[2017] UKUT 325 (TCC)

Appeal number: UT/2016/0036

VALUE ADDED TAX – PENALTY – Missing Trader Intra-Community Fraud – liability of director of company to penalty for dishonest conduct in relation to evasion of VAT - Axel Kittel v Belgian State and Mobilx v HMRC considered - whether FTT's approach to evidence flawed – whether judge who refused application for HMRC to be barred under rule 8(3) FTT Rules should have recused herself from hearing substantive appeal - appeal dismissed

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

UMAAD BUTT

Appellant

- and –

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Respondents

Tribunal: The Hon Mr Justice Newey
Judge Greg Sinfield

Sitting in public in London on 6 and 7 April 2017

Rory Mullan, Harriet Brown and Etienne Wong, counsel, acting pro bono under licence from the Bar Pro Bono Unit, for the Appellant

Jeremy Benson QC and Karen Robinson, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

Introduction

1. The Appellant, Mr Umaad Butt, was one of two directors of and owned 50% of the shares in Waterfire Limited ('Waterfire'). The Respondents ('HMRC') refused a claim by Waterfire for input tax of £6,792,184 incurred in the period 04/06 on the ground that the company, through its directors, knew or should have known that its transactions were connected with fraud, namely a missing trader intra-Community (or "MTIC") fraud. HMRC considered that Waterfire had dishonestly sought to evade VAT and that the company was liable to a penalty of £6,792,184 under section 60 Value Added Tax Act 1994 ("VATA94").

2. Section 60(1) VATA94 provides that a person who has dishonestly done something or omitted to do something for the purpose of evading VAT shall be liable to a penalty equal to the amount of VAT evaded or sought to be evaded. For these purposes, evading VAT includes obtaining a VAT credit in circumstances where a person is not entitled to that amount. Section 60(7) provides that the burden of proof as to the matters specified in section 60(1) is on HMRC. Where the person liable to a penalty under section 60 is a company and the conduct giving rise to that penalty is, in whole or in part, attributable to the dishonesty of a director or other officer, section 61 VATA94 provides that HMRC may recover the penalty or a proportion of it from the director or other officer. HMRC considered that Waterfire's conduct was attributable to the dishonesty of its directors and imposed a penalty under section 61 VATA94 on Mr Butt of £3,137,483.03, being 50% of the input tax claimed less a reduction of 10%.

3. Mr Butt appealed to the First-tier Tribunal (Tax Chamber) ('the FTT') in August 2010. In December 2013, Mr Butt applied to the FTT for a direction under rule 8(3) of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 ('the FTT Rules') that HMRC be barred from taking further part in the proceedings and the FTT issue a summary decision that Mr Butt's appeal was allowed. The application was heard by the FTT (Judge Jennifer Blewitt) on 14 May 2014. Judge Blewitt released her decision, [2014] UKFTT 490 (TC), refusing the application on 20 May ('the Summary Decision'). Judge Blewitt refused the application on the basis that she was not satisfied that HMRC's case, or part of it, had no reasonable prospect of success such that HMRC should be barred from taking further part in the proceedings. Mr Butt had also applied for the hearing of the appeal, listed June 2014, to be postponed. That application had been refused by email on 23 April and that decision was confirmed orally at the hearing on 14 May.

4. Mr Butt applied to the FTT for permission to appeal against the Summary Decision and the refusal to vacate the hearing. In a decision notice issued on 28 May 2014, Judge Blewitt refused to grant Mr Butt permission to appeal on either matter. Mr Butt then applied to the Upper Tribunal for permission to appeal. The Upper Tribunal refused permission to appeal on the papers and after a reconsideration at an oral hearing.

5. The substantive appeal was heard by the FTT (Judge Blewitt and Mr Wilson) over seven days in June 2014 with closing submissions in September. At the start of the hearing, counsel for Mr Butt made an application that Judge Blewitt recuse herself from hearing the substantive appeal on the ground that a fair minded and informed observer would conclude that there was a real possibility that she had pre-judged a major part of the issues by virtue of the fact that she had refused Mr Butt's application in the

Summary Decision. Judge Blewitt rejected the application that she recuse herself and the hearing continued. Judge Blewitt issued a decision ('the Recusal Decision') on the second day of the hearing and extended the time for appealing to be coterminous with the time limit for appealing the decision in relation to the substantive appeal.

6. In a decision released on 13 October 2015, [2015] UKFTT 0510 (TC), ('the Substantive Decision'), the FTT dismissed Mr Butt's appeal. Save as otherwise indicated, paragraph references in square brackets in this decision are to the paragraphs in the Substantive Decision. The FTT found, in [313], that Waterfire's VAT return for the period 04/06 was arithmetically correct and accurately represented the taxable supplies which were made during the period. At [320], the FTT held that the only issue for determination was whether the statutory criteria of section 61 VATA94 were fulfilled. In [321] – [323], the FTT held, relying on paragraph 47 of the judgment of Moses LJ in *Mobilx Limited and others v HMRC* [2010] EWCA Civ 517, [2010] STC 1436 ('*Mobilx'*) and paragraphs 56 – 59 of the judgment of the Court of Justice ('CJEU') in Joined Cases C-439/04 and C-440/04 *Kittel v Belgian State* and *Belgian State v Recolta Recycling SPRL* [2006] ECR I-6161, [2008] STC 1537 ('*Kittel*'), that Waterfire never had any right to deduct the VAT claimed and HMRC were entitled to refuse input tax credit where a trader enters into a transaction which he knows or should have known is connected with fraud. The FTT found, at [387], that Waterfire's actions were intended to facilitate fraud and that Mr Butt had actual knowledge that Waterfire's transactions were connected to the fraudulent evasion of VAT. In [388] – [391], the FTT found that Waterfire had acted dishonestly and its directors were dishonest. Accordingly, Waterfire was liable to a penalty under section 60 VATA94, see [392]. The FTT also found, in [393], that Waterfire's conduct was wholly attributable to the dishonesty of Mr Butt and his fellow director.

