[2015] UKUT 311 (TCC)
Appeal number: FTC/21/2013

VALUE ADDED TAX – denial of repayment of input tax due to MTIC fraud – FTT concluding that the taxpayer knew that its transactions were connected with fraud – whether extension to contra-trading transactions compatible with the right to deduct under EU law – whether case should be referred to the Court of Justice to consider the issue – whether HMRC bound to plead fraud or conspiracy to succeed

UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)

UNIVERSAL ENTERPRISES (EU) LIMITED

Appellant

- and -
THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Respondents

TRIBUNAL: MR JUSTICE HENDERSON
JUDGE MALCOLM GAMMIE CBE QC

Sitting in public at the Rolls Building in London on 10 and 11 February 2014

Michael Patchett-Joyce, Counsel, instructed by CTM Litigation and Tax Services, for the Appellant

James Puzey, Counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

Introduction

1. Universal Enterprises (EU) Limited ("Universal") appeals from the decision of the First-tier Tribunal (Judge Richard Barlow and Robert Barraclough) dismissing Universal's appeal against the refusal of the Respondent Commissioners ("HMRC") to allow Universal's claims for input tax credit for the monthly periods 04/06, 05/06 and 06/06. The total sum involved is £4,054,818.30.

2. HMRC refused to repay Universal the input tax it had claimed because it took the view that the tax arose from transactions that were connected with the fraudulent evasion of VAT arising from missing trader intra-community ("MTIC") trading.

3. As those familiar with MTIC fraud and its case law will be aware, it is a field that has developed a terminology of its own. Given the number and variety of other decisions dealing with transactions of this nature we do not propose to provide a glossary or explanation of the various terms employed. We summarise the principal features of the various transactions into which Universal entered in the paragraphs that follow and record the conclusions reached by the First-tier Tribunal ("FTT") based on the evidence. We refer to those transactions and that evidence in more detail later in this decision in so far as it is necessary to do so having regard to Universal's grounds of appeal.

The transactions in outline

4. In the April 2006 period (04/06) Universal entered into a series of transactions for the purchase and sale of mobile telephones and computer ink cartridges. 58 of the transactions that Universal entered into were said to be traced directly to a fraudulent tax loss in the chain of supply of which Universal was part (a "dirty chain"). In respect of those transactions Universal accepted that HMRC had accurately described the transactions in their evidence and that the failure by previous traders in the chain of transactions to account for VAT had been fraudulent. The only issue for the FTT to resolve, therefore, was whether Universal knew or should have known that its transactions in those dirty chains were connected with fraud (FTT§20).

5. Six further transactions in the 04/06 period and all the transactions in the May 2006 (15 in number) and June 2006 (4 in number) periods (05/06 and 06/06) were part of a 'clean' transaction chain. In other words, they comprised chains of transactions that, considered alone, involved no dishonest default. Nevertheless, HMRC claimed to be entitled to deny Universal the repayment of input tax in respect of its transactions in those clean chains on the basis that those chains were connected with fraud by being appropriately associated with 'dirty' chains (the 'contra-trading' construct).

6. In respect of the clean chains of transactions Universal also accepted that HMRC had accurately described the transactions in their evidence. In the FTT, however, Universal put HMRC to proof that the contra-trader's clean chains and Universal's transactions in those chains were connected with the frauds in the contra-traders' dirty chains. Universal also put HMRC to proof that the contra-trader was dishonest in respect of the clean chains (FTT§24).

7. Having considered the evidence the FTT concluded that Mr Ebrahim Sodha ("Mr Sodha") was Universal's directing mind and that he knew that the clean and dirty chain transactions were connected with fraud (FTT§§102 and 107). Mr Sodha had put himself forward as the person who was the principal person concerned in the actual running of the company and the transaction of its business at the relevant times. Having heard Mr Sodha's evidence and that of his daughter, Ms Fariyal Sodha, the FTT concluded that both of them were unreliable and untruthful witnesses (FTT§113).

Universal's grounds of appeal

8. Undeterred by the FTT's conclusions and by a substantial body of opinion in this Tribunal and by Court of Appeal authority to the contrary, Mr Patchett-Joyce on behalf of Universal sought to persuade us, first, that the FTT had erred on a number of grounds and, second, that before reaching our decision we should refer the case to the Court of Justice of the European Union ("CJEU") for its opinion on certain matters.

9. The six grounds of appeal that he advanced can be summarised as follows:

    a. Ground 1: There was no legal basis on which HMRC were entitled to deny Universal the right of deduction and therefore repayment;

    b. Ground 2: There was no sufficient connection between Universal's transactions and the frauds of the alleged defaulters in the contra-trading transactions;

    c. Ground 3: The FTT failed to have proper regard to the absence of any pleaded case in conspiracy where it was alleged that Universal had been involved in 'clean' chains that formed part of HMRC's contra-trading construct;

    d. Ground 4: The FTT failed to have proper regard to the absence of any pleaded case in fraud against Universal;

    e. Ground 5: The FTT was wrong to find a connection between Universal's being a party to transactions in 'clean' chains and the contra-traders' 'dirty' chains in the contra-trading construct; and

f. Ground 6: The FTT was wrong to find that Universal had the requisite knowledge of fraud in either the 'clean' chains or the contra-traders' 'dirty' chains.

10. As appears from this summary, Grounds 2, 3 and 5 are formulated specifically by reference to the concept of contra-trading. Mr Patchett-Joyce explained, however, that this was only because of the Court of Appeal's decision in *Mobilx Ltd v HMRC* [2010] EWCA Civ 517, [2010] STC 1436. It was Universal's case that there was no support for the contra-trade construct in EU law and that the construct was in fact incompatible with the reasoning of the Court of Justice in Joined Cases C-80/11 *Mahagében kft v Nemzeti Adó- és Vámhivatal Dél-dunántúli Regionális Adó Föigazgatósága* and C-142/11 *Péter Dávid v Nemzeti Adó- és Vámhivatal Észak-alföldi Regionális Adó Föigazgatósága* (hereafter "*Mahagében*") and subsequent case law.

11. Mr Patchett-Joyce submitted that there was a tension between *Mobilx* and EU law and that we should not consider ourselves bound by the Court of Appeal's decision. On that basis he suggested that no sufficient 'connection' in law had been established in relation to the 'straight' chains and that Ground 2 was therefore only limited to the deals in which the refusal of the benefit of the right of deduction depended on the contra-trading construct because Universal had assumed that we would follow and apply *Mobilx*. Ground 5 was, essentially, an extrapolation of Ground 2.

12. Mr Patchett-Joyce also took the opportunity to 'clarify' Ground 6. He noted that there was no fraud as such in the 'clean' chains and, thus, the reference to a finding that Universal was a knowing party to fraud in those chains did not make sense. He said that it was HMRC's case that fraudulent evasion of VAT occurred either at the opposite end of the domestic supply sequence (i.e. there was fraudulent evasion in the 'straight' chains, being the case put against Universal in relation to most of its 04/06 deals), or where the contra-trade concept was relied upon, such evasion had occurred in the 'dirty' chains, in which Universal did not feature (being the case put against Universal in relation to the remainder of its 04/06 deals, and its 05/06 and 06/06 deals). Universal's case was that it had no requisite knowledge that any of its transactions were connected with any fraudulent transaction; i.e. whether the connection is sought to be made via 'straight' sequences of supply, or the contra-trade construct.

13. Accordingly, he suggested that Ground 6 should be recast to read that the FTT had erred in law and was wrong to find that Universal had the requisite knowledge that its transactions were connected with fraudulent evasion of VAT, whether the fraudulent evasion relied upon was in the direct sequence of supply or via the contra-trade construct.

14. Mr Patchett-Joyce referred us to a case (*Turbu.com BV*) that was pending before the CJEU in support of Ground 1 in respect of which the CJEU

delivered its judgment following the conclusion of the hearing. The parties also informed us following the conclusion of the hearing that permission to appeal to the Court of Appeal had been given in *Fonecomp Ltd v HMRC* [2013] UKUT 0599 (TCC). Fonecomp's appeal was to raise closely related issues to those in Universal's case, in particular the issue of contra-trading, contending (as Universal had done before us) that a trader only loses the right to deduct if it knows or ought to know that the default will occur in the same chain of supply as his purchase, but not if the default occurs in a different chain of supply. As Lady Justice Arden in due course put it, "The need for there to be a fraud in the same chain of supply is the *leitmotif* of [Fonecomp's] grounds of appeal." The Court of Appeal gave its decision dismissing Fonecomp's appeal on 3 February 2015. We have had regard to both *Turbu.com* and *Fonecomp* in our decision but we have not thought it necessary to invite further submissions by the parties on the issues that they raise. The issues were fully argued before us and, as will become apparent, neither *Turbu.com* nor *Fonecomp* significantly alter the legal landscape within which we have reached our decision.

