Neutral Citation Number: [2010] EWCA Civ 517

Case No: A3/2009/0400, A3/2009/1222 AND A3/2009/1345

IN THE HIGH COURT OF JUSTICE
COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE HIGH COURT (CHANCERY DIVISION)
Sir Andrew Morritt, Chancellor
The Honourable Mr Justice Floyd
CH2008APP0116
CH2009APP0066
CH2007APP0599

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 12/05/2010

Before :

LORD JUSTICE CARNWATH
LORD JUSTICE MOSES
and
SIR JOHN CHADWICK

- -

Between :

Mobilx Ltd (in Administration)	**First Appellant**
- and -	
The Commissioners for Her Majesty's Revenue & Customs	**First Respondent**
The Commissioners for Her Majesty's Revenue & Customs	**Second Appellant**
- and -	
Blue Sphere Global Ltd	**Second Respondent**
Calltel Telecom Ltd & Anr	**Third Appellant**
- and -	
The Commissioners for Her Majesty's Revenue & Customs	**Third Respondent**

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Mr James Pickup QC, Mr Kieron Beal and **Mr Iain MacWhannell** (instructed by **Bark & Co Solicitors**) for the **First Appellant**
Mr Michael Patchett-Joyce, Mr James Rickards and **Mr Colin Challenger** (instructed by **Messrs Thomas Cooper**) for the **Second Respondent**
Mr Michael Patchett-Joyce and **Mr Duncan Fairgreave** (instructed by **the Khan Partnership)** for the **Third Appellants**

Mr Mark Cunningham QC, Ms Melanie Hall QC, Mr Philip Moser, Dr Ian Hutton, Mr Jonathan Hall and **Ms Fiona Banks** (instructed by **Messrs Thomas Howes Percival H.M.R.C. Solicitor's Office**) for the **Second Appellant and First and Third Respondents**

Hearing dates : 15th-19th February, 2010

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Approved Judgment

Lord Justice Moses:

Introduction

1. For many years, Her Majesty's Revenue and Customs (HMRC) have attempted to combat "missing trader intra-Community" VAT fraud. It is notorious that the trades in bulk mobile phone and computer chips are especially susceptible to that type of fraud. Latest published estimates (*Measuring Tax Gaps*, December 2009) disclose potential losses in 2005-2006 of up to £5.5 billion and in 2008-2009 of up to £2.5 billion. Lord Hope described the fraud as a "sophisticated attack on the VAT system", a "pernicious stratagem" and was of the view that Member States were justified in making use of "every means at their disposal within the scope of the Sixth Directive to eradicate it" (*Total Network SL v HMRC* [2008] UKHL 19 [2008] STC 644 § 6).

2. There are before this court three appeals, two by traders and one by HMRC, concerning HMRC's refusal of input tax credit claims on the basis that the traders knew or should have known that the transactions in which they were involved were or were likely to be connected with fraud. The question in these appeals is whether HMRC was entitled to do so, or, as Lord Hope would have it, whether HMRC's refusal was within the scope of the Sixth Directive. These three appeals are the first cases to reach this court since the European Court of Justice's judgment in *Axel Kittel v Belgium*; *Belgium v Recolta Recycling* Joined Cases C-439/04 and C-440/04 [2006] ECR 1-6161. Since that decision there have been twenty decisions at tribunal level and six High Court judgments. We are told there are in excess of eight hundred live appeals which await final decisions either from courts or tribunals (involving more than £2 billion of VAT). S.55 of the Value Added Tax Act 1994 (VATA) which imposed a reverse charge on certain supplies used in MTIC fraud came into effect only on 1 June 2007; it does not diminish the significance of these appeals.

3. These appeals relate to the meaning of the test which, HMRC contended, determines its right to refuse a taxable person's entitlement to deduct input tax. The appeals turn on what the ECJ meant when it ruled in *Kittel* that the right to deduct may be refused if:-

> "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" (see §§ 59 and 61, emphasis added).

4. Two essential questions arise: firstly, what the ECJ meant by "should have known" and secondly, as to the extent of the knowledge which it must be established that the taxpayer had or ought to have had: is it sufficient that the taxpayer knew or should have known that it was more likely than not that his purchase was connected to fraud or must it be established that he knew or should have known that the transactions in which he was involved *were* connected to fraud?

5. The advantage of hearing these three appeals together is that they provide a range of factual circumstances from which the crucial controversies in this case emerge. In Calltel Telecom Ltd (Calltel) and Opto Telelinks (Europe) Limited (Opto) there were

findings that the trader knew that his transactions were connected to fraud; in the appeals of Mobilx Limited (Mobilx) and by HMRC against Blue Sphere Global Limited (BSG), the factual findings of the Tribunal were that the traders knew or should have known that it was more likely than not that their transactions were connected to fraud. Accordingly, this court must determine whether knowledge of a risk that a transaction was more likely than not connected to fraud is sufficient to justify refusal of the right to deduct. A short description of the facts will demonstrate how these issues arise.

The Facts

6. The appeals in Calltel and Opto concern denial of part of their repayment claims for the months of January, February and March 2006. Calltel claimed just over £8m and Opto £10.2m. Both companies were associated and in the common ownership and control of Mr Gohir. They were wholesale dealers in mobile phones. In its decision dated 20 July 2007 the Tribunal found that the transactions in which Calltel and Opto were involved were:-

> "nothing more than a device by which the taxing authorities, in the United Kingdom and elsewhere, can be cheated." (§ 156)

Further, they found that Mr Gohir was well aware that another trader, "well removed from the appellants", would fail to account for output tax, while the remaining traders between the defaulter and the appellant would not (§ 165). The Tribunal concluded that:-

> "There is, in our view, almost nothing in the transactions which is consistent with the workings of a genuine market. We are quite sure, from his demeanour and from his untruthful evidence, that Mr Gohir was under no illusion about the nature of the trade in which the appellants were engaged. We think the Commissioners are right to contend that he was one of the ringleaders. But even if he was not, we are satisfied that he was well aware that the appellants were dealing in goods which were being used as the instrument of fraud. We are equally satisfied that the transactions were arranged for no other purpose, and that the fact that the defaulter's failure to account for output tax post-dated the appellants' dealings in the relevant goods is irrelevant." (§ 174)

7. In these appeals, therefore, it was established that the taxpayers knew that they were participating in transactions connected with fraudulent evasion of VAT. Some of those transactions were examples of what the Commissioners call "contra-trading", but in the light of the factual findings of the Tribunal as to the purpose of the transactions and knowledge of the connection with the fraud it is unnecessary to give any further explanation as to what is meant by contra-trading in the context of the Calltel appeals.

