Alleged MTIC fraud - Tribunal finding by majority that taxable person neither knew or should have known his transactions were connected with fraud – whether Tribunal applied the right legal test – yes – appeal dismissed

Appeal number: FTC/53/2010

UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)

- -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS — **Appellants**

- and -

BRAYFAL LIMITED — **Respondent**

TRIBUNAL: MR JUSTICE LEWISON

Sitting in public at the Royal Courts of Justice on 21 and 22 February 2011

Mr John Black QC and Mr Jonathan Cannan (instructed by **the General Counsel and Solicitor to HM Revenue and Customs**) for the **Appellants**
Mr Michael Patchett-Joyce (instructed by **Dass**) for the **Respondent**

1. HMRC refused Brayfal's claim to a refund of VAT on the export of mobile phones, on the ground that it knew or should have known that its transactions were connected with fraud. Mr Kibbler, to whom frequent reference is made, was the moving spirit behind Brayfal. His knowledge is Brayfal's knowledge. By its decision of 22 August 2008 the VAT & Duties Tribunal allowed Brayfal's appeal. The Tribunal unanimously found that HMRC had failed to prove that Brayfal knew or had the means of knowing at the time that it entered into the transactions in question that they were connected to fraud. HMRC appealed against that decision, principally on the ground that the Tribunal had given inadequate reasons for its decision. By consent the appeal was remitted so that the Tribunal could give further reasons for its decision. In the meantime the VAT & Duties Tribunal had been replaced by the First Tier Tribunal ("the FTT") and so it was that tribunal that reconsidered the decision. It released its decision on 3 March 2010.

2. This time the tribunal was not unanimous. The Tribunal judge (Judge David Demack) concluded that HMRC had proved that Brayfal knew or should have known that its transactions were connected with fraud. The Tribunal members (Mr Arthur Brown and Mr Peter Whitehead) remained of the view that HMRC had not proved its case. Since the members were in the majority, Brayfal's

appeal remained allowed. HMRC appeal once again; this time to the Upper Tribunal.

3. The background to the appeal is that of MTIC fraud; and the particular variant in play is contra-trading. Readers of these decisions will need no explanation of these terms; and in any event they are fully explained in the decisions under appeal. Suffice it to say that HMRC does not allege that Brayfal is the contra-trader. It is alleged to have been a "broker i.e., exporter)" in a clean chain. The significance of a clean chain is that each participant in the chain accounts correctly for VAT in relation to sales and purchases in that chain.

4. While Brayfal's appeal has been making its way through the system, the law has been considered by the courts on a number of occasions. It finds its latest authoritative pronouncement in the decision of the Court of Appeal in *Mobilx Ltd v HMRC* [2010] EWCA Civ 517. This decision was handed down on 12 May 2010, a couple of months after the revised decision of the FTT. That case examined the ramifications of the decision of the ECJ in *Axel Kittel v Belgium*; *Belgium v Recolta Recycling* Joined Cases C-439/04 and C-440/04 [2006] ECR 1-6161 ("*Kittel*"). What the Court of Appeal decided was:

   i) 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 fails to meet the objective criteria which determine the scope of the right to deduct. (§ 43)

   ii) 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. (§ 52)

iii) The principle 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. (§ 60)

iv) The test 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. (§ 59)

v) 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. (§ 81)

vi) In answering the factual question, 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 focusing 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. (§ 82)

5. I should also record that it was common ground that these principles should be applied in the light of the circumstances prevailing at the date of the taxable person's own transactions: C-354/03 *Optigen Ltd v Customs and Excise Commissioners* [2006] ECR I-483.

6. Under section 11 (1) and (2) of the Tribunal Courts and Enforcement Act 2007 a party to a case has a right to appeal to the Upper Tribunal "on any point of law" arising from a decision of the First Tier Tribunal. Section 12 gives the Upper Tribunal certain powers; but they only arise "if the Upper Tribunal … finds that the making of the decision concerned involved the making of an error of law." This formulation, as it seems to me, invites the application of the familiar test in *Edwards v Bairstow* [1956] AC 14 to the question whether an error of law has been made.