15. In the following paragraphs of our decision we deal with each of the grounds of appeal advanced by Mr Patchett-Joyce on behalf of Universal, grouped as appropriate according to the issues that they raise. We summarise Mr Patchett-Joyce's arguments and Mr Puzey's response on behalf of HMRC before setting out our conclusion based on their submissions and the authorities.

Ground 1: No Legal Basis

Universal's submissions on Ground 1

16. Mr Patchett-Joyce submitted that Sir Andrew Morritt C had accurately summarised the position under EU and UK law in *Blue Sphere Global Ltd v HMRC* [2009] EWHC 1150 (Ch), [2009] STC 2239 when he said (at §§[9]-[11]):

> "[9] *At this stage I should explain the legal bases for BSG's claim for repayment and of HMRC's right to refuse. The right of a registered trader to deduct input tax paid by him in respect of the supply of goods or services to him from output tax received by him in relation to goods or services supplied by him and to pay or be reimbursed the difference arises under both EU law and the VAT Act 1994. In respect of EU law the relevant provisions at the material time were Articles 17(2) and 28 of the Sixth VAT Directive. Article 22(8) recognised the entitlement of member states to impose other obligations necessary for the correct collection of tax and for the prevention of evasion. Similarly Article 28c(A) enabled member states to impose conditions for ensuring the straightforward application of the exemption thereby conferred in*

respect of intra-community trade "and preventing any evasion, avoidance or abuse".

[10] *The relevant provisions of domestic law in relation to the right of a registered person to deduct input tax from output tax and to be paid or reimbursed the difference are sections 24, 25 and 26 of the VAT Act and regulation 29 of the VAT Regulations 1995. Notwithstanding the terms of Articles 22(8) and 28c(A) of the Sixth Directive there is no provision in the VAT Act qualifying the registered person's right to repayment at the end of an accounting period of any excess of input over output tax.*

[11] *The right to refuse such repayment on which HMRC relies arises from a series of decisions of the ECJ to which effect has been given in a number of decisions of the VAT and Duties Tribunal and puisne judges in England. It has not been suggested that they were wrong to have done so. Consequently it is my duty to follow where they have led notwithstanding my concern as to whether this is an appropriate manner in which effectively to impose a liability for tax."*

17. The leading case to which the Chancellor was referring, and at the heart of each of the grounds of appeal that Mr Patchett-Joyce advanced on behalf of Universal, is the CJEU's decision in Joined Cases C-439/04 *Axel Kittel v État Belge* and Case C-440/04 *État Belge v Recolta Recycling SPRL* (hereafter "*Kittel*"). *Kittel* concerned a direct supply of goods to the taxpayer concerned in transactions that involved the fraudulent evasion of VAT. The CJEU emphasised at §47 that the right to deduct is exercisable immediately in respect of the input VAT on any transaction that objectively satisfies the requirements of the VAT system, that the right to deduct is an integral part of that system and that in principle it may not be limited. As the CJEU noted at §49, the question whether the VAT payable on prior or subsequent sales of the goods concerned has or has not been paid to the Member State's Treasury is irrelevant to the right of the taxable person to deduct input VAT.

18. Accordingly, in Mr Patchett-Joyce's submission, the limitation that the CJEU went on to articulate in §56 must necessarily be construed narrowly. The CJEU had stated at §53 that, "*the objective criteria which form the basis of the concepts of 'supply of goods effected by a taxable person acting as such' and 'economic activity' are not met where tax is evaded by the taxable person himself*" and at §54 that, "*Community law cannot be relied on for abusive and fraudulent ends*". At §56 to §59, effectively referring back to these earlier statements, it then stated as follows:

> *"56. In the same way, a taxable person who knew or should have known that, by his purchase, he was taking part in a transaction connected with fraudulent evasion of VAT must, for the purposes of the Sixth Directive, be regarded as a participant in that fraud, irrespective of whether or not he profited by the resale of the goods.*

57 That is because in such a situation the taxable person aids the perpetrators of the fraud and becomes their accomplice.

58 In addition, such an interpretation, by making it more difficult to carry out fraudulent transactions, is apt to prevent them.

59 Therefore, it is for the referring court to refuse entitlement to the right to deduct where it is ascertained, having regard to objective factors, that the taxable person knew or should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of VAT, and to do so even where the transaction in question meets the objective criteria which form the basis of the concepts of 'supply of goods effected by a taxable person acting as such' and 'economic activity'."

19. Mr Patchett-Joyce's attack on the FTT's decision in Universal's case, so far as it concerned this 'exception' under EU law to the right of deduction, was focussed on the requirements, having regard to objective factors, of actual or constructive knowledge and the degree of connection between the fraud and Universal's transactions which, he said, met the objective criteria needed for the right of deduction to arise. We summarise his submissions in these respects when we consider the other grounds of appeal. However, a fundamental aspect of his submission that we should refer Universal's case to the CJEU, notwithstanding Court of Appeal authority in *Mobilx* and the refusal by this Tribunal and the Court of Appeal to contemplate a reference in previous cases in which the same issue has arisen, was that the CJEU's decision in *Kittel* only dealt with transactions in which there was a 'close' connection between the fraudulent evasion of VAT and the taxpayer's transactions. He said that the CJEU had not considered a case in which the connection was more remote. In this respect, his argument was not that *Mahagében* and later case law before the CJEU had narrowed the scope of *Kittel* but that *Kittel* had always been of limited or narrow application given that it operated as an exception to the right of deduction in cases where the objective criteria giving rise to that right were satisfied. It was solely the UK's tribunals and courts that had accepted HMRC's broader construct, in particular their extension of the *Kittel* principle to contra-trading, on which the CJEU had never been given the opportunity to express its view.

20. He submitted that we should now ensure that the CJEU had the opportunity to consider whether *Kittel* established a broad or a narrow principle to qualify the right of deduction. In this regard, he said that it was only necessary that he could satisfy us that there was uncertainty on the matter: he did not have to satisfy us that his submissions were correct but only that there was doubt, which would then necessitate a reference to the CJEU whose decision would ensure a consistent application of EU law on this matter in all Member States.

21. Mr Patchett-Joyce recognised that these points had been considered by the Court of Appeal in *Mobilx* at §§[45]-[49] and concluded against him. Furthermore, in so far as a separate issue arose as to the necessity or otherwise for the UK's domestic VAT law to contain an explicit qualification on the right of deduction conferred by that law to match that under EU law, he accepted that the Court in *Mobilx* had concluded that the principle of law, derived from *Kittel*, "*does not require the introduction of any further domestic legislation*".

22. He noted, however, that on 2 April 2013 the Dutch Supreme Court, the *Hoge Raad der Nederlanden*, had lodged a Request for a Preliminary Ruling with the CJEU in Case C-163/13, *Turbu.com BV*. The question in point was as follows:

> "*Should the national authorities and judicial bodies, on the basis of the law of the European Union, refuse to apply the VAT exemption in respect of an intra-Community supply where it is established, on the basis of objective evidence, that there was VAT fraud in respect of the goods concerned and that the taxable person knew or should have known that he was participating therein, even if the national law does not make provision under those circumstances for refusing the exemption?*"

23. Mr Patchett-Joyce said that this raised directly the question whether there must be a provision of national law allowing the national authorities and judicial bodies in a Member State to refuse to apply a VAT exemption, even if the circumstances were such that a refusal to apply a VAT exemption would be justified under EU law (*i.e.* where it had been established on the basis of objective evidence that there was a VAT fraud in respect of the goods concerned and that the taxable person knew or should have known that he was participating therein). He said that there was no material difference between the matter of principle raised by the question referred in the *Turbu.com* case, and Ground 1 in Universal's case. Accordingly, he submitted that Ground 1 could not be answered with certainty until after the CJEU has delivered its decision in the *Turbu.com* reference.

HMRC's submissions on Ground 1

24. Mr Puzey for HMRC said that Lord Justice Moses had taken care in giving the judgment of the Court of Appeal in *Mobilx* to explain why the denial of the right to deduct input tax, as set out by the ECJ in *Kittel*, was not dependent upon the introduction of national legislation but rather on the application of the objective criteria underpinning the VAT system as defined in EU law. If the objective criteria (as referred to in *Mobilx* §24) were met then the right to deduct which is 'integral' to the operation of VAT could not be denied.

25. Moses LJ had made it clear in *Mobilx* §45 that the principle enunciated by the CJEU in *Kittel* §56 onwards (see paragraph 19 above) did not depend upon the

introduction of national legislation because it depended on whether the objective criteria which determined the scope of VAT and the entitlement to deduct are met. He repeated this view at §47 and at §49 pointed out that "*it is the obligation of the domestic courts to interpret VATA 1994 in the light of the wording and purpose of the Sixth Directive as understood by the ECJ*", and later "*In relation to the right to deduct input tax, Community and domestic law are one and the same*".

