[2011] UKFTT 637 (TC)

TC01479

Appeal number: EDN/08/91

VAT – repayment of input tax – MTIC fraud and contra trading – knowledge (actual and/or imputed) of Appellant – Appeal dismissed.

FIRST-TIER TRIBUNAL

TAX

A R COMMUNICATIONS & ELECTRONICS LTD **Appellant**

- and -

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

TRIBUNAL JUDGE: **Kenneth Mure, QC**
(Members): **S A Rae, LLB., WS**
Peter Sheppard, F.C.I.S., F.C.I.B., ATII

Sitting in public at 126 George Street, Edinburgh on 8, 10 and 11, 14-18 June, 4-8 October and 22-26 November 2010, 7-11 February and 3-4, 7-10 and 28-29 March 2011

Eric Robertson, Advocate, instructed by Pravin Jain, Solicitor, and John O'Donnell (BTG Tax) for the Appellant

Peter Gray, QC and Eugene Creally, QC, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

Introduction

1. This is an appeal by AR Communications & Electronics Ltd ("ARC") against the refusal by the Respondents ("HMRC") to make a repayment of input tax of £1,214,801.88, all as set out in their letter to ARC dated 25 April 2008 (A/120). The input tax was paid by ARC in respect of 16 purchases of mobile phones made in June and July 2006.

2. HMRC argue that ARC knew or ought to have known that these transactions were connected with the fraudulent evasion of Value Added Tax and found on the decision of the ECJ in *Kittel, infra*.

3. HMRC agreed to lead under reservation of all questions anent the *onus* of proof. They led 7 witnesses, 6 of whom were their own officers, and Mr John Fletcher CA, an expert witness who is in private practice. (James McGee, one of their officers, was led simply to enable him to be cross-examined on behalf of ARC, and the evidence of a further HMRC officer, Sangita Parmar, was agreed and admitted, as was part of the evidence of a third officer, Lesley Camm).

The Law

4. Section 25 of the Value Added Tax Act 1994 provides:-

> "(2) subject to the provisions of this section, [a taxable person] is entitled at the end of each accounting period to credit for so much of his input tax as is allowable under Section 26, and then to deduct that amount from any output tax as is due from him".

Section 26 (1) provides:-

> "(1) the amount of input tax for which a taxable person is entitled to credit at the end of any period shall be so much of the input tax for the period……. as is allowable by or under regulations as being attributable to [taxable supplies]".

Section 77A makes provision for joint and several liability of traders in supply chains where tax is unpaid.

Counsel referred also to the following authorities in the course of their submissions:-

(i) *Axel Kittel v Belgium [2006] ECR 1-483; [2008] STC 1537*

(ii) *Mobilx Ltd (in Admin) v HMRC [2010] EWCA Civ 517*

(iii) *Red 12 Trading Ltd v HMRC [2009] EWHC 2563 (Ch)*

(iv) *Euro Stock Shop Ltd v HMRC [2009] UKFTT 182 (TC)*

(v) *Blue Sphere Global Ltd v HMRC [2009] EWHC 1150 (Ch)*

(vi) *Pars Technology Ltd v HMRC [2011] UKFTT 9 (TC)*

(vii) *Calltel Telecom Ltd v HMRC [2009] EWHC 1081 (Ch)*

(viii) *Livewire Telecom Ltd v HMRC [2009] EWHC 15 (Ch)*

(ix) *HMRC v Brayfal Ltd [2011] FTC/53/2010*

(x) *Eyedial Ltd v HMRC [2011] UKFTT 47 (TC)* and

(xi) *Emblaze Mobility Solutions Ltd v HMRC [2010] UKFTT 410(TC)*

(xii) *Optigen Ltd v HMRC (and related cases) [2006] STC 419*

(xiii) *R (Just Fabulous UK Ltd) v HMRC [2007] EWHC 521 (Admin), 2008 STC 2123*

(xiv) *Emsland-Starke GMBH v Hauptzollamt Hamburg Jonas, 2000 ECRI 11,556*

Reference was made also to HMRC's Notice no 726 entitled "Joint and Several Liability for Unpaid VAT".

The Evidence

5. At the outset a brief Statement of Agreed Facts was negotiated. In the course of the hearing three Joint Minutes of Admissions in respect of evidence of certain HMRC officers, in particular Sangita Parmar and Lesley Camm were lodged. All these are produced in Vol K together with Parties' Written Submissions.