Grounds of appeal

7. Mr Butt now appeals, with the permission of the Upper Tribunal, against the Substantive Decision and the Recusal Decision. The grounds of appeal raise the following issues:

(1) In the absence of specific legislation, can a principle of EU law be used as the basis of penalising a UK taxpayer?

(2) Does section 60 VATA94, properly construed, permit a penalty to be imposed on a knowing participant in an MTIC fraud?

(3) Was the FTT's approach to the evidence correct in law?

(4) Would a reasonable person conclude that Judge Blewitt pre-judged matters in her summary judgment decision?

8. In relation to issues 1 and 2, the overarching submission on behalf of Mr Butt is that, in order for him to be liable under section 61 VATA94, Waterfire had to be liable to a penalty under section 60 VATA94. For Waterfire to be liable to a penalty under section 60 VATA94, it must have dishonestly obtained a VAT credit in circumstances where it was not entitled to do so. In Issue 3, Mr Butt challenges the inferences drawn by the FTT on the evidence and the FTT's reliance on certain evidence. Issue 4 is really an assertion that Judge Blewitt should have recused herself from hearing the substantive appeal.

9. For the reasons set out below, we have decided that none of the grounds reveals any error of law by the FTT and Mr Butt's appeal must be dismissed.

Issue 1: Can the Kittel principle be used as the basis of penalising a UK taxpayer in the absence of specific legislation?

10. It was accepted by Mr Mullan, on behalf of Mr Butt, that a taxable person is not entitled to claim VAT input tax where he knew or should have known of a connection to fraud ('the *Kittel* principle'). Mr Butt does not challenge the *Kittel* principle in this appeal. Mr Butt challenges the extent to which it can be used to impose penalties under sections 60 and 61 VATA94.

11. The FTT found that Mr Butt dishonestly participated in a carousel fraud and Mr Mullan said that Mr Butt does not shrink from that finding. Mr Mullan submitted that it was not enough for the FTT to find that Mr Butt knowingly participated in a fraud and was dishonest. Mr Mullan contended that the input tax claim was denied by the application of the *Kittel* principle. There was a direct connection between the *Kittel* principle (under which the input tax was denied) and the penalty (which depended upon that input tax being denied). If the right to claim input tax had not been denied then there could not have been any penalty. Mr Mullan submitted that was fatal to the penalty because the *Kittel* principle cannot as a matter of EU law be relied upon directly or indirectly to impose a criminal liability. There must be specific domestic legislation giving effect to that principle. He contended that the FTT's conclusion in [327] that it "did not need to adopt the approach of conforming interpretation in order to determine whether the statutory requirements of the legislation [section 60 VATA94] were met" was an error of law.

12. Mr Mullan relied on seven propositions:

(1) the input tax could not have been denied absent the *Kittel* principle;

(2) the *Kittel* principle is a principle of EU law;

(3) the VATA94 must be interpreted consistently with that principle in the civil law context;

(4) the penalty under section 60 was criminal for the purposes of the EU Charter and the European Convention on Human Rights ("the ECHR") and attracts safeguards;

(5) one safeguard is that EU law cannot be the source of criminal liability without express legislation in the Member State, ie the UK;

(6) that principle prevented a conforming interpretation being applied where that would give rise to criminal liability;

(7) as safeguards must be practical, it is no answer to say that section 60 is clear or that the statutory criteria are met.

13. The first three propositions are not controversial. At paragraphs 56 – 59 of *Kittel*, the CJEU held as follows:

> "56. … 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.
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> 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'."

14. In paragraphs 45 to 49 of *Mobilx*, Moses LJ rejected the argument that specific legislation was required to give effect to the *Kittel* principle, saying in paragraph 47:

> "… 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 VATA 1994 are met. It does not require the introduction of any further domestic legislation."

15. Having considered Case C-106/89 *Marleasing SA v La Comercial Internacional de Alimentacion SA* [1990] ECR I-4135 and *HMRC v IDT Card Services Ireland Ltd* [2006] STC 1252, Moses LJ concluded in paragraph 49 that:

> "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."

16. In *Mobilx*, the operation of the *Kittel* principle was explained by Moses LJ as follows:

> "51. Once it is appreciated how closely *Kittel* follows the approach the court had taken six months before in [C-354/03 *Optigen Limited v Customs and Excise* [2006] ECR I-483], 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).
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> 52. If a taxpayer has the means at his disposal of knowing that by his purchase he is participating in a transaction connected with the 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. … A trader who fails to deploy the means of knowledge available to him does not satisfy the objective criteria which must be met before his right to deduct arises."