26. Mr Puzey submitted that the request by the Dutch Supreme Court for a preliminary ruling in the matter of *Turbu.com BV* did not provide a basis for any doubt on this issue and he referred to Judge Bishopp's conclusions in *Universal Enterprises (EU) Ltd v HMRC* [2014] STC 1515. That involved an interlocutory application by HMRC in the present appeal, when Mr Patchett-Joyce had urged the Tribunal to refer this point to the CJEU having regard to the request for a preliminary ruling in *Turbu.com BV*. Mr Puzey said that Judge Bishopp had correctly declined to make a reference.

Discussion of Ground 1

27. Since the hearing of Universal's appeal the CJEU has given its decision in Joined Cases C-131/13 *Staatssecretaris van Financiën v Schoenimport 'Italmoda' Mariano Previti vof*, C-163/13 *Turbu.com BV* and C-164/13 *Turbu.com Mobile Phone's BV v Staatssecretaris van Financiën*. The CJEU ruled that the requests for preliminary rulings in Case C-163/13 and C-164/13 were inadmissible. This was because it was evident from the orders for reference that the Hoge Raad der Nederlanden had not established that there was evasion of VAT in the transactions in issue. Given that the questions submitted for reference were premised on the existence of such evasion, the CJEU considered them to be hypothetical and therefore inadmissible.

28. Nevertheless, the CJEU did consider the question that had been referred in Case C-131/13 *Staatssecretaris van Financiën v Schoenimport 'Italmoda' Mariano Previti vof*. Italmoda, a Dutch company, traded in shoes. It also carried out transactions involving computer hardware, which it acquired in The Netherlands and in Germany and sold to customers registered for VAT in Italy. The Italian customers did not declare the acquisitions or pay VAT. The Dutch Revenue refused Italmoda the right to deduct and be refunded input tax, taking the view that Italmoda had knowingly participated in fraudulent activity designed to evade VAT in Italy.

29. The Regional Court of Appeal in Amsterdam held that there was no justification for refusing the right of deduction and refund of VAT. In this regard, it took account, in particular, of the fact that the tax evasion had taken place not in The Netherlands, but in Italy, and that Italmoda had, in The Netherlands, satisfied all the formal statutory requirements. The Dutch Supreme Court noted that at the time in question the right of deduction was not subject, under Dutch law, to the condition that the taxable person must not

have deliberately participated in VAT evasion or in a tax avoidance arrangement. The question therefore arose whether deliberate participation in such evasion precluded the right to a refund of VAT, notwithstanding the absence of any provision to that effect in national law.

30. The first question posed by the Dutch Supreme Court for the CJEU's consideration was therefore as follows:

> *"Should the national authorities and courts, on the basis of the law of the European Union, refuse to apply the exemption pertaining to an intra-Community supply, the right to the deduction of VAT in respect of the purchase of goods which, after the purchase, were dispatched to another Member State, or the refund of VAT pursuant to the application of the second sentence of Article 28b(A)(2) of the Sixth Directive, when, on the basis of objective data, it has been established that there has been VAT evasion in respect of the goods concerned, and that the taxable person knew, or should have known, that it was participating therein, if national law does not make provision for refusal of the exemption, the deduction or the refund under those circumstances?"*

31. In answering that question the CJEU noted at §§43 and 44 (citing *Kittel*) that EU law cannot be relied on by individuals for abusive or fraudulent ends and, derived from this, the Court had concluded that the right to deduct VAT should be refused where it was shown, in the light of objective evidence, that that right was being relied upon for those ends. In §45 it emphasised that, "*no one may benefit from the rights stemming from the Union's legal system for abusive or fraudulent ends*". It continued:

> "*48 In this regard, it is appropriate to note that it follows from the case-law cited in paragraph 44 of the present judgment that the central function of the right of deduction provided for in Article 17(3) of the Sixth Directive, in the VAT mechanism designed to ensure complete neutrality of the tax, does not preclude that right from being refused to a taxable person in the event of participation in fraud (see to that effect, inter alia, judgments in Bonik, EU:C:2012:774, paragraphs 25 to 27 and 37, and Maks Pen, EU:C:2014:69, paragraphs 24 to 26). Similarly, the specific function of the right to a VAT refund, intended to ensure the neutrality of VAT, cannot preclude that right from being refused to a taxable person in such a situation.*
>
> *49 In the light of the foregoing considerations, it is, in principle, the responsibility of the national authorities and courts to refuse the benefit of the rights laid down by the Sixth Directive when they are claimed fraudulently or abusively, irrespective of whether those rights are rights to a deduction, to an exemption or to a VAT refund in respect of intra-Community supplies, as at issue in the case in the main proceedings.*

> *50 It must further be noted that, according to settled case-law, that is the position not only where tax evasion has been carried out by the taxable person itself but also where a taxable person knew, or should have known, that, by the transaction concerned, it was participating in a transaction involving evasion of VAT carried out by the supplier or by another trader acting upstream or downstream in the supply chain (see to that effect, inter alia, judgments in Kittel and Recolta Recycling, EU:C:2006:446, paragraphs 45, 46, 56 and 60, and Bonik, EU:C:2012:774, paragraphs 38 to 40)."*

32. As regards the question whether the Revenue and Courts of the Member State in question are required to adopt the same approach if there is no specific provision to that effect in the national legal order, the CJEU in *Italmoda* continued—

> *52 In this respect, it must be recalled that it is for the national court to interpret the national law, so far as possible, in the light of the wording and the purpose of the directive concerned in order to achieve the result sought by the directive, which requires that national court to do whatever lies within its jurisdiction, taking the whole body of domestic law into consideration and applying the interpretative methods recognised by that law (see, to that effect, judgments in Adeneler and Others, C-212/04, EU:C:2006:443, paragraph 111; Kofoed, C-321/05, EU:C:2007:408, paragraph 45; and Maks Pen, EU:C:2014:69, paragraph 36).*
>
> *53 It is consequently for the referring court to ascertain whether there are, in Netherlands law, as the Netherlands Government submits, rules of law, whether a provision or a general principle prohibiting abuse of rights, or other provisions relating to tax evasion or tax avoidance which might be interpreted in accordance with the requirements of EU law in regard to combatting tax evasion, such as those noted in paragraphs 49 and 50 of the present judgment (see, to that effect, judgments in Kofoed, EU:C:2007:408, paragraph 46, and Maks Pen, EU:C:2014:69, paragraph 36).*

33. As these paragraphs indicate, Ground 1 is a matter for the national courts of the Member State in question so far as it concerns the scope and interpretation of any relevant provisions of national law. It is a matter that has already been considered and ruled upon by the Court of Appeal in *Mobilx*, by which this Tribunal is bound, and as a result of which Universal's appeal on Ground 1 is bound to fail unless it is able to show that the FTT has made some relevant error of law in arriving at its conclusion. Nothing that the CJEU said in *Italmoda* suggests that any purpose would be served by referring Universal's case to the CJEU on Ground 1 in that respect. In so far as Ground 1 involves

the application of EU law in Universal's case, we deal with this as part of its other Grounds of appeal.

Grounds 2, 5 (sufficient connection) and 6 (requisite knowledge)

Universal's submissions on Grounds 2, 5 and 6

34. Universal's second ground of appeal is that the FTT erred in finding that its transactions were "sufficiently connected" with the frauds of the alleged defaulters in the contra-trading transactions. Ground 5 is similar in that Universal says that the FTT was wrong to find a connection between its "clean" chains and the contra-traders' "dirty" chains. Finally, Ground 6 (as explained by Mr Patchett-Joyce) suggests that the FTT was wrong to find that Universal had the requisite knowledge that its transactions were connected with fraudulent evasion of VAT, whether the fraudulent evasion relied upon was in the direct sequence of supply or via the contra-trade construct.

35. Mr Patchett-Joyce's submissions for Universal on Grounds 2, 5 and 6 accordingly comprised three elements:

    a. The first related to the way in which the principles of *Kittel* had been translated into English from the original French language version of the decision.

    b. Based on that translation and on the language used in *Kittel* and subsequent case law, the second element related to the question of what as a matter of law constituted the nature of the 'connection' that needed to exist between the taxpayer's transactions and the fraudulent evasion of VAT.

    c. The third element related to the knowledge of that fraudulent evasion on the taxpayer's part that the national tax authority had to demonstrate.

    As part of the second and third of these, there was also the question of how connection and knowledge had to be proved, given that the burden of proof rested on the national tax authority.

The English translation

36. Mr Patchett-Joyce criticised the accuracy of the English translation of certain key passages in *Kittel* from the French text of that judgment, French being both the original and the authentic language of the judgment. As regards the necessary connection with fraud, he said that the French words "*impliquée dans*" were inexactly rendered in the English translation where the words "*connected with*" are used. "*Impliquée dans*" was more appropriately

translated as "implicated in", which requires a closer connection between the relevant transaction and the fraudulent evasion of VAT.