7. It is, however, important to have in mind the limits of that test. In *Georgiou v. Customs and Excise Commissioners* [1996] STC 463, 476, Evans LJ said:

> "… it is all too easy for a so-called question of law to become no more than a disguised attack on findings of fact which must be accepted by the courts. As this case demonstrates, it is all

> too easy for the appeals procedure to the High Court to be abused in this way. Secondly, the nature of the factual inquiry which an appellate court can and does undertake in a proper case is essentially different from the decision-making process which is undertaken by the tribunal of fact. The question is not, has the party upon whom rests the burden of proof established on the balance of probabilities the facts upon which he relies, but was there evidence before the tribunal which was sufficient to support the finding which it made?"

8. He continued:

> "… for a question of law to arise in the circumstances, the appellant must first identify the finding which is challenged; secondly, show that it is significant in relation to the conclusion; thirdly, identify the evidence, if any, which was relevant to that finding; and fourthly, show that that finding, on the basis of that evidence, was one which the tribunal was not entitled to make."

9. He concluded:

> "What is not permitted, in my view, is a roving selection of evidence coupled with a general assertion that the tribunal's conclusion was against the weight of the evidence and was therefore wrong."

10. This approach was followed in (among other cases) *Arif v Revenue and Customs Commissioners* [2006] EWHC 1262 (Ch); *Mobilx Ltd v HMRC* [2009] STC 1107 and *Megtian Ltd v HM Revenue & Customs* [2010] STC 840.

11. It is necessary first to examine what explicit directions the FTT gave themselves on the law. These are to be found in paragraphs 44 to 47 of the revised decision. The question whether Brayfal knew or should have known that its transactions were connected with fraud was labelled "question 3". They said:

"44. We turn then to consider our approach to question 3. At paragraph 111 of his judgment in *Red 12 Trading*, Christopher Clarke J said this:

" … 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."

45. In reaching its own decision as to the answer to question 3, in *Blue Sphere Global Ltd v Commissioners for Revenue and Customs* (2008) UK VAT 20901 at [152], the tribunal found it helpful to adopt the approach taken in the direct tax case of *Hall (Inspector of Taxes) v Lorimer* [1992] STC 599 by Mummery J at 612 and subsequently approved by Nolan LJ [1994] STC 23 at 29:

"The object of the exercise is to paint a picture from the accumulation of detail. The overall effect can only be appreciated by standing back from the detailed picture which has been painted, by viewing it from a distance and by making an informed, considered, qualitative appreciation of the whole. It is a matter of evaluation of the overall effect of the detail, which is not necessarily the same as the sum total of the individual details. Not all details are of equal weight or importance in any given situation. The details may also vary in importance from one situation to another. The process involves painting a picture in each individual case."

46. The tribunal continued: "Individual factors may be insufficient in themselves to lead to a conclusion that a trader 'should have known', but the accumulation of a whole series of such factors may prove to be of such weight that, on the evidence before a tribunal, this can be the only conclusion."

47. Although we intend to proceed on the same basis as did the Blue Sphere tribunal, we should record that the members say that, whilst taking account of all the evidence, certain aspects of it relating to the completed deals entered into by Brayfal are of less importance than others whereas, since the supplier must have taken every reasonable measure to avoid participation in fraud (see *Livewire* at [85]), the judge takes the view that the tribunal must deal with the entirety of that evidence. The whole tribunal also considers it necessary to look at certain evidence relating to three cancelled deals, and one in which Brayfal failed to pay the VAT due on a transaction, but then proceeded to claim it in full as input tax. The members adopt their position as in its completed deals Brayfal dealt with its one supplier, Future, only on credit terms, and with its one

> customer, Universal, only on cash terms. Since this gives rise to some fundamental differences between the judge and the members, we record those differences in this part of our decision; we leave lesser matters and those which arise from consideration of the overall effect to our conclusion."