8. Floyd J dismissed the taxpayers' appeals, ([2009] EWHC 1081 (Ch)) concluding that the Tribunal was entitled to make a finding of actual knowledge (§ 73). He dismissed appeals based upon the suggestion that the Tribunal had applied the wrong test of

knowledge or that the refusal of repayment amounted to a penalty. Accordingly, it can be seen that Caltell is a paradigm of a case where the traders knew of the connection between the transactions in which they were involved and VAT fraud.

9. In neither of the other two appeals was it established that the taxpayer knew of a connection between the transactions in which they were involved and VAT fraud. BSG concerned what the Commissioners identified as "contra-trading". In his decision in *Blue Sphere* [2009] EWHC 1150 (Ch) the Chancellor sets out the description of contra-trading given by Dr Avery Jones in *Olympia Technology Limited v HMRC* [2008] UK VAT 20570. For the purposes of HMRC's appeal in BSG it is only necessary to reiterate that in contra-trading there are two chains, a clean and a dirty chain. The effect of the clean chain is to remove the necessity of a trader taking part in the dirty chain claiming repayment and therefore, by the size of the claim, alerting HMRC to the possibility of fraud. In BSG a chain transaction, going through four or five intermediaries and ending with Infinity Holdings Limited, originated from A. S. Genstar which was found to have gone missing without paying outstanding VAT liabilities, and from Wade Tech Limited, whose registration was hijacked by unidentified persons. If Infinity Holdings Limited had had to make repayment claims it would have had to do so in respect of five hundred and forty-seven deals, three hundred and fifty-six of which could be traced back to defaulting traders. Infinity set off what would otherwise have been its noticeably large input tax claim by selling domestically, for example, to BSG and thus incurred a liability to output tax which cancelled out what would otherwise have been its large input claim. BSG was used innocently, it contended, as a basis for offsetting the input tax claims which Infinity would otherwise have had. BSG exported its purchases and claimed credit for the VAT it had incurred in buying the goods as it did not have to account for any output tax on the sale as the supplies to EC customers were zero rated. The contra-trade had the advantage that it was BSG which made the repayment claim and, crucially, in respect of goods which had not been supplied by a missing trader.

10. The Tribunal concluded that Mr Peters, sole director and shareholder in BSG, had not made sufficiently exhaustive enquiries to protect BSG (§ 226). If he had asked appropriate questions:-

> "he would have concluded that the uncommercial features of the deals being offered to BSG could only be explained by taking into account other transactions which Infinity was entering into, and the most probable explanation was that those other transactions were connected in some way with fraud. Our conclusion is that BSG ought to have known that, by its purchase, it was participating in transactions connected with fraud and evasion of VAT (§ 228)."

11. The Chancellor concluded that it was not sufficient to prove that BSG was involved in transactions which might turn out to have undesirable associations (§ 52). It was necessary to prove that BSG ought to have known that by its purchases it *was* participating in transactions which were connected with a fraudulent evasion of VAT. In the context of contra-trading it was necessary for HMRC to prove that Infinity was party to a conspiracy. Unless HMRC could do so it was not possible to establish that BSG had known of any fraud. As the Chancellor put it:-

> "If Infinity did not know of the fraud when it happened and was not party to any arrangement that it should happen, how could BSG have known of any fraud before it happened?...and if BSG could not have known, how could there be circumstances from which it could properly be concluded that BSG ought to have known?" (Judgment § 54)

HMRC appeals the Chancellor's decision.

12. BSG provides an example of contra-trading in which it is said that the most which could be established was that BSG ought to have appreciated that there was a risk that the transactions in which it participated were connected with fraudulent evasion of VAT.

13. In Mobilx, HMRC denied the trader's repayment claims for three months in 2006: approximately £7.3m was claimed. The appeal concerned eighty-five purchases of CPUs occurring over two years of trading. HMRC said and the administrators of Mobilx accepted that every one of the chains of transactions, which HMRC had been able to trace, led back to a defaulter.

14. Mobilx had been trading for over two years using the same small circle of suppliers. It had been informed, one and a half years before, that seventeen out of twenty-four chains in two months had been traced to a defaulter and had later received similar information, indicating lack of improvement (see Tribunal findings § 106). The Tribunal concluded that it should have been apparent to Mobilx by the beginning of April 2006 that if it continued to deal in CPUs as it had been doing for the last two years its transactions were *more likely than not* to be connected with fraud (§ 108). There was, as the Tribunal put it, a marked lack of curiosity about the identity of the suppliers who had sold tainted goods (§ 107). The approach of the Tribunal may be exemplified:-

> "…but there must come a time when a trader, told repeatedly that every one of his purchases followed a tainted chain, is compelled to recognise that without a significant change in his trading methods every one of his future purchases is more likely than not also to follow a tainted chain – in other words, he cannot possibly be satisfied, on the balance of probabilities, that each transaction he enters into will not be connected with fraud." (§ 105)

15. Floyd J [2009] EWHC 113 (Ch) concluded that HMRC was entitled to find that Mobilx should have known, on the balance of probabilities, that all its transactions were leading back to defaulting traders (§ 80) and that all of its chains were likely to lead back to defaulting traders unless it ceased trading or significantly changed its manner of doing trade (§ 83). Floyd J concluded that two of the bases on which the Tribunal relied had not been put to the witnesses. But he concluded that there was ample evidence that Mobilx was well aware that its business was one where it was easy to become involved in MTIC fraud (§84) and that it ought either to have altered its method of trading radically, or "ceased to involve itself in that trade altogether" (§ 85). He concluded:-

> "Mobilx should have known that all its transactions were more likely than not to be implicated in MTIC fraud." (§ 88)

Accordingly, Mobilx is a case which raises the question whether HMRC is entitled to refuse repayment in circumstances where the trader ought to have known that it was more likely than not that his transactions would be implicated in MTIC fraud.

Kittel

16. The ECJ describes the circumstances in which the right to deduct should be refused in its judgment at § 61:-

> "…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."