37. As regards the knowledge of the fraud that had to be demonstrated he said that the words "*savait ou aurait dû savoir que*" were inaccurately translated by the English expression "*knew or should have known*". In particular, taking the component parts of "…*aurait dû savoir que* …", literally, "would have ("*aurait*") "must" (as a past participle, "*dû*") "to know" ("*savoir*"), the expression was more appropriately to be understood as meaning "would have had to have known" or "could not but have known". He noted that for an English common lawyer the phrase "knew or should have known" was apt to include both actual and constructive knowledge but, "knew or would have had to have known" comprehended only actual knowledge (see *Boden v Société Générale* [1993] 1 WLR 509 (Note) per Peter Gibson J).

38. He also referred to *HMRC v Livewire Telecom Ltd* [2009] EWHC 15 (Ch), [2009] STC 643 where Mr Justice Lewison had drawn attention to several other material differences between the French text and the English translation, in particular at §§[57]-[61]. The differences in translation had not been fully argued before Lewison J and he had proceeded on the basis that the translation was accurate.

39. Mr Patchett- Joyce accepted that the Upper Tribunal and Court of Appeal in previous decisions have consistently declined to entertain arguments based on these linguistic differences. He submitted, however, that our primary obligation was to apply EU law and that we were required to do so even in the face of contrary domestic precedent. He said that several recent CJEU authorities put this beyond doubt: see Case C-409/06 *Winner Wetten GmbH*, at §§53-69; Case C-173/09 *Elchinov* at §§23-28, and Case C-555/07 *Kücükdeveci* at §§54-55; confirmed by Case C-458/06 *Skatteverket v. Gourmet Classic Limited* at §§18, 20-23, 25-26, and 32.

40. He noted that previous tribunals and courts had suggested that evidence was required of the inaccuracy of the English translation and of how the judgment in *Kittel* has been construed and applied in other Member States. He said that this put too high a probative burden on an appellant. It was sufficient to show that an expression used consistently in the French text of a judgment had been translated in various different ways in the English translation of the same judgment. Thus, "*impliquée dans*" had usually been translated as "connected with" but there were also instances where "involved in" and "as part of" had been used instead. These alternative expressions might inform the meaning of "connected with" but otherwise there would be a *prima facie* need to resolve the disparities.

41. Once that *prima facie* need was established, it was clear that the courts or tribunals of a particular Member State could not themselves resolve such disparities, since that would be to assume responsibility for something that

was properly within the CJEU's remit. The correct approach was to refer the matter to the CJEU, as had recently been exemplified by the Italian Supreme Court in its request for a preliminary ruling in Case C-590/13 *Idexx Laboratoires Italia srl*. concerning the proper meaning to be attributed to certain expressions used by the CJEU in its judgment in Joined Cases C-95/07 and C-96/07, *Ecotrade SpA v Agenzia delle Entrate – Ufficio di Genova 3*. He accordingly invited us to refer appropriate questions to the CJEU for a preliminary ruling on the correct English translation of the French text of *Kittel*.

The necessary connection to fraud

42. The issue of the appropriate English translation of *Kittel* necessarily provided the background to Mr Patchett-Joyce's submissions on the issue of "*connection*" and "*knowledge*". As regards the first of these, his submissions were largely directed at the contra-trading aspect of the case, although he said that his submissions applied equally to Universal's transactions involving dirty chains where the alleged fraudulent default had taken place at several steps removed from Universal. He noted that there was no CJEU authority for a taxable person to be denied the right of deduction on the basis of the so-called contra-trade construct. Given that VAT was assessed on a transaction-by-transaction basis, he said there were good reasons why the benefit of that right should *not* be denied on the basis of such a construct. Furthermore, because the *Kittel* principle represented an exception to the fundamental right of deduction under the VAT system and given that exceptions should be construed strictly, the tribunals and courts in any Member State should not extend the ambit of an exception to circumstances that had not been within the CJEU's contemplation.

43. Mr Patchett-Joyce relied in particular on the *Mahagében* decision to say that the contra-trading construct is an inappropriate extension of the denial of the right to deduct under EU law. He referred in particular to paragraphs 45, 49, 50, 52 and 59 of that decision to contend that the case put it beyond doubt that it was not *any* connection with fraud, no matter how tenuous, that sufficed. If the alleged connection was not with fraud "*previously committed ... at an earlier stage of the transaction*" (see paragraphs 45 and 59), or with "*fraud committed by the seller or by another trader acting earlier in the chain of supply*" (see paragraphs 49, 50 and 52), there was no basis on which a tax authority in any Member State could refuse a taxable person the benefit of the right to deduct.

44. He drew attention to the fact that neither *Kittel* nor *Mahagében* nor any of the other CJEU case law had dealt with a connection to fraud as remote as that contemplated by the contra-trading construct. In this respect he also drew our attention to Case C-324/11 *Gábor Tóth v Nemzeti Adó- es Vámhivatal Észak-magyarországi Regionális Adó Föigazgatósága* at §§38, 39, 51 and 53 and §2 of the dipositif; Case C-285/11 *Bonik EOOD v Direcktor na Direcktsia*

'Obzhalvane i upravlenie na izpalnenieto' – Varna pri tsentralno upravienie na Natsionalnata agentsia za prihodite at §§40, 41 and the dispositif; and Case C-643/11 *LVK – 56 EOOD* v *Direcktor na Direcktsia 'Obzhalvane i upravlenie na izpalnenieto' – Varna pri tsentralno upravienie na Natsionalnata agentsia za prihodite* at §60.

45. In so far as the language used by the CJEU reflected the facts of the particular cases before it, it was for the CJEU on an appropriate reference by a tribunal or court of a Member State to indicate whether the principle enunciated by the CJEU could be applied more extensively rather than for the tribunal or court to extend the principle notwithstanding that language. In particular, where HMRC relied on the contra-trading construct they were dependent upon fraud committed in a wholly separate supply chain in which Universal had not featured at all.

46. Mr Patchett-Joyce referred to what the CJEU had said in *Mahagében* regarding the trader's and the revenue authority's respective obligations in respect of the monitoring of transactions. Thus:

> *61. However, the tax authority cannot, as a general rule, require the taxable person wishing to exercise the right to deduct VAT, first, to ensure that the issuer of the invoice relating to the goods and services in respect of which the exercise of that right to deduct is sought has the capacity of a taxable person, that he was in possession of the goods at issue and was in a position to supply them and that he has satisfied his obligations as regards declaration and payment of VAT, in order to be satisfied that there are no irregularities or fraud at the level of the traders operating at an earlier stage of the transaction or, second, to be in possession of documents in that regard.*
>
> *62. It is, in principle, for the tax authorities to carry out the necessary inspections of taxable persons in order to detect VAT irregularities and fraud as well as to impose penalties on the taxable person who has committed those irregularities or fraud.*

47. In Universal's case, the FTT had explained (at FTT§17) the three ways in which HMRC had said that the clean chains in which Universal had participated were connected with fraud. It was the third of these – the fact that the repayment of input tax to Universal, if found to be due, would finance the fraud – that was the particular connection alleged by HMRC in Universal's case (see FTT§21). However, Mr Patchett-Joyce contended that in no meaningful sense could it be said that the repayment of input tax "*will finance the fraud*" because the fraud has been perpetrated whether or not input tax is repaid to Universal. Rather, he said that whether or not input tax is repaid determines who bears the burden of the fraudster's actions.

48. In this regard, he noted that the first and second reasons for connecting the clean chains with the fraud involved the contra-trader's aim of disguising the fraud in its dirty chains by making it less likely that HMRC would ask to verify its returns and by making it appear that it was conducting a legitimate business. Universal could not be called upon to bear the cost of the fraud just because it had been deceived by the contra-trader.

49. He drew attention to the evidence that the FTT had recorded relating to the alleged contra-traders, A-Z and Waterfire, and noted that there was no finding that Universal bought goods from those parties other than on the basis that they were operating normal legitimate businesses.

The knowledge of fraud

50. Mr Patchett-Joyce said that it was clear from the CJEU case law that requisite knowledge must be established on the basis of "*objective factors*" (see, *Kittel*, §[59] and *Mahagében*, §§[43]-[44]). He also referred in support of the objective nature of the test to Case C-254/03 *Optigen Ltd v Customs and Excise Commissioners*, in which the CJEU at §43, in the context of dealing with the concept of economic activities, had said that "*the scope of the term economic activities is very wide, and that the term is objective in character, in the sense that the activity is considered per se and without regard to its purpose or results*".

51. He criticised the FTT for relying on a subjective assessment of the witness evidence and on matters that were not relevant to the exercise that was required to be undertaken (see *e.g.* FTT§§45-49). He said that the demeanour of a witness when giving evidence cannot be a factor relevant to the *objective* determination of requisite knowledge in relation to any particular transaction at the time that the transaction was entered into. He also said that at no point had it ever been put to any of the three witnesses for Universal that they knew or should have known of a connection to fraud.

