[2013] UKFTT 270 (TC)

TC02678

Appeal number: LON/2007/1401

VAT – MTIC – transactions connected with fraud? – yes - appellant knew transactions connected with fraud? – yes – appeal dismissed.

FIRST-TIER TRIBUNAL
TAX CHAMBER

RIGCHARM LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE RICHARD BARLOW
MR TYM MARSH MA MBA

Sitting in public in London on 5, 6, 7, 11, 12, 17, 19, 24 September and 1 October 2012.

Mr R Holland of Dass solicitors for the Appellant

Mrs J Goldring and Mr H Watkinson of counsel for the Respondents

DECISION

1. This is the appeal of Rigcharm Ltd in respect of the respondents' refusal to credit input tax of £2,560.337.50 for the three month accounting period ending April 2006 (04/06) and £154,875.00 for the period ending July 2006 (07/06).

2. By way of introduction only, we mention that the appeal is what is called, in the jargon that has become well known through other appeals, an MTIC case. Some of the appellant's transactions are what are known as clean chain broker transactions in which recovery of input tax is denied on the basis that those transactions are connected with fraudulent transactions through a contra-trader and the appellant either knew or should have known of that connection. Other transactions are dirty chain broker transactions leading back to defaulters in the UK. In using the terms clean and dirty chains and broker, contra-trader or defaulter we do so only for convenience and, as has been pointed out before by the Tribunal (see the Decision in *Totel Distribution Ltd*), use of those terms, although now well understood, cannot be allowed to prejudge or influence the Tribunal's decision one way or the other as to the correct legal and factual position.

3. Rigcharm Ltd had operated as a dispensing chemist for many years and the current director Mr Shabbir Dharas had been a director from 1982 working with his father until his father died in 2000 and thereafter Mr Dharas became the sole active director. By the early 1990s the company had built up a certain amount of capital but it was felt that it could not expand much as a dispensing chemist and the company started to deal in wholesale branded products such as Konica film. Towards the end of the 1990s it started to deal in mobile phones.

4. The appeal concerns 24 transactions of which 17 were in period 04/06 and seven were in period 07/06.

5. We will deal first with the 17 04/06 transactions.

6. Three were buffer deals in which the appellant bought telephones from UK suppliers and sold to UK customers. Despite the make, value and number of the telephones being significantly different in each deal and there being two suppliers and two customers, the appellant made a profit of exactly £1.00 per phone in each of the three deals. The appellant accounted for output tax on those transactions and claimed input tax which the respondents have not disallowed. However, the respondents allege that those transactions were in relatively long chains and that they all led back to defaulting traders who had failed to account for output tax giving rise to a tax loss when the goods were exported in zero rated transactions.

7. One transaction in April 2006 was a purchase by the appellant of 1,000 Nokia 7610 telephones from New Way Associates (a UK business) for a total of £120,000

(plus VAT) and sold to Brightways in the UAE for £127,000 (as a zero rated sale) thus the appellant would have achieved a mark-up of £7.00 per phone provided HMRC repaid the input tax claimed. Allowing for rounding to the nearest multiple of 50 pence that mark-up is exactly 6% of the tax exclusive price. In fact HMRC refused the appellant's input tax claim and that decision is under appeal in this appeal. That refusal is based on the respondents' contention that the transaction led back to a defaulting trader I Connect U Ltd which had gone missing without accounting for output tax on a transaction earlier in the chain of supplies leading to the appellant and that the appellant either knew or should have known that the transaction was connected with fraud i.e. a dirty chain broker transaction.

8. The remaining 13 transactions were all alleged to be clean chain broker transactions in which the appellant had bought telephones of various makes from two different UK suppliers and sold them to three different overseas buyers. The transactions involved different quantities, makes and values of telephones but the mark-ups the appellant would have achieved (if input tax had been paid) showed a pattern. In eleven of the transactions the mark-up was exactly 6% allowing for rounding to units of 50 pence. In one transaction the mark-up was the next nearest to 6% allowing for rounding to units of 50 pence and in the other transaction it was two units of 50 pence away from exactly 6%.

9. The UK suppliers in the 13 clean chain transactions were Blackstar UK Ltd (Blackstar) (seven transactions) and H&M Trading Ltd (H&M) (six transactions). Both of those traders were alleged by the respondents to be fraudulent contra-traders and that when the appellant carried out the 13 transactions it knew or should have known that they were connected with fraud.

10. We will next deal with the seven transactions in period 07/06.

11. Four of those transactions were buffer deals involving purchases from and sales to UK companies. All four of those transactions involved purchases from New Way Associates and the goods were all Nokia N70 telephones in quantities varying between 650 and 1,000 but in every case the appellant's mark-up was £1.00 per telephone. All four buffer transactions led back to alleged defaulting traders who failed to account for output tax and led on to exporters who made zero rated sales to overseas customers with the consequence that the respondents suffered a tax loss. The respondents have not refused the appellant's input tax claim for these transactions.

