its judgment.

MTIC fraud

While there are more complex forms, the basis structure of an MTIC fraud is as follows:

- (i) the “missing trader”- a VAT-registered trader, or a trader using another's registration- imports zero-rated goods from another Member State and charges VAT on their sale at the standard rate;

- (ii) the goods are then bought and sold along a chain consisting of a number of “intermediary” or “buffer” traders, with VAT charged and re-claimed by each intermediary trader in the usual way;
- (iii) the final intermediary in the chain sells the goods to the “broker” trader, which (as the last link) then sells the goods to another Member State or outside the EU, re-claiming the VAT paid to the last intermediary and zero-rating the supply out of the United Kingdom;
- (iv) the missing trader (consistently with his name) goes “missing”, whether by actually disappearing or by otherwise failing to account for the VAT charged to the first intermediary.

There is also a slightly more complex form of MTIC fraud, known as “contra trading”, which was first seen in the *Blue Sphere Global* case (see further below). In a contra-trade fraud, the broker trader in the first chain of transactions described above (“Broker A”) also itself purchases goods of an equal value from another Member State and sells these along a second chain before a different broker trader (“Broker B”) sells the goods to another Member State or outside the EU. Broker A then has a net VAT position of zero, and declares this on its VAT return (as the would-be claim for input VAT in the first chain is cancelled out by the output VAT due in the second chain). The large repayment claim to HMRC then comes instead from Broker B who, on the face of it, has no connection with the fraudulent VAT loss in the first (“dirty”) chain.

The principal technique available to HMRC in combating MTIC fraud is to deny the input claim of an intermediary or broker trader, thereby undoing the VAT loss caused by the missing trader. The difficulty facing HMRC is that a trader's right to reclaim (or deduct) input VAT under EU law is “automatic”, and the Court of Justice of the European Union (“ECJ”) has been largely unbending in preserving this rule.

The ECJ on refusing input claims because of fraud in the chain

The leading judgment of the ECJ on refusing input claims in response to fraud in the chain of transactions is Joined Cases C-439/06, etc *Kittel v Belgium* [2006] ECR I-6161 (“*Kittel*”). In that case, the ECJ reiterated that, as a general rule, the right to deduct arises irrespective of the purpose or results of the transaction concerned. If the ECJ had stopped there, traders could quite rightly maintain that it was irrelevant that the result of the transaction was to facilitate fraud, and that the right to deduct remains inviolate.

The ECJ went on, however, to rule that the relevant authority may, despite this general rule, refuse an input claim 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 [...]” (at [59]).

Between *Kittel* and the judgment of the Court of the Appeal, there were 20 tribunal decisions and six High Court judgments. This was enough to show that the apparently straightforward “*knew or should have known*” test might benefit from some elaboration by a court more willing to entertain paraphrasing and worked examples. The traders and HMRC looked to the Court of Appeal.

The cases on appeal

The three appeals before the Court were as follows:

- (i) An appeal by the traders from the judgment of Floyd J in *Calltel Telecom Ltd and another v HMRC (No 2)* [2009] EWHC 1081 (Ch); [2009] STC 2164 (“*Calltel*”), in which the learned judge upheld the decision of the VAT and Duties Tribunal dismissing the traders'

appeal against HMRC's refusals to repay input VAT in respect of a chain of mobile phone sales.

- (ii) A similar appeal by the trader against the judgment of Floyd J in *Mobilx Ltd (in Administration) v HMRC* [2009] EWHC 133 (Ch); [2010] All ER (D) 129. This was a case in which there was a finding that the traders should have known of the fraud, and involved both straight chains and contra-trading.
- (iii) HMRC's appeal against the judgment of the Chancellor in *Blue Sphere Global Limited v HMRC* [2009] EWHC 1150 (Ch); [2009] S.T.C. 2239 ("BSG"). This appeal related to contra-trading. The Tribunal had held that the trader ought to have known of the fraud, but had been appealed against successfully on the basis that it had reasoned on the basis that the trader had not done enough to remove the *risk* of being connected to fraud.

The three appeals presented the Court with a spectrum of findings as to the (actual and constructive) knowledge of the traders in question. The three cases also disclosed an apparent inconsistency in the significance attached by the Tribunal to the various indicia (or "badges") of fraud that were said by HMRC to have been sufficient to establish that the trader knew or should have known of the fraud.