6. Roderick Stone gave evidence first for HMRC. He is a senior officer of HMRC with specialist experience in the investigation and combating of Missing Trader Intra Community ("MTIC") fraud and has supervised investigation teams. His experience in this area has been acquired over an extended period. He spoke to his Witness Statement (No 13) which, we noted, is dated 19 November 2008. It represents a consideration of this form of fraud, noting relevant developments over the years, identifying key features of it, and describing various counter-measures.

7. Mr Stone explained that there is a succession of "deals" in an MTIC fraud chain whereby the same subjects are bought and sold by several parties in quick succession, often within one day. Firstly, the goods are imported free of VAT into the UK usually from another EU member state by a UK VAT registered trader. That party sells the goods charging output tax, for which he fails to account to HMRC. He is known as the *defaulter*, or missing trader. The goods are sold on by the defaulter to one of several intermediaries, or *buffers*. Each of them in successive deals will charge output tax on re-sale and deduct the relative input tax on purchase, typically making a token profit and accounting for a small balance of VAT. The party at the end of the chain, the *broker*, will export the goods VAT free ("zero-rated"). He will attempt to recover the input tax which he paid on acquisition. If a VAT fraud is suspected by HMRC, arising from the original failure to account by the importer/defaulter, then it may refuse to make any repayment of input tax to the broker. (That, of course, compensates for the initial default at the start of the chain). A chain with a defaulter is known as a *dirty* chain. The inclusion of several parties or *buffers* between importer and exporter serves to "distance" the party seeking repayment from the defaulter. Mr Stone explained that following certain measures introduced by HMRC in 2005 applications for repayment of input tax were in instances subjected to an

extended verification process. This occasioned a further development in the pattern of MTIC fraud, *viz* c*ontra* trading. *Contra* trading serves to camouflage the broker by introducing an offsetting output tax liability which he sets against his repayment claim. This arises from a new chain in which the broker imports a separate batch of goods. He will re-sell these, charging output tax, thus creating a tax liability to be set against his repayment claim in the first (or *dirty*) chain. The purchaser, or a subsequent purchaser, then exports the goods zero-rated, so generating a repayment claim in his hands as second broker. This second chain is usually short, and serves to further "distance" the party making recovery of input tax from the *defaulter*. There is no default in the second chain, known as the *contra* or *clean* chain. At each stage VAT is duly accounted for. The *contra* or *clean* chain extends the original chain in a sense. However, it is "clean" in the sense that the relative VAT is duly accounted for. Different goods are introduced with the *contra* chain.

8. The circulation or passing of title to the goods is shown on the successive invoices, or *invoice chain*. Its counterpart is the *cash chain* which, as representing payments, runs in the opposite direction. The party financing, usually based abroad, and who probably instigates the transaction chain, introduces a substantial cash consideration which passes from purchaser to seller. That sum will return to the financing party, albeit slightly diminished by small profits extracted by the buffers. There is, of course, introduced into the chain the amount of the VAT repayment, which customarily can be used in funding (the VAT element of) future (and unrelated) chains. Where there has been a default, a VAT repayment would represent a loss to HMRC, and be fraudulent where knowledge can be imputed to the broker in the second *clean* chain, who sells and exports the new goods zero-rated.

9. Mr Stone explained certain features characteristic of MTIC fraud, which again are set out in his Witness Statement. In particular payment for the goods often would not pass down the supply chain to the importer/*defaulter*. Frequently instructions are given for the diversion of the payment to another party, often based abroad, who is, or is associated with, the instigator. Such *third party payments*, diverting monies from the defaulting importer, frustrate the recovery of output tax due to HMRC. He commented also on typically the apparent lack of commercial purpose and absence of any sale to an ultimate consumer.

10. While title to the goods passes between the UK-based parties in the chain(s), the goods themselves generally remain physically on the premises of a *freight forwarder* in the UK until re-export. Customarily the freight forwarder would deal with storage, transport, insurance and even inspection, the costs thereof being met by the broker. IMEI (identity) numbers of the phones can be verified then too.

11. The *pricing structure* of the goods tends to create a profit for each party involved. While the *buffer* will receive a minimal amount (and while not usually adding value to the product), the broker is ensured a moderate profit (typically 4-5%). However, the broker does not seek to maximise his profit by buying from the cheapest source or the supplier abroad (which, of course, would eliminate the defaulter and buffers from the chain). So too the EU-based purchaser from the broker does not buy at cheapest price

from the original EU exporter, who sold the goods in the first instance to the defaulter.

12. The succession of deals in each chain are customarily *back-to-back*, being of the same type and specification and the same quantities, and all arranged within the space of about one or two days. Since credit is not usually available, broker traders have to have sufficient funds to bear VAT liability until repayment.