17. To resolve the issues which have arisen between the parties in these three appeals it is necessary to place that paragraph in the context of the route which led the court to express that principle. Paragraph 61 answered the second of two questions, which the court itself had reformulated so as to widen the scope of the questions asked by the referring court. The Belgian tax authorities had refused to allow the right to deduct VAT on transactions allegedly connected with carousel fraud; the basis of the refusal was a domestic statute which rendered a contract incurably void, as contrary to public policy, by reason of a VAT fraud committed by the seller. The Belgian Cour de Cassation referred the following questions to the Court:-

> "25…
>
> (1) Where the recipient of the supply of goods is a taxable person who has entered into a contract in good faith without knowledge of a fraud committed by the seller, does the principle of fiscal neutrality in respect of VAT mean that the fact that the contract of sale is void – by reason of a rule of domestic civil law which renders the contract incurably void is contrary to public policy on the grounds that the basis of the contract is unlawful by reason of a matter which is attributable to the seller – cannot cause that person to lose the right to deduct that tax?
>
> (2) Is the answer different where the contract is incurably void for fraudulent evasion of VAT itself?
>
> (3) Is the answer different where the unlawful basis of the contract of sale which renders it incurably void under domestic

> law is a fraudulent evasion of VAT known to both parties to the contract?"

The court's adaptation follows:-

> "27. By its questions, which must be considered together, the referring court asks essentially 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, Article 17 of the Sixth Directive must be interpreted as meaning that it precludes a rule of national law under which the fact that the contract of sale is void, by reason of a civil law provision which renders the contract incurably void as contrary to public policy on the ground that the basis of the contract is unlawful by reason of a matter which is attributable to the seller, causes that taxable person to lose his right to deduct that tax. That court asks whether the answer to that question is different where the contract is incurably void for fraudulent evasion of VAT.
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> 28. The referring court also asks 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."

18. It can be seen that the reformulation widened both the first and second questions. In the first question it referred to circumstances in which a taxable person *could not know* that the transaction was part of a fraud committed by the seller. In the second question the issue was widened to consider a taxable person who should have known that he was participating in a transaction which did not itself constitute a fraudulent evasion of VAT but was connected with such an evasion.

19. The answer to the first question is contained in §§ 52 and 60 of the Court's judgment:-

> "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, Article 17 of the Sixth Directive must be interpreted as meaning that it precludes a rule of national law under which the fact that the contract of sale is void, by reason of a civil law provision which renders that contract incurably void as contrary to public policy for unlawful basis of the contract attributable to the seller, causes that taxable person to lose the right to deduct the VAT he has paid. It is irrelevant in this respect whether the fact that the contract is void is due to fraudulent evasion of VAT or to other fraud." (§ 52)

20. The reasoning which led the Court to the answers it gave to both the first and second questions explains the source, nature and extent of the test it provided for refusal of the right to deduct. The Court's statement of principle depended upon the application of objective criteria which define the scope of VAT. Since the right to deduct is integral to the system of VAT, those objective criteria also define the scope of the right to deduct. It applied those objective criteria to traders who were not themselves fraudulent but knew or should have known their transactions were connected to fraud. By focussing on those objective criteria the court avoided infringing the fundamental principles of fiscal neutrality and legal certainty which lie at the heart of the VAT system.

21. This approach is the basis of the Court's approach not only in *Kittel* but in C-354/03 *Optigen Limited v Customs and Excise Commissioners* [2006] ECR I-483. The judgment in *Optigen* was handed down on 12 January 2006 by the third chamber of the court, four out of the five judges of which heard the case of *Kittel* and handed down their judgment six months later, on 6 July 2006. It is, therefore, not surprising that the court's reformulation of the questions in *Kittel* and its answers depended strongly on its approach in *Optigen*.

22. *Optigen* was an innocent party which had no knowledge or reason to have knowledge that those transactions in which it was involved formed part of a chain of supply constituting a carousel fraud. The Commissioners contended successfully before the Tribunal that the purchases and sales were devoid of economic substance and were not part of any economic activity. Accordingly, the unwitting trader was not entitled to repayment of input VAT.

23. In *Optigen* the court's starting point was the common system of VAT based on a uniform definition of taxable transactions in the Sixth Directive (§ 36). The Sixth Directive (77/388/EEC) has, since 1 January 2007, been replaced by the "Principal VAT Directive" 2006/112/EC of 28 November 2006 but only the Sixth Directive is relevant for these appeals.

24. The scope of VAT is identified in Art. 2 of the Sixth Directive. It applies, in addition to importation, to the supply of goods or services effected for consideration within the territory of the country by a taxable person acting as such. A taxable person is defined in Art. 4.1 as a person who carries out any of the economic activities specified in Art. 4.2. Art. 5 defines the supply of goods and Art. 6 the supply of services. The scope of VAT, the transactions to which it applies and the persons liable to the tax are all defined according to objective criteria of uniform application. The application of those objective criteria are essential to achieve:-

> "the objectives of the common system of VAT of ensuring legal certainty and facilitating the measures necessary for the application of VAT by having regard, save in exceptional circumstances, to the objective character of the transaction concerned." (*Kittel* para 42, citing *BLP Group* [1995] ECR1/983 para 24.)

25. The principle of legal certainty requires that the application of Community legislation is foreseeable by those subject to it (see, e.g., the Advocate General's opinion in *Optigen*, § 42). The principle demands that when a taxable person enters into a

transaction he should know that the transaction is within the scope of VAT and that his liability will be limited to the amount by which the output tax on his supply exceeds the input tax he has paid. In *Optigen* the court set out the criteria which identify the scope of VAT (see §§ 38-41). It emphasised the importance of the objective nature of those criteria (§§ 44-46). Once a transaction meets those criteria, it follows that the right to deduct for which Art. 17 provides must be recognised (§§ 52-53).

26. The right to deduct input tax is integral to the system of VAT. It may not "in principle" be limited (§ 53). It is integral to the system because it ensures the principle of fiscal neutrality which lies at the heart of the system of VAT.

