TC02702

Appeal number: LON/2007/793

VAT – MTIC – whether trader should have known of connection to fraud- consideration of Mahageben, David, Toth

FIRST-TIER TRIBUNAL
TAX CHAMBER

S & I ELECTRONICS LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE CHARLES HELLIER

Sitting in public at Bedford Square London on 22 and 23 October 2012

Michael Patchett-Joyce instructed by The Khan Partnership for the Appellant

Malcolm Davis-White QC and Aidan Robertson QC, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

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DECISION

1. Following a hearing lasting some 14 days before Cyril Shaw and myself in October 2008, we released a decision in which we decided, on the basis of our understanding of the CJEU's judgement in *Axel Kittel v Belgium* 2006 ECR I-6161 ("*Kittel*"), that S&I was not entitled to credit for its input VAT on a number of its purchases of mobile phones in deals in which it had purchased and exported them between April and June 2006.

2. We reached this conclusion because we concluded that those deals were connected with fraud and that, although we were not convinced that S&I knew that these transactions were connected with fraud, it should have known that such was the case.

3. In deciding whether S&I should have known of the connection we applied the following test, namely whether a reasonable man with ordinary competence in the position of S & I, and knowing what S & I knew (a) would have taken any additional steps, and (b) would have come to the conclusion, on the basis of what he knew and had found out, that it was *more likely than not* that the transaction was connected to fraud.

4. Both parties appealed against the decision. The Upper Tribunal's decision on the appeals is to be found at [2012] STC 1620. After our decision was released, and before the hearing before the Upper Tribunal, the Court of Appeal decided the appeal in *Mobilx Ltd (in administration) v Revenue and Customs Commissioners* and other actions [2010] STC 1436. The test of knowledge we had applied was there held to have been wrong. Moses LJ said:

> "[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 surrounded 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 transactions 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*.
>
> "[60] The true position to be derived from *Kittel* does not extend to circumstances in which the taxable person should have known that by his purchase it was more likely than not that his transaction was connected with fraudulent evasion. But a trader may be regarded as a participant where he should have known that the only reasonable explanation for the circumstances in which his purchase took place was that it was a transaction connected with such fraudulent evasion."

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5. Thus, instead of asking ourselves whether it was more likely than not that the transactions were connected to fraud we should, as the Upper Tribunal pointed out, have asked whether:

> "[46] " [S & I] knew or should have known that [its] the transactions were connected with fraud or that there was no reasonable possibility other than they were connected with fraud?

6. The Upper Tribunal was not able to conclude on the basis of the findings we had made in our decision whether or not this test was satisfied and remitted the case back to the First-tier tribunal. It was directed that this tribunal should consider the matter on the basis only of the evidence which had been deployed in considering the appeal in 2008.

7. By the time that of remission Mr. Shaw had retired. The appeal was therefore remitted to me sitting alone. Thus I have to decide whether on the evidence before the tribunal S&I should have known that its transactions were connected to fraud.

8. I should recall at this stage that we considered 90 deals and found that in 79 of them it was shown to our satisfaction that there was a connection to the fraudulent evasion of VAT (that is to say that both a connection to the alleged defaulter and its default were proved); in the remaining eleven we found that HMRC had not proved that there was such a connection or default, not that there was no connection or default. The Upper Tribunal did not disapprove of these findings.

9. Mr. Patchett-Joyce made a number of submissions on the proper scope of the second limb of the *Kittel* knowledge test in particular in the light of the recent CJEU judgements in (a) the joined cases of Mahageben kft v Nemetzi Ado-es Vamhivatal Del-dunantuli Regionalis Ado Foigazgatosage C-80/11 ("*Mahageben*") and Peter David v Nemetzi Ado-es Vamhivatal Eszak-alfoldi Regionalis Ado Foigazgatosage C-142/11("*David*") and (b) Toth v Nemetzi Ado-es Vamhivatal Eszak-magyarorszagi RegionalisAdo Foigazgatosage C-324/11 ("*Toth"*). These are discussed below, and for the reasons I shall explain, I reject them. However if it subsequently transpires that I am wrong, it seems to me that where I can provide a coherent formulation of an alternative test on the basis of those submissions, time could be saved if I offered my conclusions in relation to those tests. That I have attempted to do.

10. In summary: *Mahageben* related to the supply of logs which RK had invoiced to M. M had used the logs to make its own supplies [43] but the tax authorities thought that RK could not have supplied them. They refused the deduction on the grounds that they had no delivery evidence and that M had not acted with due diligence as the Hungarian law required. *David*: Mr David had invoiced for labour he had supplied. The labour had not been his own and he had been invoiced for its supply to him by X. X could not substantiate to the tax authorities what he had provided; Mr David had also supplied labour to a contractor and had used a subcontractor which had invoiced him. But there are doubts about the subcontractor who may not have fulfilled its tax obligations. The question before the court was what conditions could be imposed on the right to deduct income tax. *Toth:* Mr Toth had undertaken building work using subcontractors including ML who had not complied with his tax obligations or

declared his employees who as a result worked in the black economy. The CJEU addressed whether ML's tax fraud prevented Mr Toth's deduction - holding that it did so only if the *Kittel* principle applied.