13. The *banking arrangements* favoured by the participants in the chains were often peculiar in his view. The offshore arrangements of the First Curacao International Bank ("FCIB") became increasingly popular as the major UK banks, fearful of involvement with possible VAT fraud and money-laundering, withdrew their facilities from mobile phone traders. In cross-examination Mr Stone accepted, however, that such offshore banking arrangements were perfectly legitimate for trading purposes.

14. Having explained the various counter-measures taken by HMRC and by the UK Government against MTIC fraud and their effects in shrinking the volume of such trading, Mr Stone finally referred to the *grey market* opportunities. This topic was more fully explained by Mr Fletcher *infra* but essentially there are legitimate business opportunities for trading in mobile phones by parties who are not officially authorised by the manufacturers. Briefly, subsidies linked to various network operators in different territories, paid by the operators or manufacturers, can create price differences. However, modification of these subsidised phones for use in another territory is often necessary. This process of *box breaking* requires technical staff and premises with facilities to carry out the modification work. There can be different manufacturers' price lists for different territories too giving rise to *arbitrage* opportunities. Finally, unexpected variations in demand for particular models of phone can create other grey market opportunities. However, in Mr Stone's view the legitimate grey market was small in relation to the volume of mobile phones sold by independent traders during the relevant period.

15. We found Mr Stone's "overview" of MTIC fraud helpful and comprehensive. He was, of course, speaking to a general pattern rather than a consideration of the facts of the present appeal. We found his evidence credible and reliable.

16. HMRC's next witness was Christopher Grieve, the officer responsible for the verification of ARC's VAT liabilities. He referred to his Witness Statement (No 1). He is a member of an MTIC investigation team based in Glasgow and took over responsibility for reviewing ARC in succession to a colleague, Spencer Vaughan, in January 2007. Where he spoke to matters pre-dating his personal involvement, he referred to HMRC's records.

17. He explained the circumstances in which ARC's Returns for 06/06 and 07/06 became subject to extended verification. He referred to its Application for Registration, VAT 1 (B/I/1) completed in about September 2002 and its contents, including in particular an estimated annual turnover of £60,000. He described the modest business premises of ARC at the material time, and noted that at one stage it had 2 employees. There had been a switch from 3 monthly to monthly Returns from

November 2005. Contrary to ARC's indication in its VAT 1 a repayment of VAT was claimed in each Return since May 2005. Monthly Returns enable speedier repayment of VAT.

18. Mr Grieve spoke to meetings with Mr Satnam Rakhra, as a Director of ARC and VAT notices and other relative information passed to him. He explained the facility offered by HMRC's Redhill Office, confirming on enquiry the VAT registration status of businesses, available to their prospective customers and suppliers. Redhill had issued to ARC a series of letters (about 15) intimating de-registration for VAT purposes of several traders with whom it had dealt or enquired about. While "Redhill" letters do not state the reason for de-registration, some impropriety, possibly involving MTIC fraud, is, perhaps, suggested. In certain cases ARC had traded in substantial amounts. Yet, its pattern of diligence checks on trading contacts had not been changed. This and other factors had suggested to Mr Grieve that ARC's "due diligence" system checks were inadequate.

19. Mr Grieve explained that repayments of VAT had been withheld in respect of 16 transactions for mobile phones concluded in June and July 2006 in which ARC had acted as *broker*, exporting the phones and seeking a repayment of input tax paid on purchase. (These are set out on pages 4-6 of his Witness Statement). They involve 3 suppliers and via a *contra* chain, as Mr Grieve sought to show, are related back to a defaulting or missing trader. He considered that the chains in which the contested transactions fell, were contrived.

20. Mr Grieve spoke to notes of an extended interview with Mr Rakhra held on 13 April 2007 and continued later in respect of certain supplementary questions, about ARC's VAT affairs. (The questions and answers are set out separately in B/83). In the visits to ARC's premises during 2007 he had recovered extensive documentation relating to *inter alia* these 16 transactions (being the disputed transactions noted in para 1 herein) and ARC's trading "relationship" with the immediate suppliers and purchasers of the phones. It was clear to Mr Grieve that due diligence checks of suppliers and customers had not been made *before* trading but after or during the course of trading. This seemed curious given the substantial sums of money and volume of goods involved in each transaction. He considered the checks made in respect of ARC's suppliers in these 16 transactions (*viz* RVM Ltd ("RVM"), Lighthouse Technologies Ltd ("LHT") and Optronix Ltd ("Optronix")) and its customers (La Parisienne du Commerce, EC Trading, and Francphone SARL) each in turn. In many instances the checks revealed doubtful financial and credit status of these parties. A related aspect of due diligence checks was the obtaining of trade or business references. In several instances ARC and its prospective trading partner had proposed the same third party as each other's trade reference, suggesting a background, he suggested, of interdependence rather than independence.