27. It is necessary to recall the importance of that principle since it explains why the jurisprudence of the ECJ has been so resistant to attempts to combat fraud by encroaching upon the right to deduct in the case of traders who are not themselves participants in the fraud. VAT is a tax on consumption applying to goods and services up to and including the retail stage. It is proportional to the price charged by the taxable person in return for the goods or services he has supplied. It is charged at each stage of production or distribution. At each stage the amount of tax which the goods or services have already borne is deducted from the tax, for which the taxable person is liable. Deduction has two crucial effects: the tax is levied at any given stage only on the value which is added at that stage; secondly, the taxable person does not bear the burden of the tax, the final burden is on the consumer (see Art. 2 of the First Directive 67/227/EEC and Case C-475/03 *Banco Popolare di Cremona* [2006] ECR I/9373 at §§ 21 and 22).

28. Since the right to deduct is fundamental to the system of VAT because it ensures that the charge is limited to the value added at each stage of the supply and because it ensures fiscal neutrality, it may not, in principle, be limited; any derogation from the principle of the right to deduct tax must be interpreted strictly (see Case C-414/07 *Magoora* [2008] ECR I-000). Moreover, the right must be exercisable immediately in respect of all taxes charged on input transactions. Since the right arises immediately the taxable person pays tax (input tax) to his supplier, the principle of legal certainty demands that he knows when he enters into the transaction that it is within the scope of the tax and that his liability will be limited to the amount by which any output tax he may be liable to pay, on making a supply, exceeds the input tax he has paid. The objective criteria determine both the scope of the tax and the circumstances in which the right to deduct arises.

29. It was with those principles in mind that the ECJ in *Optigen* rejected the contention that the transactions of innocent parties could not be regarded as economic activities if they formed part of a series of transactions with a fraudulent objective (the argument which found favour before the Tribunal recited § 20). The Court repeatedly distinguished the transactions in which the innocent parties had entered from transactions "vitiated by VAT fraud" (see §§ 51, 52 and 55). It thus endorsed the view, expressed by the Advocate General, that regard must be had to the objective character of the concept of economic activity (§ 37 Advocate General's Opinion).

30. The Court rejected the United Kingdom's argument that unlawful transactions fell outside the scope of the VAT. Fiscal neutrality prohibits a distinction between lawful and unlawful transactions; such a distinction must be restricted to transactions

concerning products which by their very nature may not be marketed, such as narcotic drugs and counterfeit currency (see § 49 and the Advocate General's Opinion § 40). By its rejection of the United Kingdom argument, the Court made clear that the reason why fraud vitiates a transaction is not because it makes the transaction unlawful but rather because where a person 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.

31. It was the fact that the transactions of the unwitting traders in *Optigen* met the objective criteria which formed the basis of the ECJ's rejection of HMRC's attempt to deny repayment:-

> "Therefore, the answer to the first question referred for a preliminary ruling in each case should be that transactions such as those at issue in the main proceedings, which are not themselves vitiated by VAT fraud, constitute supplies of goods or services effected by a taxable person acting as such and an economic activity within the meaning of Articles 2(1), 4 and 5(1) of the Sixth Directive, where they fulfil the objective criteria on which the definitions of those terms are based, regardless of the intention of a trader other than the taxable person concerned involved in the same chain of supply and/or the possible fraudulent nature of another transaction in the chain, prior or subsequent to the transaction carried out by that taxable person, of which that taxable person had *no knowledge and no means of knowledge*. The right to deduct input VAT of a taxable person who carries out such transactions cannot be affected by the fact that in the chain of supply of which those transactions form part another prior or subsequent transaction is vitiated by VAT fraud, without that taxable person *knowing or having any means of knowing*. [emphasis added]" (§ 55)

32. It will be noted that the court in *Optigen* qualified its statement of principle by reference to the state of knowledge of the taxable person as to the fraudulent nature of another transaction.

33. In *Kittel* the Court adopted an identical approach to that which it had adopted in *Optigen*, emphasising the importance of the objective criteria which are met where a taxable person did not and could not know that the transaction was connected with fraud (§§ 39-52). Paragraph 52 (cited here at § 19) owes everything to *Optigen*'s § 55.

34. The Court then (from § 53 onwards) considered the converse: whether the objective criteria are met where a taxable person *does* know or should have known that the transaction concerned was connected with fraud. The second question it reformulated posed the obverse of the question answered in *Optigen.*

35. From § 53-55 in *Kittel* the Court set out the starting point for its development of the principles relating to cases where the taxable person was himself acting fraudulently:-

> "53. By contrast, the objective criteria which form the basis of the concepts of 'supply of goods effected by a taxable person acting as such' and 'economic activity' are not met where tax is evaded by the taxable person himself (see Case C-255/02 *Halifax and Others* [2006] ECR I-0000, paragraph 59).
>
> 54. As the Court has already observed, preventing tax evasion, avoidance and abuse is an objective recognised and encouraged by the Sixth Directive (see Joined Cases C-487/01 and C-7/02 *Gemeente Leusden and Holin Groep* [2004] ECR I-5337, paragraph 76). Community law cannot be relied on for abusive or fraudulent ends (see, inter alia, Case C-367/96 *Kefalas and Others* [1998] ECR I-2843, paragraph 20; Case C-373/97 *Diamantis* [2000] ECR I-1705, paragraph 33; and Case C-32/03 *Fini H* [2005] ECR I-1599, paragraph 32).
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> 55. Where the tax authorities find that the right to deduct has been exercised fraudulently, they are permitted to claim repayment of the deducted sums retroactively (see, inter alia, Case 268/83 *Rompelman* [1985] ECR 655, paragraph 24; Case C-110/94 *INZO* [1996] ECR I-857, paragraph 24; and *Gabalfrisa*, paragraph 46). It is a matter for the national court to refuse to allow the right to deduct where it is established, on the basis of objective evidence, that that right is being relied on for fraudulent ends (see *Fini H*, paragraph 34)."

36. The Court's reference, in § 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.

37. In Case 268/83 *Rompelman* [1985] ECR 655 the Court was concerned as to whether the acquisition of a future title to units in premises under construction for the purposes of letting in the future was economic activity within the meaning of Art. 4.1 of the Sixth Directive. The Court concluded that the payment of the purchase price in instalments, whilst the building was constructed, constituted the start of exploitation of the property by way of letting and was economic activity (see § 20) but it observed that the person applying to deduct tax must establish that he is a taxable person within the meaning of Art. 4. The Court concluded that the Revenue authorities were entitled to consider the objective criteria for identifying whether the purchaser was indeed a taxable person by requiring him to provide objective evidence that the premises were suitable for commercial exploitation (§ 24). Thus the approach of the Court was focussed on the objective criteria for identifying whether the proposed lessor, seeking to deduct input tax, was indeed a taxable person.