Mr Patchett-Joyce's submissions

(1). Would Have Had to have Known.

11. Mr. Patchett-Joyce says that the proper question is not whether the taxpayer "should have known" but whether it "would have had to have known" of the relevant fraud. He says that this is the correct translation of the original French of the judgement in *Kittel*.

12. To my mind however, unless "would have had to have known" means the same as "must have known" which I think means in effect the same as "knew", I can see no difference between "should have known" (or "ought to have known") and Mr Patchett-Joyce's preferred phrase. That is because: the second part of the test must mean something different from the first; it is plainly an objective test and in that context "would have had to have known" conveys to me no higher standard of objective intellectual compulsion than "ought to have known".

13. If, contrary to my belief, there is only one limb to the knowledge test, namely whether one can conclude that the trader knew, then the tribunal found that it was not proved that it did.

(2). The relevant connection is limited to the fraud of S&I's supplier, and the requisite knowledge is limited to knowledge of the fraud by its *immediate* supplier.

14. The issue of the nature of the requisite connection has not been remitted to me by the Upper Tribunal and Mr. Patchett-Joyce recognises that that question may only be pursued elsewhere. But he says that the question of the requisite knowledge is before me, and effectively that even if the relevant connection may be to a fraud by a person before the immediate supplier in the chain of supply, the *Kittel* principle applies only if the trader had the requisite knowledge of a fraud by his supplier.

15. In this connection Mr. Patchett-Joyce points to the following passages in *Mahageben* and *Toth* as showing that the requisite knowledge is limited to knowledge of connection to the immediate supplier's fraud. In para [45] of *Mahagaven* the court states the relevant test by reference to "transaction" in the singular: "knew, or ought to have known, that transaction was connected with fraud previously committed by the supplier or another trader at an earlier stage in the transaction." The emphasis on "the transaction" in the singular, Mr. Patchett-Joyce says, points to the transaction in which the trader was involved, not to earlier transactions in the chain. That emphasis he says is repeated in M where at paragraph [66] the court provides a caveat saying that "the taxable person is not in possession of any material justifying the suspicion that irregularities or fraud have been committed within that invoice issuer's sphere of activity." That he says points to the supply to the trader not to an earlier transaction in the chain.

16. I do not share Mr. Patchett-Joyce 's view of these cases.

17. In *David* the trader was denied input tax inter alia because it had not acted with the due diligence required by Hungarian law. The question was whether a condition so to act could be imposed by the State. The court, having explained that the question was in the context of the assumption that the transaction had been carried out and that a proper invoice had been supplied ([44]), said that in such circumstances the "only" way in which input VAT could be denied was on *Kittel* grounds:

> [45] In those circumstances, a taxable person can be refused the benefit of the right to deduct only on the basis of the case law resulting from paragraphs 56 to 61 of [*Kittel*], according to which it must be established, on the basis of objective facts, that taxable persons to whom were supplied the goods or services which served as the basis on which to substantiate the right to deduct, knew, or ought to have known, that the transaction was connected with fraud previously committed by the supplier or another trader at an earlier stage in the transaction."

18. By contrast the court said ([47]) that if a trader did have the requisite knowledge a system of strict liability (such as a condition for due diligence) went beyond what was necessary:

> "47. By contrast, it is incompatible with the rules governing the right to deduct under that directive, ... to impose a penalty, in the form of refusing that right to a taxable person who did not know, and could not have known, that the transaction was concerned was connected with fraud committed by the supplier or that another transaction forming part of the chain of supply prior or subsequent to that transaction carried out by the taxable person was vitiated by VAT fraud ..."
>
> "[48]. The establishment of a system of strict liability would go beyond what is necessary to preserve the public exchequer's rights ...".

19. In these paragraphs the court is not limiting or refining the *Kittel* test but saying that because that test is the only way input VAT can be denied to an otherwise compliant transaction, the due diligence requirement went too far. Thus at [49] it says:

> "49. Given that the refusal of the right to deduct in accordance with paragraph 45 of the present judgement is an exception to the application of the fundamental principle constituted by that right, it is for the tax authority to establish, to the requisite legal standard, the objective evidence which allows the conclusion to be drawn that the taxable person knew, or ought to have known that the transaction relied on as the basis for the right to deduct was connected with fraud committed by the supplier or by another trader acting earlier in the chain of this of supply."