12. The remaining three transactions were ones in which Nokia N70 telephones had been purchased from two different UK suppliers and were sold to two different customers (both of which were in the UAE). In each of those three transactions the chain of supply led back to alleged defaulting traders who had failed to account for output tax. When the appellant exported the goods the sale was zero rated with the consequence that, had the respondents paid the input tax the appellant claimed on its purchases, the appellant would have achieved mark-ups between 2.86% and 4.6% of the tax exclusive purchase price. These were therefore alleged to be dirty chain broker transactions.

13. In all the broker transactions, although the mark-up is as stated above, the true profit the appellant stood to make can be expressed differently because of the method of trading adopted. The appellant did not have to pay its supplier until it had been paid by its customer. Although the tax inclusive price paid to the supplier exceeded the zero rated price charged to the customer the appellant's outlay only began when it was paid by the customer so that it only had to finance the difference between the tax inclusive purchase price and the zero rated sales price, less its own profit, until HMRC paid back the input tax claimed. The appellant never had to outlay the actual full purchase price of the goods. The true profit margin would therefore have been between 37% and 16.56% in the broker deals for which the input tax claims have been refused. A consequence of the similarity of the 6% mark ups is that the true profit margin for those transactions was also very similar in each of those cases and it was around 35%. Had HMRC not challenged the input tax claims the payments would have been made within about two months of the transactions so that the 35% profit would have been made in that timescale.

The legal issues.

14. In *Kittel –v- Belgium* [2008] STC 1537 the ECJ held that on the one hand, at [60], where a recipient of a supply buys goods and "did not and could not know that the transaction concerned was connected with fraud" then the Member State in which the recipient is registered for VAT cannot provide, by its domestic law, that such a transaction is void and cannot provide that input tax is not claimable on the transaction. On the other hand, at [61], the ECJ held that "where it is ascertained, having regard to objective factors, that the supply is to a taxable person who knew or should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of VAT, it is for the national court to refuse that person entitlement to the right to deduct".

15. At [51] the ECJ had also held that a trader who has taken every precaution to ensure that his transaction is not connected with fraud, must be allowed to claim input tax. At [52] the Court held that a person who "did not and could not" know that his transaction was connected with fraud would be entitled to claim input tax despite a connection between his transaction and a VAT fraud.

16. The Court did not explain specifically what it meant by "should have known" but [51] and [52] of the judgment suggest that a trader should take, at least, reasonable precautions to avoid being involved in a transaction connected with fraud. Taken literally "every precaution" and "could not know" might suggest that the test is a very strict one. But bearing in mind [56] to [58] of the judgment we do not read it in that way. The Court used the word "should" for the first time in paragraph [56] and explained the rationale of the rule it then set out at [61]. It said that the rationale was that a person who either knew or should have known of the connection with fraud is to be "regarded as a participant" and that he "aids the perpetrators"; which appears to suggest a degree of blame that would not have attached to a person simply for

overlooking a precaution that he might have taken or who could have known of a connection but only in some obscure way.

17. The Court also explained the underlying rationale of the rule in terms of its being for the better prevention of fraud.

18. It is well established that the right to deduct input tax is exercisable immediately when a transaction occurs and the ECJ emphasised this in *Kittel*. One consequence of that is that the applicable circumstances known to the appellant at the time of a transaction and the actions taken by the appellant at or before the time the transaction occurred are the relevant facts and that information acquired by the appellant subsequently will be irrelevant. Actions taken by the appellant after a transaction will also be irrelevant as such but, of course, they may shed light on what the appellant knew at the time if, for example, they appear to amount to attempts to cover up the true circumstances applying at the time of the transaction.

19. The Court of Appeal judgment in *Mobilx and others –v- Revenue and Customs Commissioners* [2010] STC 1436 considered in detail the issues raised in cases of this sort and Moses LJ elaborated on the meaning of the "should have known" concept. He held that it is not enough for HMRC to prove that the circumstances were such that it was more likely than not that a transaction in question was connected with fraud and that what they must prove is that the transaction was connected with fraud.

20. Mr Holland argued that the decision in *Mobilx* was wrong. We are bound to follow that decision and it may be that to set out the reasons why we consider it to be correctly decided is itself to risk an accusation of lèse-majesté. However in deference to Mr Holland's arguments we will say why we think he was wrong to contend that *Mobilx* was wrongly decided.

21. Mr Holland contended that Moses LJ had conflated two concepts. The first of which is what the ECJ called in *Kittel* the "objective criteria" which in principle give rise to the right to deduct input tax which can be broadly described in a typical transaction as the purchase of taxable goods or services for the use of a taxable person in his business. The second concept which Mr Holland contended was conflated with the first is what the ECJ termed the "objective factors" which cause the right to claim input tax to be lost.

22. Mr Holland cited paragraphs 20, 28 and 30 of the judgment of Moses LJ as passages where he contended that the two concepts had been conflated but it is important to note that the ECJ's decision dealt fist with a situation where "tax is evaded by the taxable person himself" (paragraph 53) and then proceeded to deal with the situation where a person knew or should have known that he was taking part in a transaction connected with fraudulent evasion (paragraph 56) and thus came to be regarded as a participator in the fraud (paragraph 56) and by aiding the perpetrators became their accomplice (paragraph 57).