12. Mr Black QC, appearing with Mr Cannan for HMRC, did not criticise this self-direction. The direction recognises that all the evidence must be considered; that an accumulation of factors may prove a case; and that they must look at the totality of the deals. The FTT's explicit self-direction was, therefore, legally correct. HMRC must, therefore, establish that despite the fact that the FTT collectively directed themselves in accordance with the right legal test, the majority adopted some different legal test.

13. As I have said, the Tribunal judge and the Tribunal members disagreed on the answer to question 3. The members set out their reasoning in paragraphs 137 to 199 of the decision. Before coming to their reasoning on this question it is important to note that in considering earlier questions the whole FTT found that Future Communications (UK) Ltd ("Future") acted as a contra-trader in an overall scheme to defraud the public revenue and that Brayfal's transactions formed part of that scheme (§ 38). However, they went on to say:

> "we heard no evidence to show that Brayfal was aware that it was involved in the scheme, and *was thus an innocent party*." (§ 39)
>
> "On the basis of a detailed consideration of Mrs Clifford's evidence as to Future's dealings in general and of Brayfal's transactions with Future in particular, as mentioned in the last preceding paragraph, at [98] we found that Brayfal's transactions were part of an overall scheme to defraud the public revenue in which Future acted as a contra-trader, *despite Brayfal being made unaware of it.* We found as a fact that Brayfal's transactions were part of the scheme, and were thus referable to the fraudulent tax losses in Future's deal chains. As mentioned in the last preceding paragraph, *we heard no*

> *evidence to prove that Brayfal was aware of its involvement in the scheme*." (§ 40) (Emphasis added)

14. These were findings of the whole FTT, including the Tribunal judge. Some of the Tribunal judge's subsequent reasoning shows a tension (if not inconsistency) with these clear findings of fact. However, since he was in the minority it would serve no useful purpose to examine that any further. The point is that these findings are also consistent with the Tribunal members' subsequent statement that:

> "In *Blue Sphere* the Chancellor said at [46] "Plainly not all persons involved in either chain, although connected, should be liable for any tax loss. The control mechanism lies in the need for either direct participation in the fraud or sufficient knowledge of it". In the opinion of the members not only did Brayfal not have "sufficient knowledge", *it had no knowledge at all*." (§147) (Emphasis added)

15. Mr Black submitted that the members had not considered the question whether Brayfal had actual knowledge that its transactions were connected with fraud. However, in my judgment these three findings show that they did. These were conclusions of fact, with which the Upper Tribunal cannot interfere. There are further findings by the members which also address the question of actual knowledge.

16. The members began their detailed reasoning by saying that the clean chain (in which Brayfal found itself) was created before the dirty chain (§ 138). This was a vitally important point. In order for deduction of input VAT to be withheld, HMRC must prove, having regard to objective factors, that the taxable person, *at the time of his transaction*, knew or should have known that his transaction was connected with fraud. Where the impugned transactions are transactions in the clean chain this presents evidential problems for

HMRC. As the Chancellor pertinently asked in *Blue Sphere Global Ltd v HMRC* [2009] STC 2239: how can a trader who is not part of a conspiracy *know* of a fraud before it happens? If there is a regular course of conduct in which the trader knows that his transactions are connected with subsequent transactions that he knows *ex post facto* are fraudulent, there may come a time at which he can be credited with knowledge of the future. But that is not the case that HMRC advanced in this case. Moreover, in the present case, as the members pointed out all Brayfal's transactions were in the clean chain where every member correctly dealt with its VAT (§ 149). Thus the members' findings in §§ 138 and 149 were also relevant to, and supportive of, their rejection of the case based on actual knowledge. In a subsequent passage (§ 153) they said that HMRC were not aware at the relevant time that there was anything amiss with Future; so that Brayfal was "most unlikely" to have been aware. Mr Black drew attention to § 152 in which the members said:

> "Question 3 is, in our view, the one the Commissioners have to prove. They have already accepted that Brayfal was not a dishonest co-conspirator (see [22]) so must show that it had "the means of knowledge at the time of entering into its transactions that they were connected to the fraudulent tax losses"."