38. Similarly, in Case C-110/94 *Inzo* [1996] ECR I-857 the court ruled that investment expenditure before actual exploitation was economic activity where expenditure and input tax had been incurred on a profitability study for a proposed de-salination project. After the project had been abandoned the Belgian Taxing Authority claimed repayment of the input tax recovered by Inzo. The claim was rejected but the Court made it clear that the tax authority would have been entitled to repayment if the declared intention to pursue the economic activity was false. Again it focussed on the objective criteria by which the status of taxable person is clarified:-

> "In that context…*a taxable person acquires that status* definitively only if the person concerned made the declaration of intention to begin the envisaged economic activities in good faith. In cases of fraud or abuse, in which, for example, the person concerned, on the pretext of intending to pursue a particular economic activity, in fact sought to acquire as his private assets goods in respect of which a deduction could be made, the tax authority may claim repayment of the sums retroactively on the grounds that those deductions were made on the basis of false declarations." (§ 24) (my emphasis)

Those principles were repeated in joined cases C-110/98 – C-147/98 *Gabalfrisa* [2000] ECR I-01577 (§ 96).

39. In Case C-32/03 *Fini H* [2005] ECR I-1599 the Court drew no distinction between expenditure incurred for the purposes of economic activity before it is started and expenditure incurred in order to terminate economic activity. It applied the principles identified in *Rompelman*, *Inzo* and *Gabalfrisa*. It concluded:-

> "It is, in any event, 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 or abusive ends." (§ 11)

40. The same approach was applied by the court in Case C-255/02, *Halifax and Others* [2006] ECR I/1609 in which H.M. Customs and Excise sought to challenge various transactions on the basis that they were entered into solely for the purposes of VAT avoidance. The Court reiterated that provided the objective criteria for identifying supply of goods or services and economic activity were satisfied there was no basis for refusing entitlement to deduct input tax. But it emphasised:-

> "It is true that those (the objective) criteria are not satisfied where tax is evaded, for example, by means of untruthful tax returns or the issue of improper invoices." (§ 59)

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.
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> 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'. [emphasis added]"

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.

43. A person who has no intention of undertaking an economic activity but pretends to do so in order to make off with the tax he has received on making a supply, either by disappearing or hijacking a taxable person's VAT identity, does not meet the objective criteria which form the basis of those concepts which limit the scope of VAT and the right to deduct (see *Halifax* § 59 and *Kittel* § 53). A taxable person who knows or should have known that the transaction which he is undertaking is connected with fraudulent evasion of VAT is to be regarded as a participant and,

equally, fails to meet the objective criteria which determine the scope of the right to deduct.

44. Once the approach of the court in *Kittel* is understood, centred as it is on the scope of VAT and of the right to deduct, as measured by the objective criteria, many of the objections raised by traders fall away.

The Traders' Challenges: The Need for Legislation

45. The traders contend that the principles enunciated by the Court in *Kittel* cannot be applied as part of UK domestic law without specific legislation. The principle enunciated by the Court from § 56 onward does not depend upon any national measure, such as Art. 1131 of the Belgian Civil Code or Paragraph 4, Schedule 11 of the VATA 1994. Paragraph 4 of Schedule 11 was introduced to impose joint and several liability in respect of the payment of output tax in circumstances where the taxable person knew or had reasonable grounds to suspect that VAT payable in respect of a previous or subsequent supply of goods would go unpaid. That legislation was considered by the Court in Case C-384/04 *Federation of Technological Industries and Others* [2006] ECR I/4191, on which the Court in *Kittel* based the proposition 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 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 of VAT." (§ 51, referring to § 33 of *FTI*)

FTI was not concerned with the right to deduct input tax at all. The principle in *Kittel* depends on the question as to whether the objective criteria which determine the scope of VAT and entitlement to deduct are met, not upon legislation introduced pursuant to Art. 21.3 of the Sixth Directive. Art. 21 is concerned with persons liable for payment for tax; Art. 21.3 permits Member States to provide that someone other than the person liable for payment of the tax should be held jointly and severally liable in situations identified in Articles 21.1 and 21.2. It has no relevance to the right to deduct. Art. 17.2, which confers the right to deduct, contains a reference back to the taxable transactions identified in Articles 5 and 6, and thus back to those objective criteria which form the basis of concepts such as "supply of goods effected by a taxable person acting as such" within the meaning of Articles 2, 4 and 5. Those criteria are transposed into domestic law by the Value Added Tax Act 1994.

46. S.1 of the Value Added Tax Act 1994 provides that VAT should be charged, in accordance with the provisions of the 1994 Act, on, amongst other things, the supply of goods in the United Kingdom, and s.1(2) establishes that liability to account for VAT on the supply of goods within the United Kingdom is on the supplier. S.4 provides that VAT should be charged on any taxable supply of goods made by a taxable person in the course or furtherance of a business carried on by him. S.24 defines input tax:-

> "(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."

S.25(1) sets out the obligation on taxable persons to account for and pay VAT in respect of supplies made by him for each prescribed accounting period and also provides for credit in respect of input tax (see s.25(2)(3)).

47. Accordingly, the objective criteria which form the basis of concepts used in the Sixth Directive form the basis of the concepts which limit the scope of VAT and the right to deduct under ss. 1, 4 and 24 of the 1994 Act. Applying the principle in *Kittel*, the objective criteria are not met where a taxable person knew or should have known that by his purchase he was participating in a transaction connected with fraudulent evasion of VAT. That principle merely requires consideration of whether the objective criteria relevant to those provisions of the VAT Act 1994 are met. It does not require the introduction of any further domestic legislation.

48. The traders contend that to enlarge the category of participants in the fraud to those who should have known that by their purchase they were taking part in a transaction connected with fraud is to impose a new accessory liability for fraud which does not exist in domestic law; it imposes, so they assert, a negligent standard for fraud by the back door.