20. This was not a case concerned with the precise formulation of the *Kittel* test and the court does not address that issue. The most that can be said is that the Court sets out its understanding of that test. That it does in slightly different ways in paragraphs

45, 47 and 49: in paragraph 45 seemingly by reference only to "the transaction" in the singular, but in paragraph 47 by reference to transactions forming part of the chain of supply prior or subsequent to the trader's transaction, and in paragraphs 49 and 52 by reference to a transaction carried out by another trader acting earlier in the chain of supply. These slightly varying formulations do not to my mind indicate an understanding of the *Kittel* test as requiring knowledge of fraud only in the immediately preceding transaction: the clear later references to another transaction in the chain of supply make clear to me that, at most, the concentration on "the transaction" in the language of paragraph 45 is a reference to the fact that in the case under consideration the potential fraud related only to the provision of the subcontracted services to the trader.

21. The same in my view is true of the Court's analysis in *David* where the dispositive paragraph [66] excepts from the State's obligation not to impose due diligence requirements on the trader as a condition of input tax recovery circumstances where the trader "is in possession of material justifying the suspicion that irregularities or fraud have been committed within that invoice issuer's sphere of activity". Here the court was addressing the question whether the right to deduct could be refused where the taxpayer did not satisfy himself of matters related relating to the bona fides of his supplier ([51]). In that context [52], quoting its earlier reasoning in David, it said that the right to deduct could be refused only where the *Kittel* conditions were satisfied and then went on to consider the ability of the State to impose additional obligations ([55]). The measures the State could impose depended on the circumstances ([59]) and if there were indications of fraud ([60]) a trader could be required by the State to make further enquiries as a condition of getting his input VAT, but "as a general rule" ([61]) the State could not impose blanket due diligence requirements. Thus the formulation in the disposition "suspicion [of fraud] within the invoice issuer's sphere of activity" is not a recasting or refinement of *Kittel*, but the definition of a possible exception to the general rule precluding the imposition of due diligence tests.

22. Thus to my mind in neither its decision in *David* nor that in *Mahageben* did the CJEU intend to refine, limit or explain the knowledge test in *Kittel*, nor did its description of that test provide any new insight into it.

23. In my view *Kittel*, *Mahageben* and *David* indicate clearly that the relevant question is whether the trader knew or ought to have known (or should have known) that its transaction was connected with fraud by someone in the chain of supply.

24. *Toth* concerned a trader who had been refused an input tax deduction for the invoiced supply of the services of a subcontractor. The subcontractor had defaulted on certain tax obligations and there were irregularities in its VAT compliance. Mr. Toth had not investigated the relationship between the subcontractor and the workers. Four questions were referred to the CJEU of which numbers 2 to 4 were discussed before me.

25. Question no 2 was whether the fact that the issuer of the invoice employed workers in the black economy could prevent Mr. Toth from being entitled to deduct income tax. The court answered that question thus:

> "[39]. Accordingly, the answer to the second question is that [the directive] must be interpreted as meaning that it precludes the tax authority from refusing a taxable person the right to deduct VAT due or paid for services provided to him on the ground that the issuer of the invoice relating to those services did not declare the workers he employed, without that authority establishing, on the basis of objective evidence, that the taxable person concerned knew, or ought to have known, that the transaction relied on as a basis for the right to deduct was connected with fraud committed by the issuer of the invoice or by another trader acting earlier in the chain of supply.

26. I see nothing in that answer which suggests any limitation on the relevant knowledge for the purpose of the *Kittel* test.

27. Question no 3 was whether the directive must be interpreted as meaning that the fact that a taxable person had not verified whether a legal relationship existed between the workers employed at the work site and the issuer of the invoice, or whether the issuer had declared those workers constitutes "an objective factor which demonstrates that the addressee of the invoice, knew or ought to have known that he was participating in a transaction involving fraudulent evasion of VAT".

28. The court referred to its conclusion at para [66] of *Mahageben* quoted above. It said that it also applied to the supply of services:

> "[44] That conclusion in relation to a supply of goods also applies in the case of a supply of services as regards the question whether it may be considered that the taxable person knew or should have known that the supply relied on for entitlement to his rights to deduct was connected with fraud committed by the issuer of the invoice, on the grounds that he had not verified whether the issuer of the invoice had the necessary employees available to be able to supply the services at issue, whether that issuer had fulfilled his obligations as regards declaration of those employees and whether the employees of the issuer and carried out the work at issue.
>
> "[45] Consequently, the answer to the third question is that [the directive] must be interpreted as meaning that the fact that a taxable person did not verify whether either a legal relationship existed between the workers employed on a work site and the issuer of the invoice or whether the latter had demonstrated those workers does not constitute an objective factor which demonstrates that the addressee of the invoice knew ought to have known that he was participating in a transaction involving fraudulent evasion of VAT, where the addressee was not in possession of any material justifying the suspicion that irregularities or fraud had been committed within that invoice issuer's sphere of activity. Accordingly the right to deduct may not be refused on that ground where the material and formal conditions laid down by that directive for the exercise of that right are met."