The judgment of the Court of Appeal

A: Interpreting Kittel

Lord Justice Moses, with whom Chadwick and Carnwath LJ agreed, devotes paragraphs 16-44 of his judgment to a careful analysis of *Kittel*. His Lordship first set out the basics of EU law in this area, which are that:

- (i) the scope of VAT is defined by *objective* criteria, rather than by reference to the purpose or results of transactions;
- (ii) the scope of the right to deduct, which is "*integral to the system of VAT*", is also defined by these objective criteria (at [20] and [26] to [29]);
- (iii) to deny an input VAT claim where these criteria are present would infringe the principles of fiscal neutrality and legal certainty (at [26] to [29]);
- (iv) however, the ECJ has recognised the importance of preventing tax evasion, avoidance and abuse (at [35]);
- (v) accordingly, the *fraudster* has no right to deduct in respect of fraudulent transactions because "*where he commits fraud he will not be able to establish that the objective criteria which determine the scope of VAT and the right to deduct have been met*", which include the criteria that the transaction amount to "economic activity" and that the taxable person is "acting as such" (at [30] and [37] to [40]).

His Lordship then reached, at paragraphs 41 and 42, his conclusion on the effect of *Kittel*:

"41. In *Kittel* after §55 the Court developed its established principles in relation to fraudulent evasion. It extended the principle, that the objective criteria are not met where tax is evaded, beyond evasion by the taxable person himself to the position of those who knew or should have known that by their purchase they were taking part in a transaction connected with fraudulent evasion of VAT:-

'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'. [...]

The words I have emphasised “in the same way” and “therefore” link those paragraphs to the earlier paragraphs between 53–55. They demonstrate the basis for the development of the Court’s approach. It extended the category of participants who fall outwith the objective criteria to those who knew or should have known of the connection between their purchase and fraudulent evasion. Kittel did represent a development of the law because it enlarged the category of participants to those who themselves had no intention of committing fraud but who, by virtue of the fact that they knew or should have known that the transaction was connected with fraud, were to be treated as participants. Once such traders were treated as participants their transactions did not meet the objective criteria determining the scope of the right to deduct.

42 By the concluding words of §59 the Court must be taken to mean that even where the transaction in question would otherwise meet the objective criteria which the Court identified, it will not do so in a case where a person is to be regarded, by reason of his state of knowledge, as a participant.” (Moses LJ’s emphasis)

On the basis of this approach, Moses LJ saw that many of the objections raised by the traders would “fall away”, and so they did.

B: The traders' objections

(i) The need for legislation ([45] to [49])

It is fair to say that his Lordship was unimpressed by the argument that the principles in *Kittel* could not be applied as part of UK domestic law without specific implementing legislation.

The objective criteria relied upon by the ECJ, and which limit the scope of VAT and the scope of the right to deduct in the Sixth Directive, form the basis of the (remarkably similar) principles set out in sections 1, 4 and 24 of the Value Added Tax Act 1994 (“VATA 1994”). All that *Kittel* requires is an assessment of whether these criteria, are met; and this is unproblematic given that, because of the *Marleasing* duty, “[i]n relation to the right to deduct input tax, Community and domestic law are one and the same” ([49]).

It follows that there is no need for specific legislation.

(ii) The meaning of “should have known” ([50] to [52])

An apparently stronger argument raised by the traders was that HMRC had wrongly imposed a requirement for due diligence or reasonable care in order to recover input VAT in certain tainted markets (such as the “grey market” in mobile phones). It was clear from paragraph 51 of *Kittel* that traders who take every precaution reasonably required of them to ensure that their transactions are not connected with fraud cannot be deprived of their right to deduct input tax; it was much less clear that the converse was true, making any trader who failed to take such precautions a participant in the fraud.