23. It is true that the ECJ used the term "objective criteria" when referring to the criteria giving rise to the right to deduct and for the loss of that right in respect of a

fraudulent person who evades tax but on the other hand when dealing with the loss of the right to deduct for those who knew or should have known their transactions were connected with the fraud the ECJ used the term "objective evidence" when referring to how the loss of the right would arise in such a case.

24. Those distinct categories are recognised in the judgment of Moses LJ in *Mobilx*. In paragraph 41 he quotes extensively from *Kittel* and draws the same distinction between fraudulent evasion on the one hand and on the other hand a case where a person knew or ought to have known that the transaction was connected with fraud. The important point is that Moses LJ distinguished between those two situations in exactly the same way as the ECJ had done. If there is any real distinction between "objective criteria" and "objective evidence" the fact that the learned Lord Justice used the term "objective criteria" where the ECJ had used "objective evidence" has not led to any error in the Court of Appeal's reasoning, which is exactly the same as that of the ECJ.

25. Paragraph 41 of the judgment in particular ends with this sentence: "Once such traders were treated as participants their transactions did not meet the objective criteria determining the scope of the right to deduct". Use of the word "once" shows that the Court of Appeal recognised that the objective criteria, in the sense used by the ECJ, were met until the opposite was shown to be the case and they became treated as participants by evidence or as the ECJ would have put it by "objective factors" or by "objective evidence".

26. Mr Holland referred to two recent cases in the CJEU.

27. The first case is *Mahageben –v- Menzet Ado es Vamhivatal Del-dunatuli Regionalis Ado Foigazgatosaga* (C-80/11) (*Mahageben*). In that case the issue was whether National Law is compatible with EU Law where the former makes the deduction of input tax conditional upon the taxpayer claiming it being in possession of documents other than the supplier's invoice and upon the claiming party having carried out specified due diligence. As UK law does not require any such documents or due diligence that case does not have any relevance to this appeal. Questions of due diligence and indeed the possession of documents other than an invoice may be relevant as a matter of evidence in respect of questions related to whether a taxpayer knew or should have known that a transaction was connected with fraud but UK law does not prescribe how those questions should be determined.

28. The second case is *Peter David –v- Same* (C-142/11) (*David*). The *David* case raises similar issues to the *Mahageben* case. It also raises an issue as to whether the refusal of deduction in the circumstances requires the tax authority to show that the taxpayer claiming the deduction was aware of the unlawful conduct or even colluded in it. The *Kittel* line of cases makes it clear, in our opinion, that the answer to that question is that the person claiming deduction must have known or be a person who should have known about the unlawful conduct.

29. For completeness we refer to *Bonik EOOD –v Direktor na Direktsi Obzhalvane I upravlenie na izpalnenieto, Varna* (C-285/11) (*Bonik*). The *Bonik* case raised issues

somewhat similar to those in issue in this appeal but the questions referred appear to be related to whether a strict liability can give rise to a refusal of input tax recovery and whether the burden of proof can be imposed on the claiming party to show that other parties in the chain of transactions had not acted unlawfully. The established case law in the UK precludes any strict liability and places the burden of proof on HMRC so that in those respects the outcome of the *Bonik* case could not assist the appellant in this case but could put it at a disadvantage it does not presently suffer. We also consider that the *Kittel* line of cases makes the it clear what the legal position is both in that respect and in respect of a question which appears to have been raised in the *Bonik* case as to whether the National Law should specifically provide for the loss or refusal of the right to deduct or whether that is inherently provided for in the concepts established by the VAT Directives themselves.

30. The *Mobilx* litigation included some decisions relating to contra-trading. Moses LJ specifically held that it matters not if the input transaction in question precedes the transaction which gives effect to the fraud. He held that if the taxable person is proved to have entered into a transaction that he knew or should have know, at the time of entering into it, was at that time connected with fraudulent evasion or would be so connected later; that is sufficient to deny recovery of input tax.

31. Moses LJ also held that, where an issue arises about what a person should have know, it is relevant to consider whether the only reasonable explanation for the circumstances surrounding the transaction is that it is connected with fraud. He also stressed the relevance of circumstantial evidence generally.

32. In *Livewire –v- HMRC* [2009] STC 643 Lewison J remarked at [102] and [103] that in a contra-trading case there are two frauds namely the dirty chain default and its cover up by the contra-trader and that the clean chain broker must be shown to have known or to be a person who ought to have known of one or both of those frauds. The learned judge added: "If he knows or should have known that the contra-trader is engaging in fraudulent conduct and deals with him, he takes the risk of participating in a fraud, the precise details of which he does not and cannot know". At [105] the learned judge said: "In other words, if the taxable person knew of the fraudulent purpose of the contra-trader, whether he had knowledge of the dirty chain does not matter".