52. He said that the FTT had applied a "must have known" test but had done so on the basis of circumstantial evidence. In having regard to circumstantial evidence, the FTT would appear to have been following *Mobilx*, which extended knowledge to include "*those who should have known from the circumstances which surround their transactions that they were connected to fraudulent evasion*" (see *Mobilx* §59). He submitted that this was wrong. First, the EU law principle of legal certainty "*requires that rules of law be clear and precise and predictable in their effect, so that interested parties can ascertain their position in situations and legal relationships governed by European Union law"* (Case C-81/10 *P France Télécom v Commission* at §100).

53. The necessary clarity, precision and predictability must exist at the time when the transaction is entered into. However, the test articulated in *Mobilx* §59 did

not satisfy that requirement because an element of it, he suggested, can only be determined with hindsight. In explaining the test, the Court of Appeal had gone on to say:

> *"[I]f a trader should have known that the only reasonable explanation for the transaction in which he was involved was that it was connected with fraud and if it turns out that the transaction was connected with fraudulent evasion of VAT then he should have known of that fact. He may properly be regarded as a participant for the reasons explained in Kittel."*

54. Secondly, the CJEU required that the requisite knowledge be established on the basis of "objective factors" (see *Mahagében* §45) which, because VAT is a transaction tax, must be factors in each transaction, and excluding wider considerations. If the requisite knowledge had to be established, as he contended, on the basis of "objective factors", that was obviously a much stricter test than one which allowed regard to be had to "surrounding circumstances".

55. The FTT had taken into account its own assessment of the credibility of Universal's witnesses (FTT§44), Mr Sodha's personal and business background (FTT§§45-58) and matters occurring well before any of the transactions in question (FTT§59-60). None of these matters could conceivably be "objective factors" of any of the particular transactions in question. At FTT§§61 to 103, the FTT had taken account of a range of matters (thoroughness of due diligence, inspection reports, use of "ship on hold", pattern of contract negotiations and percentage of mark up, etc). The FTT had gone on in its conclusions to make findings as regard the contra-trader, A-Z (FTT§§104-106), and had found the requisite knowledge "*because the circumstantial evidence ... proves that [the principal person involved in running Universal] must have known the transactions were [connected with fraud]*". The FTT had then set out the "salient points" of the circumstantial evidence on which it relied at FTT§§109-113. Those points, he submitted, were insufficient to establish requisite knowledge because they were not objective factors from which a connection of any particular transaction with fraud can be established. Whatever the aims, purposes or intentions of Universal's suppliers, every one of them had properly accounted for the VAT paid by Universal to HMRC.

56. Mr Patchett-Joyce said that it was therefore impossible to identify any objective factor capable of establishing the requisite knowledge, let alone to conclude that HMRC had satisfied the burden of establishing such knowledge. Mr Patchett-Joyce drew our attention in particular to nine deals in which Universal had made purchases from Watts Management Services Ltd, in five of which they had sold the goods on within the UK while in four cases they had exported the goods. Universal had only been denied its right of deduction in the four cases in which the goods had been exported. He said that there was

no objective factor to distinguish between the nine deals other than that five of the purchases were followed by sales within the UK and four had led to exports. Those were objective factors that were subsequent to the accrual of the right to deduction that arose on purchase. The right of deduction could not depend on that *ex post* event.

HMRC's submissions on Grounds 2, 5 and 6

57. Mr Puzey said that Universal's attempt to extend Grounds 2 and 5 to Universal's 'dirty' chains was not within the scope of their permission to appeal. Grounds 2 and 5 referred only to the contra-trading deals. In any event, Universal was attempting to revive arguments deployed in other appeals concerning the correct translation into English from the original French text of *Kittel*. He drew our attention to the repeated rejection of these arguments in *POWA (Jersey) Ltd v HMRC*, Roth J at §§26-40; *S & I Electronics Ltd v HMRC*, Newey J at §§28-30; *POWA (Jersey) v HMRC*, application for permission to appeal, Moses LJ (Court of Appeal), §8; and *Fonecomp Ltd v HMRC*, Sales J and Judge Berner at §23.

58. Mr Puzey said that the suggestion that the case should now be referred to the CJEU by analogy with *Idexx* should be rejected. At the interlocutory application heard by Judge Bishopp Universal produced a summary of the Italian language version of the request for preliminary ruling in *Idexx* and Judge Bishopp had considered this when deciding whether a reference was appropriate. He had noted that, on closer examination, the request did not deal with an apparent conflict between different language versions of a judgment but with the inability of the referring court to determine the meaning of a particular phrase despite considering its use in different language versions of the judgment.

59. Apart from the fact that these linguistic points had found no favour with previous tribunals and courts, the FTT in Universal's case found as a fact that Universal's supplier in the contra-trading chains, A-Z Mobile Accessories Ltd, ('A-Z') was "*a dishonest contra-trader*" (FTT§104) whose transactions were deliberately fraudulent (FTT§§35-37). A-Z's director had admitted when undertaking not to serve as a director of any company that he had engaged in fraud whilst conducting the business of A-Z. Thus even on Universal's case there was a close connection with fraud in that its deals were with a fraudulent trader. Furthermore, the FTT found as a fact Mr Sodha, Universal's "directing mind", had actual knowledge that its transactions were connected with fraud (FTT§107).

60. Mr Puzey said that a careful analysis of *Kittel* and of subsequent CJEU case-law, such as *Mahagében (Case C-80/11)*, and the series of domestic UK authorities indicated that there is no conflict between domestic and ECJ authority here. At §27 of the Upper Tribunal's decision in *Fonecomp* the Tribunal had made the following observations:

"*We propose to deal with this quite shortly. Although the argument was elaborated at some length by Mr Patchett-Joyce, by reference to a significant number of authorities, we consider that the relevant European case law has been thoroughly analysed by the Court of Appeal in Mobilx Ltd v Revenue and Customs Commissioners [2010] EWCA Civ 517; [2010] STC 1436 and there is nothing that can usefully be added to its judgment in that case. In truth, the arguments rehearsed by Mr Patchett-Joyce before us go over ground which has been well-travelled domestically and in the Court of Justice and there is no material doubt about the legal principles to be applied. We consider that the FTT identified the legal principles correctly and directed itself appropriately as to the law when deciding the case before it. We also consider that there is no sound basis on which it would be appropriate to make a reference to the Court of Justice for the purposes of deciding the outcome of this appeal."*

61. As regards Universal's submissions on the contra-trading construct, Mr Puzey recalled that *Blue Sphere Global* was itself a contra-trading case. The appeal in *Blue Sphere Global* was heard with *Mobilx* and the Court of Appeal had not sought to distinguish contra-trading from any other mechanism of VAT fraud for the purposes of explaining what HMRC needed to prove in order to uphold a decision to deny input tax (although as Mr Patchett-Joyce pointed out Blue Sphere Global's appeal had been allowed by the Upper Tribunal and was upheld by the Court of Appeal). Mr Puzey drew attention to §§59-62 of *Mobilx* and in particular the conclusion at §62 that it did not matter whether evasion precedes or follows the denied transaction because if the trader's knowledge brings him within the category of a participant he is a participant *"whatever the stage at which the evasion occurs"*. He also noted that Universal's argument has been dismissed by the Upper Tribunal on several previous occasions (see *POWA (Jersey) Ltd v HMRC*, Roth J at §§51-53; *Fonecomp Ltd v HMRC*, Sales J and Judge Berner at §24; *Edgeskill Ltd v HMRC*, Hildyard J at §§116-126 (and see also *POWA (Jersey) v HMRC*, application for permission to appeal, Moses LJ at §§3-11)).

62. Mr Puzey said that the suggestion that Universal had traded with A-Z legitimately or may have been deceived in some way was simply inconsistent with the FTT's findings of fact. HMRC's Amended Statement of Case had pleaded at §1 and §28 that Universal knew or should have known of a connection between its transactions and fraud. Mr Sodha had been cross-examined for two and a half days and it was entirely open to the FTT to conclude by reference to his answers to the questions put to him that he was evasive and untruthful.

63. The Court of Appeal in *Mobilx* expressly considered at §§83-85 how proof of knowledge of fraud or the means of knowledge could be established. An assessment must be made based on all the evidence as to what the appellant

knew or should have known, including the surrounding circumstances known to the appellant when entering the transactions. The reference to 'objective factors' in *Kittel* could not be taken to preclude examination of the very matter which had to be considered, namely the knowledge or otherwise of the trader who was seeking to deduct input tax. A similar challenge to the relevance of particular matters in determining knowledge had been mounted (and failed) in the Upper Tribunal in *Fonecomp* (see §§ 47-69).