Moses LJ took what is arguably a hard line on this point, reading *Kittel* closely with C-354/03 *Optigen v HMRC* [2006] ECR I-483 in a way that removed all “play” from the later judgment:

“51 Once it is appreciated how closely Kittel follows the approach the court had taken six months before in Optigen , it is not difficult to understand what it meant when it said that a taxable person “knew or should have known” that by his purchase he was participating in a transaction connected with fraudulent evasion of VAT. In Optigen the Court ruled that despite the fact that another prior or subsequent transaction was vitiated by VAT fraud in the chain of supply, of which the impugned transaction formed part, the objective criteria, which determined the scope of VAT and of the right to deduct, were met. But they limited that principle to circumstances where the taxable person had “no knowledge and no means of knowledge” (§ 55). The Court must have intended Kittel to be a development of the principle in Optigen . Kittel is the obverse of Optigen. The Court must have intended the phrase “knew or should have known” which it employs in §§ 59 and 61 in Kittel to have the same meaning as the phrase “knowing or having any means of knowing” which it used in Optigen. (§ 55).

52 If a taxpayer has the means at his disposal of knowing that by his purchase he is participating in a transaction connected with fraudulent evasion of VAT he loses his right to deduct, not as a penalty for negligence, but because the objective criteria for the scope of that right are not met. It profits nothing to contend that, in domestic law, complicity in fraud denotes a more culpable state of mind than carelessness, in the light of the principle in Kittel. A trader who fails to deploy means of knowledge available to him does not satisfy the objective criteria which must be met” (emphasis added).

(iii) Extent of knowledge ([53] to [60])

The Court of Appeal held that it was not sufficient for HMRC to show that the trader knew or ought to have known that it was *more likely than not* that his transaction was connected with fraudulent evasion ([60]). It is not enough to show that the trader knew that he was running that risk, because a requirement of this type would be a breach of the principle of legal certainty ([55]).

The Court of Appeal was, however, unwilling to be drawn into speculating as to what factual circumstances (including the trader turning a blind eye to what he did not want to know) would suffice in a particular case to show that the trader ought to have known of the connection with fraud. His Lordship said, at paragraph 59:

“The test in Kittel is simple and should not be over-refined. It embraces not only those who know of the connection but those who “should have known”. Thus it includes those who should have known from the circumstances which surround their transactions that they were connected to fraudulent evasion. If a trader should have known that the only reasonable explanation for the transaction in which he was involved was that it was connected with fraud and if it turns out that the transaction was connected with fraudulent evasion of VAT then he should have known of that fact. He may properly be regarded as a participant for the reasons explained in Kittel.”

Moses LJ rejected the submission that the should-have-known test amounts to asking whether the trader showed Nelsonian blindness, but made clear that the test will catch a trader who “chooses to ignore the obvious inferences from the facts and circumstances in which he has been trading” ([61]).

(iv) Article 1 of the First Protocol ECHR

The Court of Appeal was, perhaps not unexpectedly, not convinced by the taxpayer's argument that the restriction on the right to deduct input tax amounted to an impermissible penalty under the Strasbourg jurisprudence on Article 1 of the First Protocol to the European Convention of Human Rights (the “right to property”).

It is, with respect to his Lordship, not entirely clear from his judgment whether Moses LJ rejected this argument on the basis that there was no interference with a property right, or because he considered that there was such an interference but that it was justified. On the whole, his reasoning is more consistent with the former analysis, as he refers to the trader with sufficient knowledge as being outwith the scope of the right to deduct. It would seem to follow that a right to the amount representing input VAT simply never arises, and so cannot be interfered with (although there is an argument that such reasoning risks becoming circular).

It is perhaps worth noting, however, how his Lordship described the trader that fails the *Kittel* test:

“64. On my interpretation of the principle in Kittel, there is no question of penalising the traders. If it is established that a trader should have known that by his purchase there was no reasonable explanation for the circumstances in which the transaction was undertaken other than that it was connected with fraud then such a trader was directly and knowingly involved in fraudulent evasion of VAT. The principle in Kittel, properly understood, is, as one would expect, compliant with the rights of traders to freedom from interference with their property enshrined in Art. 1 of the First Protocol of the European Convention of Human Rights. The principle in Kittel does no more than to remove from the scope of the right to deduct, a person who, by reason of his degree of knowledge, is properly regarded as one who has aided fraudulent evasion of VAT. (emphasis added)

This brings into a focus an ambiguity that survives Moses LJ's judgment- is the trader held to be an *actual* participant in the fraud, or is he a *deemed* participant for the purposes of the right to deduct input VAT? His Lordship appears, in the first underlined passage, to treat the trader who knows or ought to have known of the fraud as an actual participant; the second underlined passage is, by contrast, consistent with either analysis, and arguably more consistent with *Kittel* creating only deemed participation.