17. The fourth proposition is also not contentious. The Court of Appeal accepted that the penalty under section 60 VATA94 is criminal for the purposes of the ECHR in *Han and Yau v HMCE* [2001] EWCA Civ 1048, [2001] 1 WLR 2253. It follows that it is also criminal for the purposes of the Charter of Fundamental Rights of the European Union ('the EU Charter') and EU law generally. Mr Mullan relied on the EU Charter and, in particular, article 49 which provides:

> "Principles of legality and proportionality of criminal offences and penalties
>
> 1. No one shall be held guilty of any criminal offence on account of any act or omission which did not constitute a criminal offence under national law or international law at the time when it was committed. Nor shall a heavier penalty be imposed than that which was applicable at the time the criminal offence was committed. If, subsequent to the commission of a criminal offence, the law provides for a lighter penalty, that penalty shall be applicable.
>
> 2. This Article shall not prejudice the trial and punishment of any person for any act or omission which, at the time when it was committed, was criminal according to the general principles recognised by the community of nations.
>
> 3. The severity of penalties must not be disproportionate to the criminal offence."

18. In relation to propositions five and six, Mr Mullan submitted that EU law cannot impose criminal sanctions without implementing legislation and it is not possible to apply a conforming interpretation to domestic legislation to impose such a penalty. Mr Mullan referred us to Joined Cases C-74/95 and 129/95 *Criminal Proceedings against X*. The case concerned the interpretation of a Directive in the context of criminal proceedings in relation to the breach of rules relating to the use of display screen equipment by workers under legislation that implemented the Directive. In paragraphs 24 to 26, the CJEU said that criminal proceedings could not be brought based on an interpretation of a provision in a Directive and in respect of conduct not clearly defined as culpable by national law. Mr Mullan submitted that this showed that Mr Butt could rely on article 49 of the EU Charter to disapply section 60 and 61 VATA94. Mr Mullan also relied on the opinion of the Advocate General at paragraph 63:

> "The principle of legal certainty … precludes resorting to a Community directive in order to extend the definition of an offence, to the

> disadvantage of the accused, to situations different from those which strictly match the definition of the punishable acts given by national criminal law."

19. Mr Mullan submitted that the issue at the heart of this case is the interpretation of the VATA94 by conforming it with EU law. Although domestic legislation must be construed to give effect to EU legislation and principles, that approach is constrained by principles of legal certainty and non-retroactivity. Mr Mullan submitted that tax legislation can be interpreted to conform with EU law but not to impose a penalty in the absence of domestic legislation.

20. Mr Mullan also referred to Case-456/98 *Centrosteel Srl v Adipol GmbH* [2000] ECR I-6007, [2000] 3 CMLR 711 (referred to by the Court of Appeal in *IDT* at 111). This case concerned a dispute between two parties. Centrosteel was a commercial agent of Adipol and claimed certain amounts from Adipol. Adipol said that the agency agreement was void because Centrosteel was not registered as an agent. Such a rule was precluded by the Directive relating to commercial agents. The Advocate General (Jacobs) in paragraph 35 distinguished between civil and criminal liability, stating:

> "While that process of [conforming] interpretation cannot, of itself and independently of a national law implementing the directive, have the effect of determining or aggravating criminal liability, it may well lead to the imposition upon an individual of civil liability or a civil obligation which would not otherwise have existed."

21. Case C-60/02 *Criminal Proceedings against X* which concerned counterfeit goods was to similar effect (see paragraph 61) as was Joined Cases C-387/02, C-391/02 and C-403/02 *Criminal Proceedings against Berlusconi and others* (see paragraph 74). Mr Mullan stated that the cases showed that conforming interpretation of domestic legislation cannot be used to impose a penalty which is a criminal liability (in the EU Charter sense). That was the position in this case as the penalty arose from the denial of input tax by the application of the *Kittel* principle.

22. In relation to the final proposition, which is that safeguards must be real and effective and not illusory, Mr Mullan submitted that, construed properly, section 60 VATA94 does not apply to impose a penalty in these circumstances. If we were against him on that point and concluded that, applying *Mobilx*, section 60 could apply then Mr Butt's rights under article 49 of the EU Charter would have been breached or infringed. In those circumstances, Mr Mullan submitted that Mr Butt has directly effective rights under article 49 and we are required to disapply section 60.

23. Mr Mullan also made submissions on proportionality. Mr Mullan submitted that the penalty imposed on Waterfire was 100% of the disallowed tax then reduced by 10%. In this case, Waterfire incurred input tax but it was denied the ability to deduct that VAT and so it did not profit from that amount. The FTT, applying dicta from *Han and Yau*, held in [395] that the penalty was proportionate. Mr Mullan submitted that it was agreed that the penalties are penal and not compensatory but the concept of proportionality still applied as shown by article 49(3) EU Charter. Mr Mullan referred to paragraph 90 of the Advocate General's opinion in *Berlusconi*:

> "A penalty is proportionate where it is appropriate (that is to say, in particular, effective and dissuasive) for attaining the legitimate objectives pursued by it, and also necessary. Where there is a choice between

> several (equally) appropriate penalties, recourse must be had to the least onerous. Moreover, the effects of the penalty on the person concerned must be proportionate to the aims pursued."

24. Mr Mullan referred to the draft legislation in clause 129 of Finance (No.2) Bill 2017 (which proposes new sections 69C and 69D VATA94). He submitted that the new sections provide explicit legislative authority for a penalty for persons in the same situation as Mr Butt and do so by explicit reference to the *Kittel* principle. They comprehensively address the issues raised by Mr Butt in this appeal. Under the proposed legislation, Mr Butt would have faced a penalty of 13.5% of the disallowed claim rather than 45% of such claim. Mr Mullan submitted that the starting point of a penalty of 30% in the draft legislation is a correct and proportionate approach. He contended that it should have been the starting point here and showed that the penalty was disproportionate contrary to article 49(3) of the EU Charter. He also submitted that, under article 49(1), Mr Butt should have the benefit of any reduction in the penalty applicable.