64. Mr Puzey objected to Universal's submissions on A-Z and Universal's knowledge on the basis that it was an attack on the FTT's conclusions of fact for which no permission has been given. Nevertheless, he said that its conclusions were plainly not perverse on the facts as found. Without successful repayment claims by Universal the fraud could not continue because the repayments facilitated ongoing trading and through the payments to the preceding parties in the supply chain flowed back to the defaulting party. The FTT had found that there was a connection between Universal's purchases from A-Z and the default of the missing trader in transaction chains where A-Z acted as the exporter. The reference in *Mahagében* and other case law to fraud "*earlier in the chain of supply*" or at "*an earlier stage of a transaction*" was not prescriptive of the nature of the fraud or the connection to fraud which could operate to deny Universal the right to deduct where it knew or should have known of the connection. He referred to *Blue Sphere Global Ltd* where the Chancellor had pointed out at §44 that:

> "*The nature of any necessary connection depends on its context … The process of off-setting inputs against outputs in a particular period and accounting for the difference to the relevant Revenue Authority can connect two or three transactions or chains of transactions in which there is a common party whether or not the commodity is the same. If there is a connection in that sense it matters not which transactions or chain came first.*"

65. Mr Puzey said that Universal's interpretation of "objective factors" sought to exclude from consideration the evidence that would demonstrate the trader's knowledge or means of knowledge, leaving only the bare transaction documents to be considered. He noted that *Mobilx* had endorsed *Red 12 Trading v HMRC* [2009] EWHC 2563 (Ch) at §§109-111, where it was stated that "*the attendant circumstances and context of individual transactions*" can be examined because "*this is not to alter its character by reference to earlier or later transactions but to discern it.*"

66. The fact that Universal's suppliers had properly accounted for VAT was outweighed by the wealth of evidence that showed that Universal knew that its transactions were connected to fraud on a wider scale. Similarly, the fact that some of Universal's deals, such as those with Watts Management Services Limited where the goods were sold to UK traders, were left out of account was irrelevant. If HMRC can show in respect of any particular transaction that

there was a connection to fraud and that Universal knew or should have known that, Universal could properly be denied the right of deduction in respect of that transaction (*Mobilx* §§63-65).

Discussion of Grounds 2, 5 and 6

67. As appears from both parties' submissions, the arguments on the issues of the English translation of *Kittel*, the nature of the necessary connection with fraud (especially in contra-trade situations) and the state of the taxpayer's knowledge of that connection have been extensively rehearsed in previous cases. In particular, *Mobilx* as Court of Appeal authority on the issues is binding upon us in a domestic context. Subject only to the question whether the FTT had erred in law in arriving at any of its conclusions on the evidence, we would be bound to reject each of Universal's arguments under Grounds 2, 5 and 6. Nevertheless, in deference to the extensive arguments that Mr Patchett-Joyce addressed to us both in writing and orally we shall set out our views on the issues by reference to the CJEU case law.

68. The issue of the correct English translation of *Kittel* is one that we are plainly not competent to resolve having regard to our particular linguistic skills (or lack of them). However, even if we were prepared to adopt a different approach in light of Mr Patchett-Joyce's arguments on this issue, having regard to what he says about the approach of the Italian Supreme Court in *Idexx*, to that previously adopted by this Tribunal and the Court of Appeal, the FTT's conclusion that Universal (through its directing mind, Mr Sodha) *knew* that its transactions were connected with fraud militates against our doing so. Whatever uncertainty may or may not attend the correct English translation of the French expression "…*aurait dû savoir que* …", there seems to be no doubt concerning "*savait*".

69. That does not necessarily answer the question of what it is that the taxpayer in question must know and whether the French expression "*impliquée dans*" should be more appropriately translated as "implicated in", and therefore require a closer connection with the fraud than might be comprehended by the English expression "connected with". The other translations of "*impliquée dans*" to which Mr Patchett-Joyce drew our attention were "involved in" and "as part of". That apart, it is also the case that "connected with" is a somewhat imprecise and elastic concept, as indeed may be true of "*impliquée dans*". Rather than focussing on the translation of two words that in each language may be capable of bearing more than one meaning, we think it more helpful to concentrate on the whole context in which they appear and about which there is rather less linguistic dispute.

70. We have previously set out the relevant paragraphs of *Kittel* in recording Mr Patchett-Joyce's submissions on Ground 1 (see paragraph 18 above). *Kittel* §59, however, bears repetition—

"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'."

71. Mr Justice Lewison set out the French text at §59 of his decision in *Livewire*:

"*Dès lors, il appartient à la juridiction nationale de refuser le bénéfice du droit à déduction s'il est établi, au vu des éléments objectifs, que l'assujetti savait ou aurait dû savoir que, par son acquisition, il participait à une opération impliquée dans une fraude à la TVA et ceci même si l'opération en cause satisfait aux critères objectifs sur lesquels sont fondées les notions de livraisons de biens effectuées par un assujetti agissant en tant que tel et d'activité économique.*"

72. In relation to this he commented at §60:

"The key additional phrase here, which did not appear in paragraphs 55 or 56, is "au vu des éléments objectifs". This is translated as "having regard to objective factors". The word "factors" is a possible translation of "éléments", but it could also be rendered as "facts". Indeed in paragraph 55, where the same word appears, it is rendered as "evidence"."

73. Given Mr Patchett-Joyce's reliance on *Mahagében*, it is also worth setting out in full the key elements of the CJEU's judgment in that case. Case C-142/11 *Péter Dávid* that was joined with *Mahagében* concerned construction work that was said to have been performed by a number of individuals whose details could not be verified. It was not disputed that the work had been carried out and properly invoiced but it was unclear who was responsible for the work and deduction of the input tax charged was therefore refused. It was not suggested that the taxpayer had himself acted unlawfully by, for instance, filing false returns or issuing improper invoices. As regards that refusal the CJEU said this:

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

46 A taxable person who knew, or ought to have known, that, by his purchase, he was taking part in a transaction connected with fraudulent evasion of VAT must, for the purposes of Directive 2006/112, be regarded as a participant in that fraud, irrespective of whether or not he profited by the resale of the goods or the use of the services in the context of the taxable transactions subsequently carried out by him (see Kittel and Recolta Recycling, paragraph 56).

…

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

74. *Mahagében* concerned the supply of unprocessed acacia logs from another taxpayer, Rómahegy-Kert kft ("RK"). Mahagében resold the acacia logs to its customers. A subsequent inspection of RK suggested that RK's purchases of acacia logs during 2007 had been insufficient to fulfil the orders invoiced to Mahagében and that RK did not have the means of delivering the acacia logs. As a result the revenue authority sought to recover the input tax that Mahagében had deducted under RK's invoices and imposed fines and a late payment surcharge. As regards that action the CJEU said this:

"53. According to the Court's case-law, traders who take every precaution which could reasonably be required of them to ensure that their transactions are not connected with fraud, be it the fraudulent evasion of VAT or other fraud, must be able to rely on the legality of those transactions without the risk of losing their right to deduct the input VAT (see Kittel and Recolta Recycling, paragraph 51).

54. On the other hand, it is not contrary to European Union law to require a trader to take every step which could reasonably be required of him to satisfy himself that the transaction which he is effecting does not result in his participation in tax evasion (see, to that effect, Case C-409/04 Teleos and Others [2007] ECR I-7797, paragraphs 65 and 68; Netto Supermarkt, paragraph 24; and Case C-499/10 Vlaamse Oliemaatschappij [2011] ECR I-14191, paragraph 25).

…

58. As regards the national measures at issue in the case in the main proceedings, it must be noted that the Law on VAT does not

prescribe specific obligations, but merely provides, in Paragraph 44(5), that the taxation rights of the taxable person indicated as the purchaser in the invoice may not be called into question, provided that that person has acted with due diligence in respect of the chargeable event, bearing in mind the circumstances under which the goods were supplied or the services performed.

59. In those circumstances, it follows from the case-law referred to in paragraphs 53 and 54 of the present judgment that determination of the measures which may, in a particular case, reasonably be required of a taxable person wishing to exercise the right to deduct VAT in order to satisfy himself that his transactions are not connected with fraud committed by a trader at an earlier stage of a transaction depends essentially on the circumstances of that particular case.

60. It is true that, when there are indications pointing to an infringement or fraud, a reasonable trader could, depending on the circumstances of the case, be obliged to make enquiries about another trader from whom he intends to purchase goods or services in order to ascertain the latter's trustworthiness.

61. However, the tax authority cannot, as a general rule, require the taxable person wishing to exercise the right to deduct VAT, first, to ensure that the issuer of the invoice relating to the goods and services in respect of which the exercise of that right to deduct is sought has the capacity of a taxable person, that he was in possession of the goods at issue and was in a position to supply them and that he has satisfied his obligations as regards declaration and payment of VAT, in order to be satisfied that there are no irregularities or fraud at the level of the traders operating at an earlier stage of the transaction or, second, to be in possession of documents in that regard.

62. It is, in principle, for the tax authorities to carry out the necessary inspections of taxable persons in order to detect VAT irregularities and fraud as well as to impose penalties on the taxable person who has committed those irregularities or fraud."

75. It is correct to say, as Mr Patchett-Joyce submitted, that these cases involved a direct connection between the trader whose right to deduct input tax was in issue and the 'fraudulent' trader who had invoiced the construction services or acacia logs. Nevertheless, in Universal's case, as Mr Puzey pointed out, there was a direct connection between Universal and A-Z, a counterparty that the FTT concluded had acted fraudulently.