29. Mr. Patchett-Joyce describes [45] as a worked example of the application of the *Kittel* test. The test the court there applies, he says, is to look solely at the knowledge of fraud within the invoice issuer's sphere of activity.

30. I accept that the court is applying the *Kittel* test, but it is applying it in the context of the narrow question of whether the simple failure to verify demonstrated knowledge, and against the factual background in which the only possible fraud was in the invoice issuer's activities. The court had earlier, at [39], recognised the breadth of the *Kittel* test when it used the words "acting earlier in the chain of supply", but it was then applying that test in a situation where it was alleged that the issuer of the invoice had committed the fraud. These paragraphs do not indicate that the court thought that test of relevant knowledge should be limited to knowledge of the supplier's fraud.

31. I also note that a suspicion of fraud might affect the relevant conclusion.

32. Question no 4 was whether all the circumstances of the issuer and its activities could be taken into account in assessing whether the supply had in fact taken place. The court answered that question thus:

> "[53]. Having regard to the foregoing considerations the answer to the fourth question is that, where the tax authority provides specific evidence of the existence of fraud, [the directive] and the principle of tax neutrality do not preclude the National Court from verifying on the basis of an overall examination of the circumstances of the case, whether the issuer of the invoice carried out the transaction in question himself. However, in a situation such as that at issue in the main proceedings, the right to deduct may be refused only where it is established by the tax authority, on the basis of objective evidence, that the addressee of the invoice knew or should have known that the transaction relied on as a basis for the right to deduct was connected with a fraud committed by the issuer or another operator supplying inputs in the chain of supply."

33. Mr. Patchett-Joyce calls attention to the words "or another operator *supplying inputs* in the chain of supply". He says that the italicised words must be there for a purpose and that purpose is to limit the principle to persons providing something to the taxpayer - the "chain of supply" was not the entire commercial chain (the sale of clay to the brick maker, the sale of the bricks to the wholesaler, their sale to the builder, and the builder's supply of building services), but the triangular supply in which labour was provided by X which was supplied to the trader by Z, or logs were conveyed by X and their supply invoiced by Y (to whom X supplied labour). They limited the required knowledge to knowledge of fraud by a supplier to the taxpayer.

34. I do not agree. I see nothing in the judgement which suggests such a limitation. It seems to me that "another trader acting earlier in the chain of supply" and "another operator supplying inputs in the chain of supply" are the same thing.

35. Further the sentence in which these words appear is prefaced by "in a situation such as that at issue in the main proceedings". In those proceedings the only concern was over fraud at the level of those providing the services used by Mr. Toth.

36. Thus I find nothing in *Toth* which illuminates the nature of the relevant knowledge for the purposes of the *Kittel* test.

37. If I am wrong however and test were to be found to be relevant knowledge of the trader's immediate suppliers' fraud then I would conclude that the evidence before the tribunal did not persuade me that either S&I either knew or should have no such fraud nor that there was such a fraud.

(3) Outside the scope of VAT.

38. At [36] in *Mobilx*, Moses LJ said:

> "The court's reference in paragraph 55 to a quartet of previous decisions reinforces the proposition that fraudulent tax evasion falls outwith the scope of VAT and thus the scope of the right to deduct input tax. Fraudulent evasion of tax does not meet the objective criteria, such as whether the activity is "economic activity" or a taxable person is "acting as such", by which the scope of VAT and of the right to deduct are identified."

39. Mr. Patchett-Joyce says that if the result of the application of this principle is such that a transaction is outside the scope of VAT then in relation to that transaction there cannot have been any VAT chargeable on it and any attempted evasion of VAT which would have been due had it not been outside the scope cannot be the fraudulent evasion of VAT. Thus any form of knowledge of a fraudster's activity would not be knowledge of VAT fraud for the purposes of the *Kittel* test.

40. It seems to me that this is a problem only if one accepts the premise that falling within the *Kittel* provisions takes a transaction outside the scope of VAT. But that is not my understanding of principle.

41. The *Kittel* principle concerns the right to deduct. It does not address the tax chargeable on the supply which would normally give rise to the corresponding right of deduction. In *Kittel* the court said that objective criteria for the concept of supply and economic activity are not met where tax is evaded by a the taxable person himself ([53]), and it applies that principle to deny input credits to a person who knew he was participating in fraudulent evasion ([54-59]). To my mind the court cannot have intended that what it described as participation in the fraudulent evasion by a person seeking to deduct was not such participation because of the fraud in which he was participating. The initial evasion must therefore be treated as evasion of VAT for the purposes of the later test whether or not that evasion would cause that initial transaction to fall foul of the principle at paragraph [53].