25. Mr Benson for HMRC submitted that Mr Butt had misunderstood the basis for the penalty imposed upon him. The basis for the decision to impose the penalty was not the fact that Waterfire had been denied its entitlement to claim input tax credit in accordance with the *Kittel* principle but that the statutory criteria in sections 60 and 61 VATA94 had been met. A penalty may be imposed under section 60 if HMRC can prove that (a) a person does an act; (b) for the purpose of evading VAT; and (c) that his conduct involves dishonesty. No conforming legislation is required to establish whether the statutory criteria are met in a given case.

26. In essence, Mr Butt's submission is that the *Kittel* principle cannot, as a matter of EU law, be relied on, directly or indirectly, to impose a criminal liability such as a penalty under sections 60 and 61 VATA94 without domestic legislation to give it effect. He contends that while the *Kittel* principle can be applied to deny Waterfire the right to deduct VAT, it cannot be used to impose a penalty on Waterfire or its directors.

27. In our view, that submission is unsustainable given the existence of sections 60 and 61 VATA94 at the time that Waterfire incurred the VAT which it later sought to deduct and in the light of Moses LJ's comments in [47] and [49] of *Mobilx* that the *Kittel* principle does not require the introduction of any further domestic legislation and that, in relation to the right to deduct input tax, Community and domestic law are one and the same. It follows that no domestic legislation was required to deny Waterfire the right to deduct VAT on the ground that the company, through its directors, knew that the transactions were connected with fraud or to impose a penalty in respect of such conduct. We accept that EU law cannot impose criminal sanctions without implementing legislation but that is not the position in this case. The *Kittel* principle, which was derived from earlier cases, did not make Waterfire or Mr Butt liable to a penalty. The effect of the *Kittel* principle was that, notwithstanding the presence of objective criteria which form the basis of the concepts of 'supply of goods effected by a taxable person acting as such' and 'economic activity', Waterfire had no right to deduct input tax because it knew that its transactions were connected to fraud. The liability to penalties under sections 60 and 61 VATA94 arose separately and was subject to different criteria. The sections were already on the statute book at the time of the events which gave rise to the liability to a penalty, having been inserted into the Value Added Tax Act 1983 in 1985. No changes were necessary to those sections to enable them to

apply to the situation where a taxable person seeks to deduct VAT which, under Community and domestic law, it was not entitled to do as a result of its knowledge of a connection with fraud. In our opinion, the FTT was right to say, in [327], that it did not need to adopt a conforming interpretation in order to apply section 60 VATA94. The only issue for the FTT, as it identified in [320], was whether the statutory criteria of section 61 VATA94 were fulfilled in this case. The FTT found that they were and we consider whether it was entitled to do so in discussing the remaining issues.

28. In relation to proportionality, we consider that the FTT reached the correct conclusion in [395] for the reasons it gave. There is nothing obviously wrong or disproportionate in calculating a penalty by reference to the total amount sought to be evaded. Further we consider that the new legislation is not relevant to this issue as it was not in force and not even contemplated at the time of the claim or even at the time of the decision of the FTT. That is also the answer to Mr Mullan's submissions on Article 49(1) of the EU Charter.

Issue 2: Is a knowing participant in an MTIC fraud liable to a penalty under section 60 VATA94?

29. Section 60 VATA94 provides that a person who has dishonestly done something or omitted to do something for the purpose of evading VAT shall be liable to a penalty equal to the amount of VAT evaded or sought to be evaded. For these purposes, evading VAT includes obtaining a VAT credit in circumstances where a person is not entitled to that amount. In this case, the issues for determination by the FTT in relation to Waterfire's liability to a penalty were, as the FTT identified in [372], (i) did Waterfire do any act for the purpose of evading VAT, which includes obtaining a VAT credit in circumstances where it was not entitled to such credit and (ii) did that conduct involve dishonesty?

30. The essence of Mr Wong's submissions on this issue is that Waterfire was not liable to a penalty under section 60 VATA94 (and thus Mr Butt could not be liable to a penalty under section 61) because, at the time that it claimed to deduct the VAT in question, Waterfire was entitled to do so and it only lost its right to deduct the VAT when HMRC established that Waterfire had knowledge of a connection with fraud. Mr Wong submitted that, on that analysis of the *Kittel* principle, section 60 does not apply to a person in Waterfire's situation because if the right to deduct is retained until knowledge of a connection with fraud is established then the first of the statutory criteria is not met and, further, Waterfire was not acting dishonestly at the time that it claimed the input tax in question because it was entitled to it so the second of the criteria was not satisfied either.

31. We do not accept Mr Wong's analysis of the application and effect of the *Kittel* principle. Mr Wong contended that Waterfire was entitled to deduct the VAT until HMRC proved that it was not so entitled. He relied on some passages from cases that considered the *Kittel* principle (*Mobilx* paragraph 81, Case C-285/11 *Bonik* paragraph 43). We do not consider that the passages supported Mr Wong's submission. They only stated that the tax authority had the burden of proving that the taxable person knew, or should have known, that the relevant transaction was connected with fraud. Those passages said nothing about when the right to deduct was lost.