76. In terms of the basic principle established in *Kittel*, the subsequent case law of the CJEU including *Mahagében* does not necessarily advance matters on the basis that the Court, as is its custom, adopts a formulaic approach to the

expression of the principle. Nevertheless, the formulaic repetition by the Court of the principle it has established in the context of different national legal provisions helps to illustrate the scope and application of the principle to different factual scenarios.

77. In this respect, the whole basis of Universal's case is that neither HMRC nor any UK court or tribunal can point to any case that has to date been referred to the CJEU from any Member State that illustrates that the principle in *Kittel* applies to the circumstances involving the contra-trading construct. Nevertheless, the CJEU's summary in §59 of *Kittel* plainly indicates that it is the taxpayer's *transaction* that must be connected with fraud ("*une operation impliquée dans une fraude à la TVA*") and furthermore it is irrelevant that that transaction otherwise meets all the relevant criteria that would otherwise entitle the taxpayer to offset or be repaid the input tax attributable to its acquisition. The fact that Universal's transactions in a 'clean' chain in all respects satisfy the requirements entitling Universal to be repaid its input tax is not in itself enough to preserve Universal's right to deduct that tax if HMRC can demonstrate that those transactions are connected with fraud.

78. In the present case, as we have just mentioned at paragraph 75 above, the FTT accepted that HMRC had demonstrated that A-Z's transactions were connected with fraud, certainly in those cases in which A-Z was itself the contra-trader. (We consider those transaction in which Waterfire was the contra-trader under Grounds 3 and 4 below.) The sole question is therefore whether Universal knew, or should have known, whether its transactions with A-Z (being transactions connected with the fraudulent evasion of VAT) were so connected.

79. In this respect, the CJEU's explanation in §§53 to 62 of *Mahagében* provides an illustration of the respective responsibilities of the taxpayer and the Revenue Authority. The taxpayer can rely on the legality of a transaction without the risk of losing its right to deduct input VAT when it takes every precaution which could reasonably be required of it to ensure that the transaction is not connected with fraud. At the same time, the Revenue Authority cannot absolve itself of its responsibility of properly policing the operation of the VAT system and seek to shift that burden to taxpayers by requiring them to take additional measures to counter fraud, which if not adopted would then prejudice their right to deduct input VAT.

80. In this case the FTT, having heard the evidence, was plainly satisfied that Universal had failed in several material respects to conduct its business with A-Z in a manner that involved taking every precaution that could reasonably be required of it to ensure that its transactions with A-Z (which the FTT found were connected with fraud) were not connected with fraud. In our view, that of itself would have entitled the FTT to conclude that Universal should have known (even in the more limited sense of the French language for which Mr Patchett-Joyce contends) that its transactions were connected with fraud. The

FTT in fact went further than that and concluded that Universal *knew* that its transactions were connected with fraud. Although that finding was made solely on the basis of circumstantial evidence, the FTT reached this conclusion having heard the evidence and having formed the view that Mr Sodha and his daughter were evasive witnesses whose evidence was not to be believed. That is a conclusion that the FTT was uniquely placed to reach and is not one in respect of which we can say that there was no evidence on which they could so conclude.

81. Both Mr Sodha and his daughter were extensively cross-examined in relation to Universal's transactions for which they (and Mr Sodha in particular) were responsible. The fact that they may not have been asked directly whether they knew of the fraudulent nature of the transactions in question does not vitiate the FTT's conclusion based on their evidence that they (or at least Mr Sodha as Universal's directing mind) did know of it. We do not think it credible to suggest that in such a case the *Kittel* principle is inoperable merely because, looked at in isolation, all the elements giving rise to the right to deduct are otherwise present in Universal's transactions.

82. Accordingly, we do not accept any of Universal's Grounds 2, 5 and 6.

Grounds 3 and 4 (failure to plead and put a case in conspiracy or fraud)

Universal's submissions on Grounds 3 and 4

83. Universal's third ground of appeal is that HMRC never pleaded any case of a conspiracy against Universal where clean contra chains had been identified. It said that the FTT was therefore wrong to conclude in relation to those chains that Universal knew at the relevant time that they were connected with fraud.

84. In advancing this ground, Mr Patchett-Joyce relied on Mr Justice Lewison's decision in *Brayfal Limited* [2011] UKUT 99 (TCC). *Brayfal* concerned contra-trading and it was common ground that the time at which a trader either had to have known or should have known that his transaction was connected with fraud was the time of his transaction, at which point the right of deduction would arise absent actual or constructive knowledge.

85. At §16, Lewison J noted that the clean chain in *Brayfal* was created before the dirty chain, which raised the question that the Chancellor had posed in *Blue Sphere Global Ltd v HMRC* [2009] STC 2239: "*how can a trader who is not part of a conspiracy know of a fraud before it happens?*". At §17, Lewison J observed that because the dirty chain was created after the clean chain "*actual knowledge and conspiracy are likely to be interchangeable concepts.*" Finally, at §19 he noted that because there is no fraud in a clean chain in isolation, for a trader in a clean chain to know or have the means of knowledge that his transaction is connected with fraud, the trader must either know or

have the means of knowledge that the contra-trader is a fraudster, or he must know or have the means of knowledge of the fraud in the dirty chain.

86. As regards the order of the chains of transactions Mr Patchett-Joyce noted that the Waterfire deals (on which see below) in its dirty chains clearly followed the deals in Universal's clean chains. Similarly, there was a pattern to the A-Z deals in which there was a series of clean chains followed by a dirty chain and then further clean chains followed by a dirty chain.

87. Mr Patchett-Joyce submitted that unless a trader is part of a conspiracy, no trader can possibly have the requisite knowledge to deny his entitlement to input tax in a transaction that is part of a clean chain. In Universal's case HMRC had never pleaded or suggested as part of their case to the FTT, that Universal was a party to a conspiracy or a fraudster. He referred to §16 of Mr Justice Floyd's decision in the Upper Tribunal in *Mobilx* and §§28 and 29 of Judge Bishopp's decision in *POWA [Jersey] Ltd* for the proposition that HMRC were bound to plead conspiracy and to put that allegation to Universal's witnesses in cross-examination.

88. Ground 3 was said to be particularly relevant to five transactions in which HMRC had identified the contra-trader as being a company called "Waterfire". Universal had never obtained any relevant supplies from Waterfire so that these five deals represented 'remote' contra-trading. If they were to succeed in refusing Universal the right of deduction, HMRC had to establish:

> "*to the requisite legal standard, the objective evidence which allows the conclusion to be drawn that the taxable person knew, or ought to have known, that the transaction relied on as a basis for the right [of deduction], was connected with fraud committed by the supplier or by another trader acting earlier in the chain of supply*" (*Mahagében*, §49).

89. In that respect HMRC had been unable to demonstrate any objective factor attaching to the immediate supply to Universal in these five deals that could establish actual or constructive knowledge of fraud where the fraud was committed by a trader in an entirely different chain of transactions remote from Universal and about whom Universal claimed to be oblivious. Universal's immediate supplier in those five deals would have accounted for the output VAT that it received.

90. That in turn posed the question of what was the relevant objective factor that HMRC had identified in the other clean transaction chains in which Universal's immediate supplier was the contra-trader? In relation to these it was impossible to discern any objective factor identifiable at the time at which Universal entered into the transaction with its immediate supplier that would enable Universal to differentiate between the case in which its supplier was acting as a contra-trader and those in which there was a more remote contra-

trader – Waterfire. In either case, therefore, there was no basis for denying Universal the right to deduction of input tax. Indeed, the only way in which they could do so was to plead and prove a case in conspiracy; in other words, that Universal was a party to a common agreement or accord to commit fraudulent evasion of VAT.

91. Universal's fourth ground of appeal raised a similar point in asserting that the FTT failed to have proper regard to HMRC's failure to plead any case in fraud against Universal or, indeed, in saying that that the contra-traders were acting fraudulently. At the same time Universal also complained that the FTT had reached decisions on a number of other matters relied upon in its decision that had never been pleaded, such as the circularity of payments, amounts lent to Universal and the uniformity of Universal's "mark-up" on the deals. According to Universal's grounds of appeal, "*the issues dotted around witness statements are not for the Tribunal to consider; it is what is in the pleaded case.*"

HMRC's submissions on Grounds 3 and 4

92. In response Mr Puzey accepted that HMRC had not pleaded or alleged that Universal was a party to fraud or conspiracy: they did not need to. HMRC's pleaded case was that Universal knew or should have known of a connection between its transactions and fraud. That was the test laid down by *Kittel* and the FTT had concluded from the circumstances of the case that Mr Sodha (as Universal's directing mind) must have known of that connection. The Court of Appeal's judgment in *Mobilx* made it clear that there was no difficulty in applying such a test:

> "*49. It can be no objection to that approach to Community law (the Kittel Test) that in purely domestic circumstances a trader might not be regarded as an accessory to fraud.*"

93. The Court of Appeal had also not shared Universal's view that a trader had to be a party to the fraud or a co-conspirator if he was to know of or to have the means of knowledge of a fraud in a contra-trading situation or where the fraudster was several points removed from the deducting trader. Lord Justice Moses had pointed out at §62 of *Mobilx* that the trader with knowledge of a connection with fraud or the means of knowledge "*is a participant whatever the stage at which the evasion occurs*". Mr Justice Briggs had also made it clear in *Megtian Ltd v HMRC [2010] STC 840* at §§35-39 that it was unnecessary to prove that a trader knew the detail of the fraud or the identity of the participants, so long as he was aware, or should have been aware, that his transactions were connected with that fraud. Mr Justice Hildyard had agreed with this in *Edgeskill Ltd v HMRC* [2014] UKUT 38 (TCC) at §126(5).