33. In *HMRC –v- Brayfal* [2011] STC 1338 at [19] Lewison J, after noting that there is no fraud in the clean chain, said that the clean chain broker must be shown to have known or to have had the means of knowledge that his transaction is connected with fraud and "he must either know or have the means of knowledge that the contra-trader is a fraudster". We assume the judge's reference to the means of knowledge is shorthand for the "should have known" concept as understood in the authorities because having the means of knowledge by itself is not sufficient to disallow input tax. But the relevance of the passage is that the reference to the contra-trader is to him as a fraudster without any specific type of fraud being specified. The judge then added that the taxpayer's input tax claim would also be disallowed if he had knowledge or the means of knowledge of the dirty chain.

34. We interpret Lewison J's remarks as meaning that the taxpayer must know or be a person who should have known of a fraud before input tax will be disallowed and the fraud in question will in fact be either the dirty chain fraud or the cover up by the contra-trader. But he need not know or be a person who should have known what precise form the fraud takes as long as he knew or should have known there was a fraud of some type being committed by the contra-trader or alternatively that he actually knew or should have known about the dirty chain fraud, the latter being less likely to be capable of proof where the claimant is in the clean chain because he will have dealt only with the contra-trader. That interpretation of Lewison J's remarks is also more in tune with the judgment of Briggs J in *Megtian –v- HMRC* [2010] STC 840 at [35] to[39] (especially [38]) and indeed to *Mobilx* and *Kittel* itself.

35. Mr Holland referred to a remark made by Judge Dr Avery Jones in the First-tier decision in *Livewire*: "The nature of contra-trading is easy to state [in terms of clean and dirty chains] but the problem in real life is that there is no logical connection between the clean and dirty chains". He may be right about that but the issue in this case is whether the clean chains are connected with the fraud of the contra trader not whether they are connected with any particular dirty chain. That is to say the connection contended for is that the clean chain transactions assist the fraud as a whole rather than any individual dirty chain transaction.

36. Mr Holland contended that the *Mahageben* and *David* cases showed that contra-trading allegations were not a proper basis for denying input tax claims because they referred to phrases such as 'fraud committed earlier in the chain of transactions' but we hold that to be simply because that was the form the transactions in those cases took. There is nothing in *Kittel* that suggests that the connection with fraud should take any particular form before it will be apt to disallow a claim for input tax. What has to be proved is a connection with the fraud. Whilst it is true that the ECJ did not refer to contra-trading that was no doubt because it was not relevant on the facts to do so but having decided that a connection with fraud was the vital question it was not necessary or probably even possible for the ECJ to spell out every possible type of connection that might arise.

37. Mr Holland also contended that a contra trading allegation, even if proved, is not a valid reason for refusing input tax claims in the clean chain. He cited in support of that the *Mahageben* case in which the CJEU referred to transactions connected with a fraud "previously committed by the supplier or another trader at an earlier stage in the transaction" and the remark quoted above by Judge Dr Avery Jones. We do not agree that those factors support Mr Holland's contention that the UK courts and tribunals have been wrong to recognise the contra trading concept as a genuine phenomenon and as a potential basis for denying input tax claims where it can be shown that the clean chain transaction is connected with the fraud.

38. The Court in *Mahageben* made it very clear that it was not overruling the *Kittel* judgment. In *Kittel* the ECJ stipulated that the right to deduct is lost if there is a connection with fraud (again we stress not a connection with another fraudulent transaction) and it did not specify or limit the form that connection might take. The limiting factor was specifically the knowledge of a connection with the fraud on the

part of the taxpayer whose input tax was being refused or that the taxpayers should have known there was a connection.

39. Further, we hold that the fact that the ECJ made liability to lose the right to deduct input tax dependent, in some cases, on being a person who should have known of the connection with fraud, is entirely inconsistent with and refutes any argument to the effect that the taxpayer must be shown to be a fellow conspirator with the contra trader. Mr Holland had so argued. The question cannot be judged as matter of UK law and so a direct comparison with the UK law of conspiracy is invalid but even if one assumes some equivalent concept not precisely based on UK law it seems obvious the "should have known" principle is completely inconsistent with a positive requirement for active participation in the fraud. A person who should have known something must mean a person who did not in fact know it because the concept is stated as an alternative to the case where the person concerned did know it. It follows that, at least in the case of a person who is only shown to be someone who should have known of the connection, that person cannot be equated with a conspirator or other active participant in the fraud or in the planning of the complex fraud.

40. In fact we see no reason why a person who is shown to know of the connection necessarily thereby is shown to be an active participant equivalent to a conspirator. A trader may know of the connection but simply go along with the fraud without engaging positively with the other fraudulent participants.

41. It is relevant to note that the ECJ in *Kittel* (at paragraph 56) said that a person who knew or should have known of the connection with fraud "must … be regarded as a participant". To be regarded as something is not the same as being that thing and again the ECJ therefore made it clear in that passage of its judgement that the refusal of a claim for input tax does not depend upon proof of active or conspiratorial participation in the fraud itself.

The course of the proceedings.

42. The appellant agreed the evidence of some of the respondents' witnesses and although a number of witnesses were called whose evidence was not agreed the cross examination of those witnesses was extremely limited. Mostly only a few points of detail or clarification were raised by Mr Holland. We will deal with such points of fact as appear to have been disputed and to remain disputed and make our findings on them. But because of the limited cross examination and concessions later made by Mr Holland we need not deal in great detail with most of the respondents' evidence and we can summarise most of it as undisputed evidence.