C: Proof

HMRC raised the question of whether the (evidential) burden of proof may shift to the trader where the surrounding circumstances are sufficient to establish that the trader should be treated as a participant, i.e. whether sufficient knowledge is capable of being inferred from the circumstances of the transaction and/or its place in a series of similarly suspect transactions.

In general, the Court of Appeal responded that the circumstances surrounding the transaction, such as its being of a type very often associated with fraud, are capable of establishing that the trader should have known of the connection. The Court stressed, however, that tribunals should not place undue focus on the question of whether the trader acted with due diligence. Instead, the focus should be, in part, on seeing the transaction in context, on which point Moses LJ quoted the following passage from *Red12 v HMRC* [2009] EWHC 2563:

“109 Examining individual transactions on their merits does not, however, require them to be regarded in isolation without regard to their attendant circumstances and context. Nor does it require the tribunal to ignore compelling similarities between one transaction and another or preclude the drawing of inferences, where appropriate, from a pattern of transactions of which the individual transaction in question forms part, as to its true nature e.g. that it is part of a fraudulent scheme. The character of an individual transaction may be discerned from material other than the bare facts of the transaction itself, including circumstantial and “similar fact” evidence. That is not to alter its character by reference to earlier or later transactions but to discern it.

110 To look only at the purchase in respect of which input tax was sought to be deducted would be wholly artificial. A sale of 1,000 mobile telephones may be entirely regular, or entirely regular so far as the taxpayer is (or ought to be) aware. If so, the fact that there is fraud somewhere else in the chain cannot disentitle the taxpayer to a return of input tax. The same transaction may be viewed differently if it is the fourth in line of a chain of transactions all of which have identical percentage mark ups, made by a trader who has

practically no capital as part of a huge and unexplained turnover with no left over stock, and mirrored by over 40 other similar chains in all of which the taxpayer has participated and in each of which there has been a defaulting trader. A tribunal could legitimately think it unlikely that the fact that all 46 of the transactions in issue can be traced to tax losses to HMRC is a result of innocent coincidence. Similarly, three suspicious involvements may pale into insignificance if the trader has been obviously honest in thousands.

111 Further in determining what it was that the taxpayer knew or ought to have known the tribunal is entitled to look at the totality of the deals effected by the taxpayer (and their characteristics), and at what the taxpayer did or omitted to do, and what it could have done, together with the surrounding circumstances in respect of all of them.”

His Lordship then closed this analysis with a clear warning to traders that one circumstance that would lead, unless another reasonable explanation is put forward, to the conclusion that the trader ought to have been aware of the connection with fraud is the trader's benefiting from an opportunity to “*reap a large and predictable award over a short space of time*” ([84]).

The result and comments

The Court of Appeal dismissed all of the appeals before it, concluding that the error of law made by the Tribunal in *Moblix* (asking whether the trader ought to have known that the transactions were *more likely than not* to be connected with fraud) was not material, as the Tribunal had made sufficient findings of fact to meet the correct test.

It is fairly clear that the Court of Appeal intended to send a message to traders in certain industries that if they close their eyes to the obvious, they risk being considered participants in the fraud that they facilitate, and so losing their right to deduct VAT. There is certainly much in Moses LJ's judgment that will have been welcome to HMRC.

The Court also, however, made clear that it is not enough that the trader simply ran the risk of being involved in fraud; and while the line between this and having been in a position where it ought to have known of the connection with fraud may be difficult to discern in many cases, this must provide some comfort to the trader who knowingly enters a suspect industry but attempts to steer clear of fraudulent trading.

One substantial effect of the judgment may prove to be the shifting of the focus onto the ability of the trader to show an alternative explanation for the circumstances suggestive of fraud. It is to be expected that traders will face an uphill task to convince a sceptical tribunal that there was at the relevant time a legitimate grey market in which, for instance, huge and consistent returns were readily available to start-up companies with no previous experience in the sector.

Melanie Hall QC, Philip Moser, Ian Hutton and Fiona Banks were instructed by HMRC

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