94. Mr Puzey said that Universal's attempt to show that *Mahagében* required that it had purchased direct from the fraudulent trader was contrived. Both *Mobilx*

and *POWA (Jersey)* had explained why *Kittel* (upon which *Mahagében* was based) did not require privity of contract as between the fraudster and the party seeking repayment of tax (see *POWA* per Roth J at §§26-40). *Mobilx* had answered the question, "*how can a trader who is not part of a conspiracy know of a fraud before it happens?*", directly at §62, where Lord Justice Moses noted that: "*If the circumstances of that purchase are such that a person knows or should have known that his purchase is or will be connected with fraudulent evasion it cannot matter a jot that that evasion precedes or follows that purchase.*" There is no necessary implication in this that the trader must be a party to a conspiracy.

95. In any event, Mr Puzey noted that the FTT had concluded that Universal had actual knowledge of the fraud committed by others (FTT §107). At FTT§§109-112, the FTT had provided its assessment of how Universal's business had been run. It had examined the operation of the business in all material respects and had concluded that it did not believe Mr Sodha's evidence. There was no room for doubt that Mr Sodha actually knew that his company's transactions were connected to the fraud of others and there was no requirement to prove that he knew the identity of a particular contra-trader nor the precise method by which the fraud was being undertaken. This was the case for all the contra-trading deals, including those in which in which there was a "buffer" between Universal and the contra-trader ("remote contra-trading").

96. Finally, Mr Puzey said that HMRC's pleading was not deficient. The allegation that Universal knew or should have known that its transactions were connected with fraud was set out in §1 of the Amended Statement of Case. This did not involve a conclusion that Universal itself was fraudulent. The Amended Statement of Case also set out at §21 that A-Z and Waterfire were contra-traders and the schedule explained contra-trading and that it was part of an overall scheme to defraud. It was not a necessary part of cross-examination that it should be put directly to Universal's witnesses that they knew or should have known of a connection to fraud given that it was plainly pleaded. Mr Puzey drew our attention to various aspects of the cross-examination that formed the basis of the FTT's summary at §§43 to 86 and its conclusions. Universal's witnesses had had every opportunity to answer the case that was being put.

97. Mr Puzey also pointed out that Rule 25(2)(b) of The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 stated that HMRC's statement of case must "set out the Respondents' position in relation to the case". HMRC had complied with that requirement. It was not necessary to plead evidence as part of HMRC's case. Nevertheless, Universal's banking arrangements, loans and mark-ups were all referred to in the Amended Statement of Case (see §§27.6, 7.8 and 7.2 respectively) and the suggestion that no issue regarding mark-ups had been put to Mr Sohda was incorrect (as FTT §69 demonstrated).

Discussion of Grounds 3 and 4

98. As Mr Puzey noted, HMRC's Amended Statement of Case states in paragraph 1 that their decision denying entitlement to the right to deduct input tax was made because Universal's transactions were connected with the fraudulent evasion of VAT and Universal knew or should have known of that fact. The Amended Statement of Case goes on to particularise the 58 deals in the period 04/06 which had been traced directly to defaulting traders and the 25 deals in periods 04/06, 05/06 and 06/06 that had been traced to defaulting traders via named contra-traders.

99. Furthermore, in its Notice of Issues the Appellant Contests, Universal accepted that HMRC had sufficiently evidenced that fraudulent tax losses existed in all Universal's supply chains, except its contra-trading chains, and that fraudulent tax losses existed at the start of all the "dirty" supply chains relating to each of the contra-traders. The only issues in dispute were whether:

    a. the contra-traders were fraudulent or knew or should have known of the fraud in their supply chains;

    b. Universal's transactions were connected to fraud in the relevant sense; and

    c. Universal knew, should or could have known of the fraud in its supply chains.

100. In our view HMRC pleaded the matter appropriately, and it is apparent that Universal fully understood the case that it had to meet, recognising that the burden of proof lay with HMRC. In particular, what was pleaded required HMRC to satisfy the Kittel test. It may be that evidence to suggest that Universal was itself a participant in the fraud or that it was engaged in a conspiracy would ensure that the *Kittel* test was met. The *Kittel* principle is, however, a principle of the EU VAT system and we do not consider that it requires HMRC to plead either fraud or conspiracy as part of their case. Assuming that HMRC is able to produce evidence sufficient to support its case on the application of the *Kittel* test to the civil standard, Universal would need to respond essentially by showing that there was in the circumstances a reasonable basis for its transactions so that it would be impossible or unsafe to conclude that the *Kittel* test was satisfied. Plainly, HMRC having satisfied the FTT that the contra-traders were fraudulent and that Universal's transactions were connected with fraud, Universal failed to displace the further conclusion that it had actual knowledge of the fraud.

101. In this respect we have already noted in dealing with Grounds 2, 5 and 6 that Universal's transactions with A-Z were connected with fraud where the transaction chains were themselves "dirty" chains, or in respect of the "clean"

chains where A-Z itself was the fraudulent contra-trader. Is Universal in a different position where the contra-trader was Waterfire and therefore more remote from Universal? The FTT found that the transactions between Universal and A-Z were still connected with fraud even though they involved Waterfire as the contra-trader. Its finding that Universal knew of that depends upon the circumstantial evidence surrounding its dealings with A-Z. There appears to be nothing in the FTT's findings on the evidence to suggest that Universal could otherwise have known that Waterfire was a fraudulent contra-trader or that the particular transactions with A-Z depended for their connection to fraud on Waterfire rather than on A-Z. In essence, the FTT concluded that the manner in which Universal chose to conduct its business with A-Z was such that it knew that those transactions were connected with fraud.

102. Universal's situation might be said to mirror that of Mobilx, which had continued to trade with a small circle of suppliers and had not changed its trading methods notwithstanding that it had been told that the majority of its transactions had been traced to defaulters. As the Tribunal in *Mobilx* put it,

> "*...there must come a time when a trader, told repeatedly that every one of his purchases followed a tainted chain is compelled to recognise that without a significant change in his trading methods every one of his future purchases is more likely than not also to follow a tainted chain – in other words he cannot possibly be satisfied, on the balance of probabilities, that each transaction he enters into will not be connected with fraud.*" (see *Mobilx* §14)

103. In the present case, Universal chose to trade with a fraudulent trader, A-Z, on a basis that led the FTT to conclude that it knew that its transactions were connected with fraud. The fact that the particular connection with fraud in the case of some transactions is established because certain transactions were associated with Waterfire's fraud rather than with A-Z's fraud plainly did not suggest to the FTT any difference in Universal's state of knowledge of the fraud with which its transactions were associated, and we are satisfied that this is a conclusion that the FTT was entitled to reach having regard to the view that it took of Universal's evidence.

104. Finally, as we noted in paragraph 14 above, since we heard Universal's appeal the Court of Appeal has given its decision in *Fonecomp Ltd* [2015] EWCA Civ 39, and dismissed Fonecomp's appeal without any reference to the CJEU. That decision is a further nail in Universal's coffin given its explicit consideration of the arguments based on the CJEU case law (in particular in Fonecomp's case the decision in Case C-285/11 *Bonik EOOD*, rather than as in Universal's, the decision in *Mahagében*) against the 'extension' of the *Kittel* principle to contra-trading. We do not think it necessary to refer in any detail to Lady Justice Arden's judgment in *Fonecomp* (with which McFarlane and Burnett LJJ agreed) but, in respect of Grounds 3 and 4 and the issues of the

Waterfire contra-trades, we note her reaffirmation at §§48 and 49 of what Mr Justice Briggs had said in *Megtian*:

> "Lack of knowledge of the specific mechanics of a VAT fraud affords no basis for any argument that the decision of [the tribunal] was wrong in law: what is required is simply participation with knowledge in a transaction 'connected with fraudulent evasion of VAT'".

In this case the FTT concluded that Universal had actual knowledge that all its transactions were connected with fraud. In our judgment that is the beginning and end of the matter, and we see no basis for overturning that conclusion as erroneous in law given the FTT's view of the evidence.

Conclusion

105. Universal's appeal is accordingly dismissed.

Mr Justice Henderson

Judge Malcolm Gammie

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