43. Although the proposed timetable of witnesses had included time for the appellant's evidence, which was expected to consist of the evidence of Mr Shabbir Dharas the director of the appellant, no live evidence was given by the appellant at all. The circumstances were these. On the day Mr Dharas was due to give evidence Mr Holland announced that Mr Dharas was in hospital with a knee problem and would not be giving evidence. Mr Holland expressly stated that he was instructed not to seek an adjournment but that the decisions under appeal were still disputed by the

appellant. The very limited medical evidence produced by Mr Holland might or might not have satisfied us that Mr Dharas was too ill to attend or rather that he would have remained too ill to attend for any length of time but we did not have to consider any such issues because Mr Holland was instructed that Mr Dharas would not be coming and did not want to apply for an adjournment. It was noticeable that Mr Holland was not attended by anyone at any point during the hearing and although there is no compulsion on the appellant to attend when it is represented by a solicitor it is somewhat unusual in a case like this that no one from the appellant should attend at all during the hearing.

44. Mr Holland did not suggest that any of the respondents' evidence was incredible as expressed in the witness statements and the evidence in chief of those witnesses who were called and who confirmed the evidence stated in their witness statements and explained it in their evidence in chief.

45. The appellant did not concede that the claim to input tax was invalid and so the appellant's case is in effect that even taking the respondents' evidence of fact at face value the conclusions to be drawn from it do not support the respondents' case. The evidence that the appellant knew or should have known the transactions were connected with fraud and the connections themselves are mostly if not entirely based on circumstantial evidence and the conclusions to be drawn from the primary facts and so it was open to the appellant to argue that the respondents had not proved their case. The burden of proof rested on the respondents so far as the real issues in the case were concerned.

46. Mr Dharas had given a witness statement and we will give it such weight as we consider appropriate but it was itself very limited as it only amounted to a commentary on the evidence of two of the respondents' witnesses interspersed with a few comments.

The evidence.

47. We will deal with the evidence that the various alleged defaulting traders were dishonest. We will deal with the defaulting traders in the buffer deals first, then the dirty chain transactions. As far as the clean chain transactions are concerned the appellant, through Mr Holland, did not challenge the allegation that the two contra traders had acted dishonestly and we will explain why we need not make findings about the relevant alleged defaulting traders in the contra-traders' dirty chains and deal with the contra traders themselves fairly briefly.

48. We will then make our findings about whether the clean chain transactions were connected with the fraudulent transactions in the alleged contra trading transactions.

49. Finally, we will make our findings about whether the appellant knew or should have known that its dirty chain transactions were connected with the fraud and whether its clean chain transactions were connected with the fraud, albeit in those cases through the contra trader.

The alleged defaulting traders: buffer deals.

50. There are five alleged defaulting traders in the buffer deals.

51. The first is Oracle Wines UK Ltd (Oracle). That company began to trade in mobile phones in July 2003 on a small scale but at a visit by an officer of HMRC on 30 January 2006 the director of Oracle, Mr Ratoo, told the officer the company had conducted 12 deals in the three months then ending and when the VAT return was received two of the sales had been omitted. When the records were produced it transpired that Oracle's VAT liability for the period ending 01/06 was over £1million.

52. On 5 April 2006 several more transactions came to the respondents' notice via a freight forwarder and the commissioners issued a notice shortening Oracle's tax period and demanding it make a return immediately. On an unannounced visit an officer discovered that the company had been making third party payments and that the amounts it received from its customers were wholly insufficient for it ever to be able to pay the VAT it then owed. Initially an assessment for £1.2million was issued but as more transactions came to light it appeared that Oracle had conducted transactions worth in the region of £125million. The respondents contend, and we agree, that that sum is not credible in ordinary trading. An assessment for £23million was raised (based on transactions which included the transaction which led to the appellant's deal 2 of April) and Oracle has neither paid nor appealed against it.

53. Mr Ratoo produced false documents in an attempt to persuade HMRC that there were offsetting inputs to set against the unpaid output tax. He was also unable to access his company's FCIB bank account giving rise to a suspicion that the company was actually being operated by someone else which is further borne out by the third party payments and the non-receipt of payments from customers.

54. We have no hesitation in finding that Oracle was a dishonest defaulter including in respect of the transaction that led to the appellant's buffer deal.

55. The second defaulting trader in the buffer deals is Bullfinch Systems Ltd (Bullfinch) which registered for VAT in October 2005 declaring its business to be "software and security implementation". This company relates to the appellant's deal 4 in April 2006.

56. Bullfinch's first VAT return for 10/05 declared sales worth £7million and the one for 01/06 declared sales of £1.5million. Bullfinch came to the commissioners' attention when freight forwarders informed them that the company was dealing in phones and on making a direction to shorten its VAT period and requiring it to make a return an officer visited and found that Bullfinch had no records at its office. Assessments totalling £56million were issued which meant that Bullfinch had a turnover of over £320million in the three and a half months to 11 May 2006. The transaction leading to the appellant was included in that assessment. The assessments have neither been paid nor appealed and the director is untraceable and has disappeared.