32. Mr Wong also submitted that, when Waterfire made the claim at issue in this appeal on 15 May 2006, the position of buffer traders, broker traders and contra traders in MTIC fraud cases was unclear and remained so until, arguably, the CJEU gave its judgment in *Kittel* on 6 July 2006. We consider that the position was much clearer than Mr Wong sought to suggest, at least for taxable persons with actual knowledge of a connection with fraud. Clear guidance could be obtained from the CJEU's judgments in Case C-32/03 *I v S Fini H* [2005] STC 903 ('*Fini'*), C-255/02 *Halifax plc and Others v HMCE* [2006] STC 919 ('*Halifax*') and Joined Cases C-354/03, C-355/03 and C-484/03 *Optigen Ltd v HMCE* [2006] ECR I-483 ('*Optigen'*).

33. In *Fini*, the CJEU held, in paragraph 33, that:

> "If the tax authorities were to conclude that the right to deduct has been exercised fraudulently or abusively, they would be entitled to demand, with retrospective effect, repayment of the amounts deducted".

34. The approach of the CJEU in *Halifax* is also instructive. The case did not concern fraud but a tax avoidance scheme which was found to be an abusive practice. As can be seen from the passage from *Fini* quoted above, the CJEU treats fraud and abuse in the same way. In *Halifax*, the CJEU held, in paragraphs 94 and 95, that

> "94. It follows the transactions involved in an abusive practice must be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice.
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> 95. In that regard, the tax authorities are entitled to demand, with retroactive effect, repayment of the amounts deducted in relation to each transaction whenever they find that the right to deduct has been exercised abusively".

35. In *Optigen*, the CJEU held, at paragraph 53, that:

> "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."

The clear implication of that sentence is that where the taxable person knew or had any means of knowing of the existence of VAT fraud in the chain of transactions the right to deduct input VAT would be affected. That was what the CJEU stated explicitly in *Kittel*.

36. It seems to us to be clear from those passages that where a taxable person knows that transactions in relation to which a claim to deduct VAT has been or is to be made are connected with fraud then the right to deduct is removed with retrospective effect. The passages quoted show that it is permissible, where there is fraud or abuse, to revisit and redefine the transactions to restore the position as it would have been absent the abuse or to counter the fraud. In our view, that means that where knowledge of a connection with fraud is established the taxable person is to be treated as never having acquired a right to deduct VAT in relation to those transactions. The reason is that knowledge of a connection with fraud means, as the CJEU explained in *Kittel*, that the objective criteria necessary for there to be a supply of goods are not present and so no right to deduct can arise. As a matter of practicality, the tax authority is unlikely to be

aware of the fraud or the taxable person's knowledge of the connection with it until after a claim to deduct VAT has been made but that cannot mean that a person who made such a claim with actual knowledge that his transactions were connected with VAT fraud nevertheless acquired a right to deduct VAT and retained it until the tax authority established that he had such knowledge.

37. It is convenient to mention at this point that it was also submitted on behalf of Mr Butt that paragraph 93 of *Halifax* precluded the imposition of a penalty in relation to an abusive practice in the absence of "a clear and unambiguous legal basis" for such a penalty. Mr Mullan submitted that there was no clear and unambiguous basis for the penalty under section 60. We do not agree. We consider that the statutory criteria in section 60, as identified by the FTT in [372], are clear and unambiguous. On a correct application of the *Kittel* principle, Waterfire became liable to the penalty when it did any act for the purpose of obtaining a VAT credit to which it was not entitled, such as submitting a return including transactions that it knew were connected with fraud, if that conduct involved dishonesty. In this case, Waterfire, by entering into transactions that it knew were connected with fraud, knowingly participated in that fraud. The FTT found that Waterfire and its directors had acted dishonestly and that finding is not challenged. In the circumstances, the FTT was entitled to conclude that Waterfire was liable to a penalty under section 60 VATA94 and thus Mr Butt was liable to a penalty under section 61.

Issue 3: Was the FTT's approach to the evidence correct in law?

38. On behalf of Mr Butt, Ms Brown made submissions on inferences drawn by the FTT from evidence and the application of the law to the facts by the FTT. She accepted that Mr Butt could not challenge the FTT's findings of primary fact and so Mr Butt did not dispute that he, and thus Waterfire, knew or should have known that the transactions were connected with fraud. However, Ms Brown submitted that the FTT's approach to the evidence was unsatisfactory in a number of ways and, accordingly, its conclusions on certain key issues were flawed and could not stand.

39. Ms Brown submitted that the FTT's conclusion on dishonesty was based on inadequate reasoning. The FTT rejected Mr Butt's submissions on dishonesty at [334] and identified the appropriate test for dishonesty as being derived from *R v Ghosh* [1982] 2 QB 1053. Ms Brown did not suggest that was not the appropriate test. The FTT also observed in [334] that HMRC alleged that Mr Butt was a knowing participant in the fraud and thereby dishonest. The FTT justified this approach to establishing dishonesty in [389] by reference to the words of Briggs J, as he then was, in paragraph 41 of *Megtian Ltd (In Administration) v HMRC* [2010] EWHC 18 (Ch):

> "A person who knows that a transaction in which he participates is connected with fraudulent tax evasion is a participant in that fraud. That person has a dishonest state of mind."