42. I therefore conclude that this argument does not affect the question of the existence of the relevant knowledge which has been remitted to me.

(4) The reasonable businessman

43. In addressing whether S&I should have known of a fraud in our original decision we applied the test of what the reaction of a reasonable businessman would have been to the facts known to S&I at the relevant time.

44. Mr. Patchett-Joyce criticises this use of the reasonable businessman in determining what the taxpayer should have known. He says that (i) its use was criticised by Lewison J in *Livewire* [2009] STC 643at [122] to [125], and (ii) the test in *Kittel* does not require the concept or consideration of what a reasonable businessman would have done, it simply requires the commissioners to prove, having regard to objective factors, that the taxpayer would have had to have known that its transactions were connected with fraud.

45. In *Livewire* the tribunal had considered what facts should be treated as known by the taxpayer company and what skill it should be treated as having. It considered a test in the Insolvency Act 1986 in relation to the question it set itself of determining experience of a reasonable businessman and concluded that the taxpayer should not be treated as endowed with the knowledge and skill of a competent director but:

> "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."

46. Lewison J said:

> "[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. …
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> "[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….."
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> "[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."

47. My reading of the remarks of Lewison J in the quoted paragraphs does not coincide with that of Mr. Patchett-Joyce. It seems clear to me that he is not criticising the use of the reasonable businessman test but the particular standard imposed by the tribunal in that case.

48. In relation to Mr. Patchett-Joyce's second criticism, I believe it evaporates on further consideration. The second limb of the *Kittel* test requires the tribunal to determine whether a taxpayer should have known of the fraud. That must be an objective test, and it must be made by reference to objective factors. But, having set out the objective factors, how is one to determine whether they lead to a conclusion that a person should have known? The process of reasoning from fact to conclusion is a human one and it requires a human to do it. That raises the questions of what sort of human: a child, an overzealous customs officer, or a reasonable man, and of what degree of knowledge to attribute to him. (Whatever else, it seems to me that it cannot be a question of what the appellant actually concluded because that is the same as knowledge.) The only human entity in a position to conduct this exercise is the tribunal, and to my mind use by the tribunal of the "reasonable businessman" in its decision-making is merely an attempt to describe the mindset it adopted in taking that decision. By using "reasonable" it indicates that it did not attempt to clothe itself in the mindset of a child, a paranoid customs officer or habitual VAT villain, but retained its own (presumed reasonable) mindset; and by the use of "businessman" described itself as having some knowledge of commercial transactions. It is thus a description of the deducting mindset of the tribunal in approaching the facts (and a denial of any pretence of being something different) rather than the creation of a new test. Thus in this decision it would make no difference if I replaced "the reasonable businessman" with "I".

(5) Can it be found that a trader should have known of fraud when it is not proved that fraud does not exist in the chain or where it is shown that there is no fraud?

49. I have noted above that we found that it was not proved that in eleven of the 90 deals there was a connection to a fraud. The question arises in the circumstances of those eleven deals as to whether it is logically possible to find at the same time: both that the taxpayer should have known that they were connected to fraud, and that is not proved that they were. That question is acute because the objective factors which convinced us that a reasonable business man would have concluded that it was more likely than not that the transactions were connected to fraud were the same in every case. There was no difference between those factors in relation to a deal not shown to be linked to fraud and one which was.

50. This question is more disturbing when one is applying the test in *Mobilx*. Applying that test, the should have known limb is satisfied if the only reasonable explanation of the facts is that the taxpayer's transactions are connected with fraud: but if the only reasonable explanation of what was known to S&I was fraud, how can the tribunal find that it was not proved that they were connected with fraud - particularly where the tribunal will have had details of the sales and purchases in the chain of supply which were not available to S&I?

51. Put another way, does our original finding that some deals were not proved to be connected to fraud necessarily entail a conclusion, not only that S&I could not have concluded that the only reasonable explanation of the circumstances of those eleven deals was fraud, but also, because the information available to S & I in all the other cases was the same, that in no case could S & I have so concluded?

52. Mr. Davis-White answered this thus. He gave the example of a person so severely injured in a car crash that a bystander might say that the only reasonable expectation was that he would die, but unbeknown to him a skilled surgeon was on hand who actually saves him. The "only reasonable explanation" allows for the possibility of another explanation. Further Mr. Davies-White says that the conundrum disappears when the possibility of the trader taking further steps (making further enquiries) is considered.

53. Mr Davis-White also points to para [59] of Moses LJ's judgement in *Mobilx* where he says:

> "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 transactions was connected with fraudulent evasion of VAT then he should have known of that fact."