57. We have no hesitation in finding that that evidence proves that Bullfinch was a dishonest defaulter including in respect of the transaction that led to the appellant's buffer deal.

58. The third defaulter is USM IT Suppliers Ltd (USM).

59. USM claimed to have begun to undertake wholesale transactions in January 2006 but it made sales between February 2006 and 14 March 2006 totalling £44million. Its director admitted that it had been involved in third party payments and had in fact only received "commission" for its sales. That appears to amount to admitting that it had allowed its name to be used for transactions in which it had not really acted as a principal at all thereby becoming involved in sham transactions.

60. On 14 March 2006 the director told an officer that the company had made no sales after 10 March but that turned out to be untrue.

61. The company was involved in a large number of deals in April and May including the transaction that led to the appellant's deal 8 of April 2006 and including transactions after the company was de-registered. The April and May deals were not declared and assessments of £32.1 million have neither been appealed nor paid and the company has not appealed against its de-registration.

62. The fourth defaulter is Parfums UK Ltd (Parfums) which was the alleged defaulter in the appellant's July deals numbers 1, 2 and 3.

63. The company traded in a small way of business in cosmetics but appears to have ceased to trade in 02/04 as it made nil returns from 02/04 to 02/06 and failed to submit a return for 05/06. It was de-registered from 14 July 2006. However that company or someone purporting to be it was involved in transactions valued at £29.7million in July 2006 for which the commissioners issued an assessment of £5.2million to a taxable person purporting to be Parfums which has not been challenged or paid. It is obvious that a hijacked company is in fact a fraudulent activity albeit of an unknown person and we have no hesitation in finding that those three transactions led back to that dishonest default.

64. The last defaulter in respect of buffer transactions (deal 4 of July 2006) is Phone City Ltd (Phone City). The company's first VAT return was for period 05/05 in which tax of £3,700 was declared. Tax declared in the next quarter was £102.5million and for the period 1 June to 26 July (when the company was de-registered) it was £304.8million.

65. When officers visited on 6 July and 17 August 2005 and 16 March 2006 it seemed that the persons at the premises knew little of the company's activities. The company had been instructed to make third party payments and in June 2006 it failed to produce records which had been lawfully demanded by an officer and so de-registration was effected from 25 July 2006. Various purported directors have denied being responsible

66. Phone City has not appealed against assessments totalling more than £37million and has continued to fail to produce records.

67. On that evidence we find that Phone City was a dishonest defaulter including in respect of the transaction leading to the appellant.

The alleged defaulting traders: dirty chains.

68. The first one is I Connect U Ltd (ICU) and this was the alleged defaulting trader in the appellant's deal 3 in April.

69. ICU applied to be registered for VAT on 23 September and stated that its business would be "telecom and electronic sales wholesale and retail also air freight cargo" and that its estimated turnover would be £50,000.

70. On 11 April 2006 officers visited the company and spoke to the director who said he had not yet done any deals but he was proposing to do so and the officers issued a direction requiring a return be made up to 10 April. On 12 April an officer phoned to ask about the return and the director said it would be ready the next day. The officer asked if there would be any large deals declared on the return and the director said there would be. He was asked why he had not mentioned that when he had been asked the same question the day before and he said he had been mistaken. In fact when the return was made on 13 April the company declared deals worth £4.3million and claimed a refund of VAT of £13,385.

71. It was later discovered that another 15 deals had not been declared at all and that the full value of purchases by the company was £7.6million.

72. Later, an assessment was issued for £3.5million which included items in respect of input tax claimed for phones which had not yet been on the market at the time they were supposed to have been purchased. The assessments were not paid and the company was wound up.

73. We have no hesitation in finding that ICU was a dishonest defaulter.

74. The second alleged defaulter in the appellant's alleged dirty chain transactions (i.e. deal 5 in July 2006) is Phone City Ltd about which we have already made a finding.

75. The third alleged defaulter is Bluestar Communications GB Ltd (Bluestar) and that company's transactions relevant to this appeal relate to the appellant's deals 6 and 7 in July.

76. That company registered for VAT by an application dated 22 July 2005 and declared its intended business would be "communications installations" with an estimated turnover of £60,000 in the following twelve months. The company was registered with effect from 14 August 2005.

77. Because the company had verified the VAT registrations of traders involved in phone transactions an officer visited the director on 30 January 2006 and informed him about MTIC fraud and discussed due diligence and third party payments. The director said he had only made a single sale which was not a phone transaction but that statement turned out to be untrue as the company had transacted some phone sales only one week before that visit.

78. Despite being warned on 30 January about third party payments the director made some such payments. The company kept inadequate records and carried out inadequate due diligence. Later, the director claimed the company could not pay a VAT assessment because its funds were frozen in the FCIB bank but that was untrue because the company had taken most of its money out of the account before it was frozen leaving it in a position where it could not pay the VAT. The director gave an undertaking not to act as a director for twelve years having admitted that he had run the company in a manner that involved putting HMRC at risk and that it had imported goods worth £8.6million in 13 days but had failed to account for at least £1.5million of VAT having paid its supplier and thereby leaving itself unable to pay the VAT.