40. The FTT set out its conclusion on dishonesty at [388] and [393]:

> "388. The *Ghosh* test for assessing dishonesty comprises an objective test and the second stage a subjective test. In applying that test we concluded that, according to the ordinary standards of reasonable and honest people, Waterfire's acts committed for the purpose of obtaining a VAT credit to which it was not entitled were wholly and obviously

> dishonest. As to the subjective element, we rejected the submission made on behalf of the Appellant that Waterfire held an honest and genuine belief of entitlement to VAT repayment. There was no oral evidence from Mr Butt on the issue and we could only conclude that Waterfire, through its directors, must have known that its actions were, by ordinary standards, dishonest. As Waterfire was dishonest it follows that its directors who caused Waterfire to behave dishonestly were also dishonest.
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> …
>
> 393. Our conclusion in respect of dishonesty and reasons are set out above. We were satisfied that Waterfire, through the Appellant as a director, was carrying out transactions and acting as a contra-trader for the purposes of a scheme to defraud the revenue. We were therefore satisfied that the conduct of Waterfire which gave rise to the penalty was wholly attributable to the dishonesty of the Appellant and his co-director."

41. Ms Brown submitted that the only reasoning for the finding of dishonesty is to be found in [390] and [391] and that was inadequate. She stated that the FTT failed properly to consider whether there was compelling, or other, evidence to show that Mr Butt satisfied the *Ghosh* test. The FTT simply recited the evidence without giving sufficient reasoning to show what led the FTT to find that Mr Butt was dishonest.

42. However, we consider that there was no lack of evidence or reasoning in relation to dishonesty in the Substantive Decision. The FTT reviewed the evidence at length in the decision. It is clear from [123], [127] and [364] that the FTT accepted the evidence of HMRC Officer Mody which showed that Mr Butt was dishonest. The FTT's conclusion on dishonesty followed its earlier conclusion that Mr Butt had actual knowledge of the connection with fraud at [387]:

> "Having considered all of the evidence before us, we concluded that the Appellant had actual knowledge that the transactions of Waterfire were connected to the fraudulent evasion of VAT. Our conclusion was therefore that by entering into those transactions, acting as a contra-trader and making VAT returns which included those artificially contrived transactions, we were satisfied that Waterfire had done an act for the purpose of evading VAT. We were also satisfied that Waterfire did so in circumstances where it was not entitled to the sum claimed as it had no right to deduct, that right having been lost as the transactions fell outwith the scope of VAT by their fraudulent nature and Waterfire's actual knowledge of that fraud."

In view of the words of Briggs J in *Megtian*, that finding of actual knowledge would be enough on its own to justify a conclusion of dishonesty.

43. Ms Brown also submitted that by failing to consider the inherent probabilities, the FTT failed to apply the standard of proof properly. The FTT dealt with the standard of proof at [11]:

> "As we understood it, the Appellant (as indicated by the submission quoted below) appeared to suggest that although the civil standard of the balance of probabilities applies a heightened standard is required as the

> appeal involves an allegation of dishonesty. We did not accept that any heightened standard applies in this case and we cannot add anything useful to the words of Lord Hoffman in *Re B* [2009] 1 AC 11:
>
> > 'I think the time has come to say once and for all that there is only one civil standard of proof and that that is proof that the fact in issue more probably occurred than not.'"

44. Ms Brown accepted that there is only one standard of proof, namely the balance of probabilities, but contended that the FTT had ignored the reference by Lord Hoffmann to inherent probabilities. She submitted that the FTT never considered the part that inherent probabilities played in its deliberations. That meant that the FTT failed properly to consider whether the evidence provided by HMRC met the compelling standard required to prove on the balance of probabilities that Mr Butt was dishonest. Ms Brown did not say that a different standard of proof should be applied but that evidence in excess of what there was in this case was required.

45. Ms Brown is correct to say that the FTT does not refer explicitly to the inherent probabilities but, in our opinion, it was not necessary to do so. The FTT identified the correct test in [11] by reference to *Re B*. There is nothing in the Substantive Decision to suggest that the FTT did not apply that test and we reject the idea that it was necessary to identify specific "inherent probabilities" or that some higher standard of "compelling" evidence was required. As stated by Lady Hale in paragraph 70 of her speech in *Re B*:

> "Neither the seriousness of the allegation nor the seriousness of the consequences should make any difference to the standard of proof to be applied in determining the facts. The inherent probabilities are simply something to be taken into account, where relevant, in deciding where the truth lies."

That approach was re-affirmed by the Supreme Court in *In Re S-B (Children) (Care Proceedings: Standard of Proof)* [2010] 1 AC 678. We consider that the standard of proof to be applied in cases such as this case is, as the Supreme Court held in *In Re S-B*, the ordinary civil standard of proof of the balance of probabilities ie whether the alleged conduct more probably occurred than not.

46. Ms Brown also criticised the evidence of HMRC officer Claire Sharkey and the FTT's reliance on it. Ms Sharkey's evidence related to the circularity of payments in the transactions chains. Ms Sharkey analysed accounts held with the First Curacao International Bank ('FCIB'). Due to the number of transactions Ms Sharkey analysed a sample; in period 04/06 she analysed all of the chains in which Waterfire acted as broker and a selection in which Waterfire was the acquirer. In periods 01/06 and 07/06, Ms Sharkey selected those chains which featured different suppliers to and customers of Waterfire. In almost all the deal chains analysed, Ms Sharkey identified a circularity of funds.