54. Mr Davis-White says that the italicised words show that Moses LJ recognised that one could reach a conclusion that the only reasonable explanation of a transaction was connected to fraud when the transaction was not in fact proved to have been so connected.

55. I am generally with Mr. Davis-White on the these points. The only reasonable explanation does not preclude the existence of unreasonable but possible explanations. However in the eleven deals in which we found that the connection was on balance not proven, a conclusion that the only reasonable explanation was connection to fraud might call into question our finding that the deals were not proven to be connected. That finding in each case was reached on the evidence of (i) the chain of supply to S&I and (ii) the alleged fraud of a person in that chain: but our decision betrays that we did not consider the factors relevant to S&I's knowledge in reaching our conclusions as to whether those deals were connected with fraud. That may be therefore a fault in our decision as regards those details, but it is not one which may be corrected by me in this decision. But because we concentrated on the direct evidence in relation to the fraud and the chain of supply rather than the wider circumstances, and because we did not find that there was *not* fraud, it leaves open to me to find that the only reasonable explanation of the circumstances of the deals in these cases was that they were linked to fraud.

56. Had we found that it was proved that certain deals were not connected to fraud, in my view, one could only then find that the only reasonable explanation for the other deals was connection to fraud if either the circumstances of those deals were outside the reasonably possible or if there was evidence distinguishing their circumstances from the others.

57. (7) Measures required: what further steps could S&I have been reasonably expected (or assumed) to have undertaken for the purpose of determining what it should have known?

58. Mr. Patchett-Joyce raises the question as to whether the objective factors on which the decision is to be made are limited to those actually known to the trader, or whether there should be added to the mix those facts which the "reasonable businessman" would have found as a result of any investigation he would have felt compelled to make. In my judgement such facts are to be added to the mix for the reasons in the following paragraphs. But I state my conclusions in S&I's case on the basis (a) that I am correct in this judgement, and (b) that I am not.

59. To my mind the formulation of the test, using as it does the words "should", "ought", "would have had to", raises the question of what conclusion to reach if you have a suspicion. The answer depends on the strength (and evidence for) the suspicion. If what you see seriously worries to you then you should, ought or would have had to, investigate further; if it is a mere passing fancy you would not. Thus what you should, ought or would have had to know must include what you would have found out. I find some comfort in this conclusion in the caveat of the CJEU in *Toth* where at paragraph [45] it says that the lack of due diligence is not an objective factor demonstrating knowledge where there was no "suspicion" of fraud. Where there was such suspicion, the failure to investigate could therefore possibly be an objective factor. That could only be because it suggests that either the failure to investigate demonstrates knowledge, or that such investigation should have been undertaken and would have revealed fraud. Likewise in *Mahageben* at [60] reference is made to a reasonable trader:

> " It is true that where there are indications pointing to infringements or fraud, a reasonable trader would, depending on the circumstances of the case, be obliged to make enquiries about another trader from whom he intends to purchase goods or services in order to assess the latter's trustworthiness ...".

60. This is in the context of a potential fraud by a supplier but the acceptance of the obligation to make enquiries is described in the context of a reasonable trader.

61. In *Kittel* the court held that a person who did not know or did not have "the means of knowing" of fraud was not barred from the right of deduction; the converse was the trader who "knew or should have known" of the fraud. In *Mobilx* Moses LJ said [51] that the CJEU must have intended the phrase "know or should have known ... to have the same meaning as "knowing or having any means of knowing". Against that background it is clear to me that in determining whether the only reasonable explanation of the relevant circumstances was fraud, one must assume that the trader has knowledge of that which he has the means of discovering and which he should or ought to discover.

62. In our decision we concluded that S & I's knowledge of the circumstances surrounding its transactions was such that it would have given rise to a "very serious concern, and possibly a conclusion that it was more likely than not, that each of S&I's April, May and June transactions would have been connected with fraud" [214]. We continued at [215] to say that a reasonable businessman in these circumstances would have undertaken further investigations and that these circumstances and those investigations and would have revealed the fraud.

63. Mr. Patchett-Joyce says that *Mahageben* at [53] emphasises that:

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

He says that such precautions are limited to those which are "required" of them, and that such precautions are properly described as "measures":

> "[59] In those circumstances, it follows from the case law referred to in paragraphs 53 and 54 of the present judgement, that determination of the measures which may, in a particular case reasonably be required of a taxable person wishing to exercise the right to deduct VAT in order to satisfy himself that his transactions are not connected with fraud committed by a trader at an earlier stage of a transaction depends essentially on the circumstances of that particular case.
>
> "[60] It is true that, when there are indications pointing to an infringement or fraud, a reasonable trader could, depending on the circumstances of the case, be obliged to make enquiries about another trader from whom he intends to purchase goods or services in order to ascertain the latter's trustworthiness."