79. We find that Bluestar was a dishonest trader.

The contra trading.

80. The defaulting traders in the H&M dirty chains in the relevant periods were Fonezville Ltd, Homes Sales and Lettings Ltd and UR Traders Ltd. The defaulting traders in the Blackstar dirty chains in the relevant periods were Fastec Solutions Ltd and Bright Time UK Ltd.

81. The appellant's concession that it accepted that the alleged contra traders were dishonest in respect of chains of transactions in which VAT was not accounted for necessarily involves an admission that there were defaults in the contra trader's dirty chains and so we need not do more than note that concession.

82. It is convenient to add here that the evidence of circulation of funds through the accounts of numerous parties was fully borne out by the evidence we heard which was not challenged as to its accuracy except in very minor details. That evidence amply proved that the contra traders were an essential part of a very large and elaborate fraudulent scheme involving a large number of traders in a number of countries. The evidence included evidence showing that not only did the funds circulate back to the same parties but also in some cases more than one party appeared to be using the same computers.

83. In addition, the fraud in which the contra traders were involved was demonstrated to have consisted essentially of obtaining money from HMRC. Input tax paid by HMRC to the purchasers of goods who then made zero rated sales by way of exports (or technically despatches to other EU countries) were the only source of additional funds in the whole scheme. The rest was merely circulation of existing funds. Those additional funds were obtained by so called brokers in either clean or dirty chains and

although it is only as a result of the non-payment of output tax in the dirty chains that any fraudulent gain was made it is impossible to distinguish between the clean and dirty chain input tax claims so far as the source of the fraudulent funds is concerned. The money paid into the scheme is fungible and so the input tax claimed by either clean or dirty chain transactions just goes into the pot indiscriminately. The clean chain input tax helps to fund the whole scheme just as much as the dirty chain input tax even though between them they are only effective if there is an evasion of output tax somewhere in the scheme.

84. It is also clear that the organisers of the fraud must have thought there was some purpose in engaging in the clean chain transactions or else they would not have occurred.

85. The clean chain brokers did contribute the fraudulent money to the scheme temporarily, or so it was intended, between the time they paid for the goods and the time they recovered their input tax. That money was available for use within the fraud either as additional capital or as the dishonest gains the participants in the fraud shared by whatever means that sharing was devised.

Clean chains connection with fraud.

86. As we have explained above the clean chain transactions between the contra traders and the appellant contributed funds to the overall fraudulent scheme. That is clearly a connection between the two. In addition the clean chain transactions helped to disguise the enormous size of the fraud. That is also a connection between the two. If the goods in question had been genuinely sourced from the place whence they purported to come they may have been newly introduced into the fraudulent scheme.

87. The evidence shows that the contra traders were at the very heart of the scheme though not necessarily its organisers. There is no evidence to suggest that they had any legitimate non-fraudulent business and so it follows that they had no purpose other than to further the fraud when they entered into the transactions with the appellant. That reinforces our finding that the transactions were connected.

Did the appellant know or should it have known of the connections.

88. The appellant's transactions were connected with contrived and fraudulent schemes. The FCIB evidence concerning the circulation of money and the analysis of the patterns of trade with goods beginning and ending with the same cohort of companies abroad and passing through UK companies having been brought to the UK for no apparent purpose; all point in the direction of contrivance and of a fraudulent scheme on a large scale so far as the contra trading transactions are concerned.

89. The appellant was undoubtedly part of that scheme. It is of course possible that the appellant was unwittingly part of it but the least that can be said is that the

organisers of the scheme must have been able to manipulate the appellant into taking part in the transactions in question both in terms of from whom it bought and to whom it sold the goods.

90. Every transaction the appellant entered into as a broker with the contra traders ended with the goods going to EU countries and to customers who were part of the overall scheme.

91. Banking for all the contra trading transactions was through the appellant's FCIB account and all the banking for the dirty chain transactions was through the Barclays Bank account. We find that that was not coincidental and it is further evidence that the contra transactions were part of the overall scheme but also it is some circumstantial evidence that the appellant was aware that those transactions were part of a scheme. That is further borne out by the fact that Mr Dharas claimed that the company used whichever bank account had funds in it whereas on examination the pattern just referred to became apparent.

92. The appellant used different paperwork for the contra deals in that its supplier declarations were different depending on whether the transaction was a contra trading transaction rather than a dirty chain or buffer transaction. That suggests that the appellant was aware of the nature of the transaction beyond simply having a supplier and a customer willing to sell and buy at acceptable prices.