49. It is the obligation of domestic courts to interpret the VATA 1994 in the light of the wording and purpose of the Sixth Directive as understood by the ECJ (*Marleasing SA* 1990 ECR 1-4135 [1992] 1 CMLR 305) (see, for a full discussion of this obligation, the judgment of Arden LJ in *Revenue and Customs Commissioners v IDT Card Services Ireland Limited* [2006] EWCA Civ 29 [2006] STC 1252, §§ 69-83). Arden LJ acknowledges, as the ECJ has itself recognised, that the application of the *Marleasing* principle may result in the imposition of a civil liability where such a liability would not otherwise have been imposed under domestic law (see *IDT* § 111). The denial of the right to deduct in this case stems from principles which apply throughout the Community in respect of what is said to be reliance on Community law for fraudulent ends. It can be no objection to that approach to Community law that in purely domestic circumstances a trader might not be regarded as an accessory to fraud. In a sense, the dichotomy between domestic and Community law, in the circumstances of these appeals, is false. In relation to the right to deduct input tax, Community and domestic law are one and the same.

Meaning of "should have known"

50. The traders contend that mere failure to take reasonable care should not lead to the conclusion that a trader is a participant in the fraud. In particular, counsel on behalf of Mobilx contends that Floyd J and the Tribunal misconstrue § 51 of *Kittel*. Whilst 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 is contended that the converse does not follow. It does not follow, they argue, that a trader who does not take every reasonable precaution must be regarded as a participant in fraud.

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 before his right to deduct arises.

Extent of Knowledge

53. Perhaps of greater weight is the challenge based, in Mobilx and BSG, on HMRC's denial of the right to deduct on the grounds that the trader knew or should have known that it was more likely than not that transactions were connected to fraud. The question arises in those appeals as to whether that is sufficient or whether, as the Chancellor concluded in BSG, the right to deduct input tax may only be denied where the trader knows or should have known that the transaction *was* connected to fraud (see judgment, § 52). In short, does a trader lose his entitlement to deduct if he knew or should have known of a risk that his transaction was connected to fraudulent evasion of VAT? HMRC contends that the right to deduct may be denied if the trader merely knew or should have known that it was more likely than not that by his purchase he was participating in such a transaction. It contends that if it was necessary to show more than appreciation of a risk then the Court's decision in *Kittel* would not represent a development of the law and would fail to achieve the objective, recognised in the Sixth Directive, to which the Court referred at § 54.

54. As I have already indicated, the mere existence of that objective and the principle that Community law cannot be relied upon for fraudulent ends (e.g., *Fini H* § 32) does not provide any justification for a general principle that any transaction connected with fraud is vitiated. Such an approach was rejected in *Optigen*.

55. If HMRC was right and it was sufficient to show that the trader should have known that he was running a risk that his purchase was connected with fraud, the principle of legal certainty would, in my view, be infringed. A trader who knows or could have known no more than that there was a risk of fraud will find it difficult to gauge the extent of the risk; nor will he be able to foresee whether the circumstances are such that it will be asserted against him that the risk of fraud was so great that he should not have entered into the transaction. In short, he will not be in a position to know before he enters into the transaction that, if he does so, he will not be entitled to deduct input VAT. The principle of legal certainty will be infringed.

56. It must be remembered that the approach of the court in *Kittel* was to enlarge the category of participants. A trader who should have known that he was running the risk that by his purchase he *might* be taking part in a transaction connected with fraudulent evasion of VAT, cannot be regarded as a participant in that fraud. The highest it could be put is that he was running the risk that he might be a participant. That is not the approach of the Court in *Kittel*, nor is it the language it used. In those circumstances, I am of the view that it must be established that the trader knew or should have known that by his purchase he *was* taking part in such a transaction, as the Chancellor concluded in his judgment in *BSG*:-

> "The relevant knowledge is that *BSG* ought to have known by its purchases it was participating in transactions which were connected with a fraudulent evasion of VAT; that such transactions might be so connected is not enough." (§ 52)

57. HMRC object that the principle should not be restricted to those cases where a trader has deliberately refrained from asking questions lest his suspicions should be confirmed. This has been described as a category of case which is so close to actual knowledge that the person is treated as having received the information which he deliberately sought to avoid (see Lord Scott in *Manifest Shipping Co Limited v Uni-Polaris Insurance Co Limited and Others* [2001] UKHL 1 and *White v White* [2001] 1 WLR 481 paragraphs 16 and 17, 486 E-G). HMRC seeks to rely upon the views of Lewison J in *Livewire and Olympia* [2009] EWHC 15 (Ch) (§ 85) and Burton J in *R (Just Fabulous) v HMRC* [2008] STC 2123 (§ 45) that:-

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

58. As I have endeavoured to emphasise, the essence of the approach of the court in *Kittel* was to provide a means of depriving those who participate in a transaction connected with fraudulent evasion of VAT by extending the category of participants and, thus, of those whose transactions do not meet the objective criteria which determine the scope of the right to deduct. The court preserved the principle of legal certainty; it did not trump it.

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*.

60. The true principle to be derived from *Kittel* does not extend to circumstances in which a 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.

Legal Certainty

61. Such an approach does not infringe the principle of legal certainty. It is difficult to see how an argument to the contrary can be mounted in the light of the decision of the court in *Kittel*. The route it adopted was designed to avoid any such infringement. A trader who decides to participate in a transaction connected to fraudulent evasion, despite knowledge of that connection, is making an informed choice; he knows where he stands and knows before he enters into the transaction that if found out, he will not be entitled to deduct input tax. The extension of that principle to a taxable person who has the means of knowledge but chooses not to deploy it, similarly, does not infringe that principle. If he has the means of knowledge available and chooses not to deploy it he knows that, if found out, he will not be entitled to deduct. If he chooses to ignore obvious inferences from the facts and circumstances in which he has been trading, he will not be entitled to deduct.

62. The principle of legal certainty provides no warrant for restricting the connection, which must be established, to a fraudulent evasion which immediately precedes a trader's purchase. If the circumstances of that purchase are such that a person knows or should know that his purchase is or will be connected with fraudulent evasion, it cannot matter a jot that that evasion precedes or follows that purchase. That trader's knowledge brings him within the category of participant. He is a participant whatever the stage at which the evasion occurs.