64. Mr. Patchett-Joyce says that the indications must relate to the particular case - i.e. the particular supply: general awareness of a fraud will not be sufficient to trigger an obligation; nor will simply the risk of infringement. Further he says that this passage shows that the obligation is "to make enquiries about another trader from whom he intends to purchase goods or services" so that it is limited to the supplier, and is not more extensive; and it is limited to the trustworthiness of his suppliers.

65. I do not share Mr. Patchett-Joyce's interpretation of these passages. To my mind they are directed to the specific question of when and whether a member state may impose conditions on a taxpayer's right to deduction. They are not directly related to the application of *Kittel* test: that test does not relate the conditions imposed by the state but whether the taxpayer has the means of knowledge of connection to fraud. The "measures" to which the court refers are not relevant to the test: in the context of evaluating whether someone had means of knowledge, but measures which a state seeks to impose as an additional condition for deduction.

66. As a result I consider that in deciding what information was available to a trader for the purpose of determining what he should have concluded, he should be taken to have found out what a reasonable businessman in his circumstances would have found out , and I do not see these passages as proscribing such an approach.

67. (8) Unistar Group Ltd, Unistar Trading Ltd v HMRC

68. I should note that after the hearing had taken place I was kindly sent a copy of the FTT's decision in this case by The Khan Partnership. I read it but it did not affect my thinking. I therefore did not seek HMRC's comments on it.

Was the only reasonable explanation of S&I's deals that they were connected to fraud. And, if so, should S&I have known that?

69. In our original decision we made a number of findings which are relevant to this issue.

(i) A chain of transactions before S&I.

70. S&I knew that there was a chain of transactions before each of its acquisitions. It knew that its transactions were part of a back-to-back chain of acquisitions and sales because it knew that traders did not want to hold stock (see the quote from Mr. Ahmed at (vi)(a) on page 57). It was clear to me that S&I was aware that contemporaneously with its purchase and sale there was a series of virtually contemporaneous purchases and sales by UK traders.

(ii) Margins

71. S&I were aware that it was a feature of the market that the margin per phone made by "buffer" (UK to UK) trader in the chains were fairly standard and less than that made by exporters.

(iii) Non UK Specification Phones

72. The phones S&I dealt in were mostly of Central European specification with plugs not intended for the UK market. Although it was possible to change plugs relatively cheaply this could not be done in back-to-back transactions. Thus S & I must have known that these phones passed speedily through the hands of members of the chain without conversion for the UK market.

73. The only possible explanations that I can see for this are: (i) that the phones had been converted in the UK (for why else were they in the UK) to non UK specification prior to the start of the chain of contemporaneous transactions; (ii) they were being bought and sold as commodities in a price arbitrage market in which their precise specification did not matter; and (iii) they were in the UK so that they could be exported.

74. As regards (i) it seems to me that it is possible that UK specification telephones could be acquired in the UK and converted here to EU specification with the intention of being sold on into the EU. It does not however seem reasonable to suppose that such conversions would have been done on a speculative basis – without the guarantee of a certain customer – on the kind of scale which S&I's transactions involved: whilst it seems perfectly reasonable that a single consignment of phones might have been converted for a sale which failed and which were then offered for sale more generally (or that a single consignment of phones with European specification might have been brought into the UK with the object of changing them ready for sale in the UK market, and that perhaps circumstances changed and the holder received an offer he could not refuse from a member of S&I's chain so that they were then exported to their "home" market by S&I) I can see no reasonable explanation of how this could happen in such a large number of cases. I conclude that (i) is not a reasonable explanation.

75. So far as (ii) is concerned I can understand phones being dealt with as commodities so that traders in the UK might buy and sell them even though they were not configured for the UK market. But that does not explain why all the consignments of phones were in the UK: such trades would not require the movement of the phones across frontiers. Neither their export by S&I nor their presence in the UK while being bought and sold by members of the chain are consistent with that explanation. Indeed any transport is inconsistent with such trade because it increases cost and diminishes margins.

76. I conclude that the only reasonable explanation for the presence of these phones in the UK was that they were brought into the UK for the purpose being exported after having been bought and sold by a chain of UK dealers who did not hold stock.

77. (iv) Details on invoices etc

78. The invoices and purchase orders sent and received for each of the deals contained very little detailed description of the phones. That indicated to us (and indicates to me) that neither S&I nor its customers were really interested in those details. We found (and I find) that consistent with the use of the phones for purposes which require their movement in a chain of transactions involving their export but

also consistent with their use as a commodity in an arbitrage market. Those seem to me to be the only reasonable explanations of that circumstance.

79. But the second of these explanations is not reasonable in the light of the other circumstances.

80. In the case of non-UK specification phones arbitrage trading makes no commercial sense for the reasons set out at [76] above Thus for these phones this factor further confirms that the only reasonable explanation of the trade was connection to some scheme involving their trading and export.