17. He said that the members had wrongly jumped from "no conspiracy" to "means of knowledge" without addressing limb 1 of the *Kittel* test: namely actual knowledge. In my judgment this paragraph must be read in context. The relevant context is that the whole Tribunal had already found that Brayfal was not aware that it was involved in the scheme; and that since the dirty chain was created after the clean chain actual knowledge and conspiracy are likely to

be interchangeable concepts. I do not, therefore, consider that on the facts of this case this paragraph reveals a legal error.

18. The Tribunal members then went on to consider whether Brayfal, through Mr Kibbler, "should have known" that its transactions were connected with fraud. They considered and weighed the evidence. This is what they had said they would do in § 47; which I have already quoted. So they were implementing their self-direction; not adopting a different legal test. One point that they specifically considered was whether they should prefer the evidence of Mr Kibbler to that of Mrs Clifford (who was the main witness for HMRC). The Tribunal judge preferred Mrs Clifford's evidence. But the members did not. They preferred the evidence of Mr Kibbler; and they gave reasons for their preference. Whether I agree with those reasons is neither here nor there. They were questions of fact for the FTT.

19. The essence of contra-trading is that transactions in the clean chain are used to mask transactions in the dirty chain. There is no fraud in the clean chain. The dirty chain is where the fraud takes place. Accordingly in order for a trader in the clean chain to know or have the means of knowledge that his transaction is connected with fraud, he must either know or have the means of knowledge that the contra-trader is a fraudster; or he must know or have the means of knowledge of the fraud in the dirty chain. The members accepted Mr Kibbler's evidence that he could only check Brayfal's own customers and suppliers (§ 158). In other words they found that he had no knowledge or means of knowledge of the dirty chain.

20. So the question was: did Mr Kibbler have the means of knowledge that Future was a fraudster? Having considered a number of different points the members summarised their conclusion as follows:

> "Summing up, in the members' opinion Mr Kibbler is an experienced businessman with many years experience of exporting mobile phones. He visited Future on a number of occasions and found what appeared to be a perfectly respectable business with premises appropriate to the level of business he conducted with them. He was aware that some of the staff had experience in trading mobile phones and also that Future had taken over a company, Unique Distribution, which was formerly part of the British Leyland Group, which he knew from his experience was a reputable company. He asked questions on where they sourced their supplies and was given acceptable answers although not names of actual suppliers. The members believe that no supplier would be prepared to disclose the actual source of its supplies and no reasonable customer would expect him to. For this reason the members conclude that Brayfal did all it could reasonably be expected to do to ensure the integrity of its supply chain."

21. That was a conclusion of fact which the members reached on the evidence. In my judgment it betrays no error of law. They expressed their ultimate conclusion on question 3 as follows (§ 199):

> "For the above reasons the members have concluded that Brayfal carried out all the reasonable enquiries that were required to prove to their satisfaction that on the balance of probabilities it had no actual knowledge or means of knowledge that the transactions it was entering into were connected with fraud. In coming to this decision they have taken account of the fact that Brayfal did not always conduct the full list of due diligence as suggested in its working practices. They have however concluded that, if it had completed these checks, they have no evidence to show that they would have made Brayfal aware that its transactions were tainted by fraud."

22. Their ultimate conclusion dealt with both actual knowledge and the means of knowledge (i.e. both limbs of the *Kittel* test). If anything, the way in which the members formulated their conclusion imposed a higher burden on Brayfal than

they should have done. They found that Brayfal had proved that it did *not* have actual knowledge or the means of knowledge, whereas we now know from *Mobilx* that the burden of proof lies on HMRC to prove that Brayfal *did* have knowledge or the means of knowledge. The appeal must be dismissed.

MR JUSTICE LEWISON

UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)

Release date: 2 March 2011