Penalty: Article 1 of the First Protocol ECHR

63. The taxpayers further support their challenge by reference to the jurisprudence of the European Court of Human Rights in *Intersplav v Ukraine* No. 803/02, 09/01/07, in which the ECHR declined to accept the Ukraine's assertion of a right to refuse a refund "in the absence of any indication of the applicant's direct involvement in [such] abusive practices" (§ 38). In *Bulves v Bulgaria* No. 3991/03, 22/01/09, the Court referred to *Intersplav* in ruling:-

> "However, it considers that if the national authorities, in the absence of any indication of direct involvement by an individual or entity in fraudulent abuse of a VAT chain of

> supply, *or knowledge thereof*, nevertheless penalise a fully compliant recipient of a VAT-taxable supply for the actions or inactions of a supplier over which it has no control and in relation to which it has no means of monitoring or securing compliance, they are going beyond what is reasonable and are upsetting the fair balance that must be maintained between the demands of the general interest of the Community and the requirements of the protection of the right of property." (§ 70) [my emphasis]

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. I 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.

65. The *Kittel* principle is not concerned with penalty. It is true that there may well be no correlation between the amount of output tax of which the fraudulent trader has defrauded HMRC and the amount of input tax which another trader has been denied. But the principle is concerned with identifying the objective criteria which must be met before the right to deduct input tax arises. Those criteria are not met, as I have emphasised, where the trader is regarded as a participant in the fraud. No penalty is imposed; his transaction falls outwith the scope of VAT and, accordingly, he is denied the right to deduct input tax by reason of his participation.

Conclusions on Challenges

66. It is not arguable that the principles of fiscal neutrality, legal certainty, free movement of goods and proportionality were infringed by the Court itself, when they were at pains to preserve those principles (see §§ 39-50). By enlarging the category of participation by reference to a trader's state of knowledge before he chooses to enter into a transaction, the Court's decision remained compliant with those principles.

The Instant Appeals

67. In the light of my analysis it is necessary to return to the factual conclusions of the Tribunals in the instant appeals. There can be no question of a second challenge to the findings of actual knowledge in *Calltel* and *Opto*.

68. BSG and Mobilx are different. In both those appeals, the question arises whether the Tribunal applied the test in *Kittel* correctly. If it did not, the question then arises as to whether, on the application of the correct test, the true and only reasonable conclusion is that the trader knew or should have known that his transactions were connected with fraud or that there was no reasonable possibility other than they were was

connected with fraud. If a decision either way would fall within the bounds of reasonable conclusion, this Court ought not to interfere.

69. In BSG, the Tribunal posed the question correctly (see § 105) and framed its conclusion in terms of the correct test:-

> "Our conclusion is that *BSG* ought to have known that, by its purchases, it was participating in transactions connected with fraudulent evasion of VAT." (§ 228)

70. However, the problem identified by the Chancellor, particularly at § 52, is that the Tribunal appears to have approached the evidence by asking whether Mr Peters, the sole director and shareholder in BSG, exercised sufficient care and diligence when faced with what the Tribunal regarded as the uncommercial features of the deals being offered to BSG. It focussed on what he might have discovered had he made further investigations (see § 228). This approach, in the view of the Chancellor, led it into error. The Chancellor pointed out that no amount of enquiry would have revealed knowledge of the fraud with which Infinity's transactions were connected in the dirty, but not the clean chain, of which BSG's transactions formed part (see judgment, §§ 54-55).

71. The Tribunal set out a number of features of the deals which appeared to be uncommercial. It is unnecessary to list them but they led the Tribunal to say:-

> "225. Having regard to Mr Peters in relation to his own companies and his previous employers, we consider that the absence of any such investigation by Infinity into BSG should have raised suspicions in his mind.
>
> 226. We do not find on the evidence before us that there was control and manipulation, although we do consider that Mr Peters was much too ready, without careful and detailed review and exhaustive checks of all aspects of the proposed transactions, to become committed to them. It is not correct that he turned a blind eye to various elements of the transactions, but his enquiries were not sufficiently exhaustive to protect *BSG*."

72. The Tribunal set out a number of important questions:-

> "(1) Why was BSG, a relatively small company with comparatively little history of dealing in mobile phones, approached with offers to buy and sell very substantial quantities of such phones?
>
> (2) How likely in ordinary commercial circumstances would it be for a company in BSG's position to be requested to supply large quantities of particular types of mobile phone and to be able to find without difficulty a supplier able to provide exactly that type and quantity of phone?

> (3) Was Infinity already making supplies direct to other EC countries? If so, he could have asked why Infinity was not making supplies direct, rather than selling to UK traders who in turn would sell to such other countries.
>
> (4) Why are various people encouraging BSG to become involved in these transactions? What benefit might they be deriving by persuading BSG to do so? Why should they be inviting BSG to join in when they could do so instead and take the profit for themselves?" (§ 227)

73. Finally, the Tribunal concluded that:-

> "We think that if he had asked and obtained answers to the appropriate questions, he (Mr Peters) would have concluded that the uncommercial features of the deal being offered to BSG could only be explained by taking into account other transactions which Infinity was entering into, and that the most probable explanation was that those other transactions were connected in some way with fraud." (§ 228)

74. I am not prepared to reject the Chancellor's conclusion that the Tribunal's findings were insufficient to establish that BSG ought to have known that by its past purchases it *was* participating in transactions which were connected with fraudulent evasion of VAT (judgment, § 52). But I put my view in that guarded way for this reason. Read as a whole, the Tribunal does not appear to have found that BSG should have concluded that the only reasonable explanation for the circumstances in which it entered into the impugned transactions was that those transactions were connected with fraud. But the Tribunal came very close to making such a finding and I have only stepped back from reaching that conclusion myself because of the Tribunal's references to risk (§§ 162 and 226) and in particular because of the Tribunal's undue focus on whether Mr Peters had exercised due diligence or done "enough to protect himself". That is not the only question.

75. The ultimate question is not whether the trader exercised due diligence but rather whether he should have known that the only reasonable explanation for the circumstances in which his transaction took place was that it was connected to fraudulent evasion of VAT. The Tribunal might have concluded that Mr Peters should have known that the transactions into which he entered were connected with fraud, by reference to the unconventional nature of those circumstances (a finding it came close to making at § 228). But it was not the only decision within the bounds of reasonable conclusion.

76. Accordingly, the importance of BSG may be in the Tribunal's recognition of the surrounding uncommercial circumstances which it identified in the questions I have set out above. But for the reasons I have given I would dismiss HMRC's appeal.