81. So far as the UK specification phones were concerned, S&I's knowledge of the consistent margins in UK- UK trading is inconsistent with a conclusion that these could be arbitrage transactions (because in such transactions trading margins would not have been so uniform). Such a conclusion would be unreasonable.

(iv) Knowledge of fraud

82. Knowledge that the phones were being traded in the UK for the purpose only of exporting them has only one reasonable explanation namely that they were connected with VAT fraud.

83. S&I knew that there was significant VAT fraud in the market in which it operated. It knew that some of its transactions had been connected to such fraud. It also knew the nature of the fraud. So it knew that it involved the default by one member of a supply chain in the payment of VAT and the export of phones. It must have known that the only reasonable explanation of trade in the UK for the purpose of exporting was VAT fraud.

84. I conclude that S&I should have known that the only reasonable explanation of the deals was that they were connected to VAT fraud. I reach this conclusion without considering what additional information S&I could have obtained.

85. However even if there were a possible explanation of the other circumstances of each of its deals other than connection to VAT fraud, it is clear to me that the concerns detailed in our decision would have excited such serious concern that they were linked to fraud that the only reasonable response would have been to make the further investigations described in paragraph 215 of our decision, and that those investigations would have revealed that there was a connection to fraud. That is because the information received would have only one reasonable explanation, namely fraud. Thus if as I believe to be the case, I am entitled to consider what S&I would have found out if it had taken the steps a reasonable businessman in its position would have taken, it would have concluded that its deals were connected to fraud.

Passages in our decision

86. We addressed our decision to the test of likelihood of connection, and provided our conclusions on the basis of the requirement that the test was met if it was more likely than not. But there is in my view a link between what may be called a risk

based approach and the "no other reasonable explanation" approach. It is this: an explanation that is highly unlikely is not a reasonable explanation; one that is likely is reasonable. If the delivery van does not arrive there may be a number of possible explanations. One is that the driver has been eaten by a lion, another that she is stuck in traffic. The absence of a zoo, a circus or reports of an escaped lion in the vicinity makes the first of these an unlikely and therefore unreasonable explanation; the presence of a nearby normally congested road makes the second a not unlikely and a reasonable explanation; if in the circumstances that reason is more likely than not it must logically be the most reasonable explanation. On that basis one might characterise our decision as being that the most reasonable explanation was connection to fraud.

87. It remains to consider, against that background, whether any of our earlier conclusions were inconsistent with those expressed here.

88. At para [208], in relation to the deals with the identified suppliers, we concluded that a reasonable businessman in S&I's position would have come to the conclusion that it was more likely than not that the deals were connected to fraud. There is no inconsistency here.

89. At para [201] we referred to the following factors which HMRC had said pointed to uncommercial dealing: (i) counterparties acting variously as supplier and purchase; (ii) back to back same day trades; (iii) small consistent margins earned by buffers; (iv) higher margins earned by S&I; (v) no insurance; (vi) limited description in invoices. Each gave us some measure of concern. We concluded: "Taking these issues together we find they do not point unequivocally to involvement in transaction[s] connected to fraud. But they would raise in the mind of the reasonable businessman serious concerns about such a connection.". This remains my view. The facts would point "unequivocally" to fraud only if there were no other possibility. In my opinion S&I could have considered it theoretically possible that there was no connection to fraud; but although that was a possibility it was not in my view a reasonable one for the reasons I have explained above.

90. At para 214 we said, in relation to the other deals that the factors we noted would have given rise "to a very serious concern, and possibly a conclusion that it was more likely than not that each of S&I's...transactions would have been connected to fraud." It might be said that "possibly" was used to indicate that there were other reasonably possible explanations. But that fails to look at our conclusion in the round. We were sure (and I remain sure) that the suspicions we identified would have justified very stringent further investigation, and we were sure (and I remain sure) that that investigation would have uncovered fraud. Because of the test we were applying had no need to consider whether the identified issues on their own had no reasonable explanation other than fraud. The words quoted merely indicate that we might have been able to reach that conclusion earlier.

91. My (and our) reaction to the deals was that the facts were such that if we had been in the position of S&I, I (we) would have known they were linked to fraud. We were persuaded that Mr. Ahmed himself did not reach that conclusion, but we were

clear that we would have done. At the time of writing our decision we described that conviction against the test of coming to a conclusion on balance, but, had the test been that, had we been S&I's shoes we would have concluded that the only explanation was fraud, we would have come to that conclusion.

.**Conclusion**.

92. I find that S&I should have known that its deals were connected to fraud because that is the only reasonable explanation of the circumstances of those deals.

Rights of Appeal.

This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

CHARLES HELLIER
TRIBUNAL JUDGE

RELEASE DATE: 5 April 2013