47. The FTT set out its approach to the evidence of Ms Sharkey at [365]:

> "365. As regards the evidence of Ms Sharkey, we were satisfied that the sampling was fair and reasonable. We concluded that the large number of money flows traced by Ms Sharkey provided an extensive and accurate overview from which we could reasonable [sic] draw conclusions. It must also be noted that the Appellant did not challenge the accuracy of

> Ms Sharkey's tracing exercise. The Appellant's argument that Waterfire always featured in the chains sampled because Ms Sharkey started with the company reflects the fact that this appeal is concerned with Waterfire's trading during the relevant period and the wider circumstances of that trading; we are not concerned with the transactions of other traders. We found Ms Sharkey's evidence of circularity in money flows, similar patterns of traders, shared IP addresses and third party payments compelling evidence that Waterfire's transactions were part orchestrated and part of an overall scheme to defraud. However we found that this was the limit of Ms Sharkey's evidence, which did not assist us in determining the issue of whether the Appellant knew that Waterfire's transactions were connected with fraud."

48. Ms Brown submitted that Ms Sharkey did not have sufficient expertise to determine how to sample the transactions for the purposes of her evidence. Ms Brown criticised Ms Sharkey's selection of data, namely what she used and what she left out, and the fact that she always started with Waterfire. Ms Brown also contended that the FTT failed to understand the limits of its own expertise and should have recognised that an expert was needed. Ms Brown submitted that Ms Sharkey's evidence appeared to be the key factor on which the FTT based its decision whereas, in the circumstances, the FTT should have treated the opinions of Ms Sharkey with extreme circumspection and given them no or little weight.

49. We do not accept that the FTT erred in its approach to the evidence of Ms Sharkey and consider that the FTT was entitled to draw the conclusions that it did from her evidence. It was agreed that Ms Sharkey was not an expert (see [357]) but we consider that she did not need to be in order to summarise the movement of funds as shown by the FCIB records. Ms Sharkey's evidence was not expressed to be expert evidence and did not contain expressions of opinion. In any event, the FCIB records were all available to Mr Butt if he wished to challenge what Ms Sharkey said about them. Ms Sharkey's evidence was that the FCIB records showed that there was circularity. That was evidence from which the FTT could conclude that a fraudulent scheme existed as it did in [365] and Ms Brown said that Mr Butt did not dispute that there was a fraudulent scheme. It is quite clear from [365] that Ms Sharkey's evidence was not used by the FTT to determine whether Mr Butt knew that the transactions were connected with fraud although that is a permissible (some might say inevitable) inference to be drawn from the existence of an orchestrated scheme.

50. Ms Brown made similar points in relation to the evidence of Mr John Fletcher, a consultant with KPMG. Mr Fletcher's evidence provided detail as to the grey market in mobile phones generally and features of the trade which could be considered indicative of legitimate grey market trading. The FTT stated the key features of Mr Fletcher's evidence upon which it relied and the purposes for which it relied upon that evidence in [369] and [370]. In particular, Ms Brown criticised the final sentence of [370]:

> "We concluded that although most of the features of trading identified by Mr Fletcher went to the existence of a fraud rather than the Appellant's knowledge in it, others, such as the implausibility of the market share traded by the Appellant, raised questions in respect of which we were left with no answers."

51. Ms Brown submitted that, in that sentence, the FTT effectively reversed the burden of proof. She contended that the evidence provided by Mr Fletcher was not

enough to justify the conclusion of dishonesty on the part of Waterfire. We do not read the sentence in that way. It appears to us that the FTT was simply saying that questions were raised but, because Mr Butt did not give any evidence, those questions remained unanswered. There is no suggestion that the FTT was thereby placing the burden of proof on Mr Butt, only that some inferences that could be drawn from Mr Fletcher's evidence were not challenged by any evidence from Mr Butt. The FTT was entitled to conclude, in the absence of any evidence from Mr Butt, that the only explanation for Waterfire's implausible market share supported a conclusion of dishonesty. It is clear from the Substantive Decision that the evidence of Mr Fletcher was not the only evidence of dishonesty relied on by the FTT.

Issue 4: Would a reasonable person conclude that Judge Blewitt had pre-judged matters in the Summary Decision?

52. In the Summary Decision, Judge Blewitt refused an application by Mr Butt for HMRC to be barred from taking further part in the proceedings and for the appeal to be allowed. The basis of the decision was that Judge Blewitt was not satisfied that HMRC's case, or part of it, had no reasonable prospect of success which, it is agreed, was the relevant test. In paragraph 64 of the Summary Decision, Judge Blewitt observed that the decision did not pre-judge any of the issues to be determined at the hearing of the substantive appeal and the FTT had made no findings of fact.

53. On the Friday before the hearing of the substantive appeal, Mr Butt made an application for Judge Blewitt to recuse herself. The application was heard by Judge Blewitt alone immediately before the start of the hearing and an oral decision refusing the application given on the day with a full written decision issued the following day.

54. At [8] of the Substantive Decision, the FTT noted that:

> "As will become apparent, the Appellant sought to rely on a number of the grounds raised in support of its application for summary judgment against HMRC. It should be made clear that the arguments were heard and considered afresh by this Tribunal and considered in the context of the evidence that was presented (which had not formed part of the application for summary judgment, which was determined on legal submissions only)."