Mobilx

77. There remains only the case of Mobilx. For the reasons I have given, both the Tribunal and Floyd J applied the wrong test. The question was not whether Mobilx

should have known that its transactions were more likely than not to be connected with fraud (the test applied by the Tribunal at § 108 and by Floyd J at § 88). The correct question is whether it should have known that its transactions were connected with fraud. That, as I have said, could be established by demonstrating that it ought to have known that the only reasonable explanation for the circumstances in which the transactions in question were undertaken was that they were connected with fraud. In my judgement, although the Tribunal applied the wrong test, the primary facts found by the Tribunal did establish that the only reasonable explanation for the transactions in respect of which Mobilx claimed repayment of input tax, in their returns between April and June 2006, was their connection with fraudulent evasion of VAT.

78. The vital finding of fact is that set out by the Tribunal at § 106:-

> "This is not a case in which an occasional purchase can be traced back to defaulters while most are untainted, nor one where a trader has dealt with only one supplier of tainted goods, while other suppliers' goods have been untainted. As the administrators accepted, every one of those chains of transactions in CPUs which HMRC had been able to trace led back to a defaulter, regardless of the identity of Mobilx's immediate supplier or, indeed, its purchaser. Had that been the case only in Mobilx's first few months of trading it might be attributable to misfortune or inexperience; but by the end of March 2006 Mobilx had been trading for over two years, using the same fairly small circle of suppliers. As we have recorded, Mr Hetherington agreed that the information Mobilx received at the meeting which took place on 14 September 2004 (that 17 out of 24 chains in May and June had been traced to defaulters) was "a disaster" from Mobilx's point of view, and there were several further indications by HMRC in a similar vein before the beginning of April 2006, particularly at both of the meetings in March 2006. There was no improvement: not one traced chain turned out to be legitimate. Mr Martin's letters of 7 April and 1 June 2006, received by Mobilx within the relevant period, contained yet more of the same information. Yet throughout Mobilx carried on dealing in CPUs, using the same suppliers unless, faced with what it could accept only as overwhelming and inescapable evidence, it felt obliged to suspend trading; in that we agree entirely with Mr Cunningham."

The response to the warnings Mobilx received from HMRC is set out at § 107:-

> "Mobilx's attitude (and, indeed, Mr Hetherington's) was not that to be expected of a company whose directors, as Steven Bell in particular emphasised, had high ethical standards, and were extremely anxious to avoid becoming drawn into fraudulent transactions. The response to HMRC's letters notifying Mobilx of tainted chains which they had traced was concern and disappointment, but not that Mobilx had been drawn into fraudulent chains; in fact there was a marked lack of

> curiosity about the identity of the suppliers who had sold tainted goods. It is true that the information the Commissioners provided was lacking in detail but, as Mr Hetherington eventually agreed, Mobilx could have made much greater use of it than it did (and, had it done so, would have realised by mid-2005 that it was repeatedly buying tainted goods from Sound Solutions, with which it continued to trade)."

79. It is on the basis of those findings that both the Tribunal and the judge concluded that Mobilx ought to have known that every transaction in which it was engaged was likely to lead back to fraudulently defaulting traders. Further, as the judge noted, the evidence clearly established that Mobilx knew that the CPU business in which it was engaged was rife with MTIC fraud (see § 84). Accordingly, this is a case in which Mobilx knew that those transactions which could be traced by HMRC had led back to fraud in the past in a trade where fraud was rife. It chose not to change the manner in which it conducted its trade but merely continued to trade in the same pattern as before.

80. In my judgment, on the basis of those findings the true and only reasonable conclusion, is that Mobilx ought to have known that the only realistic possibility, as it continued to trade in that manner, was that its purchases would be connected with fraudulent evasion of VAT and not merely that all its transactions were more likely than not to be connected with fraud. In those circumstances, despite the Tribunal's error of law in the test which it applied, that error makes no difference to the true and only reasonable conclusion. For that reason, I would dismiss Mobilx's appeal. I would also dismiss HMRC's appeal in Blue Sphere and the appeals of Calltel Telecom and Opto.

Questions of Proof

81. HMRC raised in writing the question as to where the burden of proof lies. It is plain that if HMRC wishes to assert that a trader's state of knowledge was such that his purchase is outwith the scope of the right to deduct it must prove that assertion. No sensible argument was advanced to the contrary.

82. But that is far from saying that the surrounding circumstances cannot establish sufficient knowledge to treat the trader as a participant. As I indicated in relation to the BSG appeal, Tribunals should not unduly focus on the question whether a trader has acted with due diligence. Even if a trader has asked appropriate questions, he is not entitled to ignore the circumstances in which his transactions take place if the only reasonable explanation for them is that his transactions have been or will be connected to fraud. The danger in focussing on the question of due diligence is that it may deflect a Tribunal from asking the essential question posed in *Kittel*, namely, whether the trader should have known that by his purchase he was taking part in a transaction connected with fraudulent evasion of VAT. The circumstances may well establish that he was.

83. The questions posed in BSG (quoted here at § 72) by the Tribunal were important questions which may often need to be asked in relation to the issue of the trader's state of knowledge. I can do no better than repeat the words of Christopher Clarke J in *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."

84. Such circumstantial evidence, of a type which compels me to reach a more definite conclusion than that which was reached by the Tribunal in Mobilx, will often indicate that a trader has chosen to ignore the obvious explanation as to why he was presented with the opportunity to reap a large and predictable reward over a short space of time. In *Mobilx*, Floyd J concluded that it was not open to the Tribunal to rely upon such large rewards because the issue had not been properly put to the witnesses. It is to be hoped that no such failure on the part of HMRC will occur in the future.

85. In so saying, I am doing no more than echoing the warning given in HMRC's Public Notice 726 in relation to the introduction of joint and several liability. In that Notice

traders were warned that the imposition of joint and several liability was aimed at businesses who "know who is carrying out the frauds, or choose to turn a blind eye" (3.3). They were warned to take heed of any indications that VAT may go unpaid (4.9). A trader who chooses to ignore circumstances which can only reasonably be explained by virtue of the connection between his transactions and fraudulent evasion of VAT, participates in that fraud and, by his own choice, deprives himself of the right to deduct input tax.

Sir John Chadwick:

86. I agree.

Lord Justice Carnwath:

87. I also agree.