93. The consistency of mark ups is evidence of both the contrivance involved in the scheme as a whole and the likelihood that the appellant must have either known in advance what its mark up was to be or at least that it was manipulated into agreeing figures with both its supplier and its customer that ended up achieving those consistent mark ups. The appellant stated in his witness statement that: "there was always keen negotiation" and "the company achieved whatever margin it could" both of those statements suggest that the appellant had carried out normal negotiations but those statement are impossible to reconcile with the consistent mark ups and we find those statements to be untruthful. It cannot have happened that the mark ups were so consistent other than by agreement, in which case the appellant must have realised that the transactions were contrived, or by obvious manipulation, in which case the appellant must also have realised that the manipulation was happening. No evidence of negotiations was produced such as notes or copy emails or telephone records.

94. Undoubtedly the appellant knew very well though its director Mr Dharas that fraud was rife within the trade sector in which it was operating. The commissioners' evidence amply demonstrates that Mr Dharas had been told, in respect of three different tax periods before the ones relevant to this appeal, that all of his broker transactions had traced back to defaulters.

95. If Mr Dharas was being manipulated, the manipulation could only have been successful if he turned a blind eye to the obvious fact that if goods were being offered to him at a take it or leave it price and his customers was offering to buy at a take it or leave it price that would be a clear indication of fraud. Such wilful blindness in a trade sector in which fraud was known to him to be rife would be clear evidence that

not only did he know fraud was possible but also that the particular transactions were in fact fraudulent ones.

96. On the other hand if the goods were offered on the basis that the seller announced that the appellant could add 6% to the purchase price or the customer announced that it would allow the appellant to add 6%, either of those facts would only be consistent with contrivance and, given the known general level of fraud in the trade, with fraud.

97. It is reasonable to assume that any trader would have to calculate his margin at least in approximate terms in order to ensure he was not making a loss in any deal and had such a calculation been made in this case it would surely have alerted Mr Dharas to the consistency.

98. Further evidence of general knowledge of the existence of fraud was given in the form of warning letters to Mr Dharas as director of various other companies he had been involved with and the appellant itself giving warnings about transactions chains in which fraud had occurred. On more than one occasion input tax claims had been refused or delayed.

99. The appellant's buffer deals all involved a margin of £1.00 per phone. That cannot have gone unnoticed by Mr Dharas and although input tax has not been disallowed on those transactions it is clearly further evidence of the existence of fraud and indeed of the willingness of the appellant to become involved in fraud or at least to turn a blind eye to the obvious.

100. In one of the buffer deals the appellant sold the goods to a company operated by an employee of the appellant which then sold the goods to a UAE company owned by Mr Dharas raising the question why the appellant did not sell direct to the UAE making a greater profit than the £1.00 per phone it made on the buffer deal. Mr Dharas explained this in his witness statement by saying that the appellant could not afford to do the broker deal at that time but that turned out to be untrue as the respondents were able to demonstrate by reference to the appellant's bank account details. Whilst that transaction is not one of the ones in respect of which input tax has been refused the fact that Mr Dharas lied in his witness statement calls into question the truthfulness of his other statements.

101. The mark ups on the dirty chain deals in which the goods all went to the UAE were not consistent in the same way as the broker deals in the contra trading transactions but profits were still high and the difference between those deals and the contra trading deals is yet further evidence that the appellant must have known the deals were in two different categories at the time they were conducted.

102. The appellant admitted through Mr Dharas's witness statement that it concentrated its due diligence on the suppliers rather than the customers. This was said to be because he thought that if there was a tax loss it would be on the UK supply side. However, he was sending goods of high value to customers of whom he knew very little and he must have realised that there was a commercial risk involved in sending goods overseas without enquiring about his customers' means to pay. Such

due diligence as the appellant conducted was wholly inadequate for that purpose. Some of it was in foreign languages and some of the credit reports raised questions rather than gave reassurance. HMRC contested whether the credit reports were in fact obtained before trading began and Mr Dharas's statement does not provide any evidence about that.

103. In fact his witness statement simply says that he made initial contact with the EU purchasers via the IPT website and that he recalled meeting their representatives at the Cebit Exhibition, suggesting that no other due diligence was carried out though some documents were produced which he might have been able to explain had he given evidence. We can only make our findings on what has been presented to us but it is clear that due diligence enquiries on customers were wholly inadequate.

104. The transactions were often carried out in ways that contradicted the parties' written terms of business so far as retention of title and release of goods was concerned.

105. Of course, it is not illegal for traders to take risks or to vary their terms of business informally. But the departure from written terms and the casual attitude to due diligence are strong circumstantial evidence that somehow the appellant knew that all would be well in these transactions despite these surprising departures from prudent business practice and that can only really be explained by the appellant knowing that the transactions would take a certain course regardless of how they were carried out. Given the value of the goods involved and the known prevalence of fraud in the trade that is also evidence from which the appellant should have been able to appreciate that the transactions were not legitimate normal commercial deals but were rather connected with the fraud.

Conclusions

106. Much of the evidence is circumstantial and we bear in mind that the burden of proof is on the commissioners but having considered all the evidence placed before us we are fully satisfied that the appellant knew that the transactions in question were connected with fraud and applying the law as we have set it out above we hold that the appeal is dismissed and that the commissioners were entitled to refuse to pay the input tax that has been disallowed.

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

RICHARD BARLOW
TRIBUNAL JUDGE

RELEASE DATE: 29 April 2013