55. The FTT referred to the application for summary judgment again in [340]:

> "[T]he Appellant's application for summary judgment was premised on the basis of legal argument without any evidence being called or considered. The legal test to apply was entirely different to that applicable to this appeal; as recognised by the Upper Tribunal the issues were not pre-judged or determined but rather the test applied was whether Judge Blewitt was satisfied that HMRC's case, or part of it, had no reasonable prospect of succeeding such that it should be barred from taking part in proceedings. In contrast, this appeal has been decided on findings of fact from the evidence heard together with our determination of the legal arguments of the parties. The decision was reached by this Tribunal without regard to the test applied in the application for summary judgment."

56. Mr Mullan submitted that, in the Summary Decision, Judge Blewitt had interpreted the law and determined that, on the facts as asserted, HMRC's case had a

reasonable prospect of success. He contended that showed that the judge had prejudged issues of law.

57. The test to be applied when considering an application for recusal is well-known and can be found in many places. It was authoritatively formulated by Lord Hope in *Porter v Magill* [2002] 2 AC 357 (HL), at para 103 as follows:

> "The question is whether the fair-minded and informed observer, having considered the facts, would conclude that there was a real possibility that the tribunal was biased."

58. Mr Mullan referred to the case of *Sengupta v Holmes* [2002] EWCA Civ 1104 ('*Sengupta*'). In that case, Laws LJ refused to give Dr Sengupta permission to appeal on the papers but permission was granted by two other Lord Justices after Dr Sengupta renewed his application in court. The appeal was listed before a panel that included Laws LJ. Dr Sengupta submitted that Laws LJ should recuse himself on apparent bias grounds because he had refused permission on the papers. The application was refused. The issue for consideration when faced with such an application, as set out in paragraph 31, is whether the judge has pre-judged the issue and in consequence it is reasonably feared that he or she cannot or will not revisit the issue with an open mind. In approaching that issue, Laws LJ, with whom the other Lord Justices agreed, gave the following guidance on when an apprehension of apparent bias would be justified at paragraphs 32 to 34:

> "32. I accept that there will be some circumstances where such a fear would certainly be reasonable. If a judge has presided at a first instance trial and roundly concluded on the facts – after hearing disputed, perhaps hotly disputed, evidence – that one of the parties lacks all merit, everyone would accept that it would be unthinkable that he should sit on that party's appeal. He has committed himself to a view of the facts which he himself had the responsibility to decide. …
>
> 33. In some such cases the judge's inability to open his mind on the appeal would be not just apparent, but real: if after a careful and professional review of all the evidence, given by witnesses whom, so to speak, he has looked in the face, he has arrived at the conviction that the party in question is a crook or a rogue, guilty as charged (whether the case is criminal or civil), he might not conscientiously be able to put himself back into a state of mind where he has no preconceptions about the merits of the case.
>
> 34. There may also be cases, though one hopes there will not be, in which a judge called on to make a preliminary decision expresses himself in such vituperative language that any reasonable person will regard him as disqualified from taking a fair view of the case if he is called on to revisit it."

59. Laws LJ then went on, in paragraph 35, to describe the ordinary case where an apprehension of apparent bias would not be justified:

> "But the ordinary case is far from those instances. It is of the kind that has happened here: the judge in question has not himself had to resolve the case's factual merits, and has not expressed himself incontinently. All he has done is to conclude on the material before him that the result arrived at in the court below was correct. And he has done so in the

> knowledge that, at the option of the applicant, his view may be reconsidered at an oral hearing. In such a case is there a reasonable basis for supposing that he may not bring an open mind to bear on the substantive appeal if, after permission granted by another judge, he is a member of the court constituted to deal with it?"

Laws LJ answered his question in the negative and observed that, absent special circumstances, a readiness to change one's mind upon some issue, whether upon new information or simply on further reflection, and to change it from a previously declared position, is a capacity possessed by anyone prepared and able to engage with the issue on a reasonable and intelligent basis and the fair-minded and informed observer would recognise that to be the case.

60. Mr Mullan submitted that the Summary Decision followed a full hearing with oral argument. He contended that, having decided the legal issues, the informed person would think that there was a real possibility that Judge Blewitt had closed her mind on the issues.

61. We do not agree. Applying *Sengupta*, we regard this as one of Laws LJ's ordinary cases. Judge Blewitt was careful to state that she had not made any findings of fact and she did not express herself incontinently. There is nothing in the Summary Decision or the Substantive Decision to suggest that Judge Blewitt was not able to bring an open mind to bear on the issue in the substantive appeal.

62. In any event, the application for summary judgment was made on the basis that, as a matter of law, HMRC could not succeed in their case on the basis of the facts as pleaded. On an application under rule 8(3) of the FTT Rules, the task of the FTT was not to determine whether HMRC's case, or part of it, would be upheld after the substantive hearing but whether that case has any reasonable prospect of success. That was the approach taken by the FTT in paragraphs 64 and 87 of the Summary Decision. The point was argued again at the substantive hearing on the basis of the facts as found following that hearing. If the FTT made any error of law on the issue then the appeal should be allowed. If there is no error of law then there would be no point in remitting the case to another tribunal. We have concluded that the FTT in this case did not make any error of law.

Disposition

63. For the reasons given above, Mr Butt's appeal against the Substantive Decision is dismissed.

64. We should like, finally, to thank Mr Mullan, Ms Brown and Mr Wong for the help they have provided on a pro bono basis.

The Hon Mr Justice Newey

Judge Greg Sinfield
Judge of the Upper Tribunal

Release date: 8 August 2017