21. Mr Grieve explained the succession of transactions in each of the 16 "chains" of which these transactions formed part. Strictly, ARC became involved in the *contra* chain, the "clean" chain set up to produce a liability on a fresh importation, to be offset by the repayment sought at the conclusion of the associated "dirty" chain. Helpfully he explained this by reference to a sequence of invoices and related

documentation in each case, then to "spreadsheets" which he himself had prepared. In Vol B/108 spreadsheets showing the 25 chains which included ARC's deals concluded in June 2006 are produced. Where ARC acted as *buffer*, the deals are not contested. However, where ARC acted as *broker*, they are contested. These latter, 12 in number are set out on pages 4-15 inclusive of B/108, and are included in the deals noted in the Table annexed to para 10 of Mr Grieve's Witness Statement. They are dated 9-15 June 2006. In Vol B/109 spreadsheets showing the 5 chains including the 4 disputed transactions entered in July 2006 are contained. These are shown at pages 2, 3, 4 and 5 and are included in the Table annexed to para 12 of Mr Grieve's Witness Statement. They are dated 18 and 19 July 2006. He noted also Mr Loureiro's cashflow diagrams. (See para 29 *infra*).

22. Mr Grieve identified certain factors as suggestive of an MTIC fraud. In the chains the series of transactions are invariably "back-to-back" – for the same model and same numbers of phones. They are relatively expensive models. The deals are usually all concluded on the same day. There is a consistent pattern of mark-ups, more to the *broker* than to the *buffers*, and increasing for the last *buffer*. The sequences of the parties in the chains are similar. No value seems to be added at any of these stages. ARC had the same 3 suppliers in all the disputed deals, *viz* RVM, Optronix and LHT. The same freight forwarder was used in many transactions. No retailer, manufacturer, or authorised distributer appeared in any of the chains. Further the level of profit was low in relation to the value of the turnover. There is also the common involvement of the FCIB.

23. Mr Grieve spoke finally to factors suggestive of the Appellant company's and Mr Rakhra's awareness of MTIC fraud at the material time. In addition to the letters of de-registration from the MTIC fraud unit of HMRC the company was warned by letter dated 1 December 2005 (A23) that while repayment for the period to 31 August 2005 was being made, it was subject to the process of extended verification. Turnover in the Year to August 2006 had increased to over £278M as compared with its estimated annual turnover of £60,000 volunteered in 2002 on registration. This increased turnover had been achieved by a small company with modest premises and a staff of only 4.

24. In cross-examination Mr Grieve agreed that the Appellant company and Mr Rakhra had not been advised actually to stop trading in mobile phones. However, according to Mr Grieve, Mr Rakhra had confirmed to him his general awareness of the prevalence of fraud in this trading sector. The "Redhill" letters did not in terms warn of MTIC fraud although they referred to the nature of the goods involved. In instances these letters are dated months' after HMRC's decision to de-register.

25. Mr Grieve accepted that he had not been involved personally with ARC in June and July 2006, the dates of the disputed Returns. His information relating to that period was gleaned from other officers' records. He acknowledged certain discrepancies between his written notes of a meeting with the Appellant company's representatives on 13 April 2007 (B77) and a subsequent typed *aide-memoire* (B83) relating to that and subsequent meetings. At the meetings he learned of Mr Rakhra's experience in the retail telecoms industry with DX Communications and on his own

account. In cross-examination he confirmed that there had been a good record of co-operation by ARC with HMRC's officials.

26. Mr Grieve conceded that his remarks in para 101 of his Witness Statement about Mr Rakhra's being a director of Inter Communications Ltd were incorrect and he withdrew them. (The Joint Minute of Admissions corrects this in any event). He acknowledged (significantly) that there was no direct evidence of a "controlling mind" orchestrating the deal chains. He was pressed that he had not considered or understood the nature of the Appellant company's business as that of "matching" supply and demand. Viewed individually certain aspects of ARC's trading (eg mark-ups, back-to-back deals, absence of writing) might not be reliable indications of MTIC fraud and be consistent with commercial trading, Mr Grieve accepted, but he explained that his conclusions were inferred from their totality.

27. Mr Grieve was questioned closely about the manner in which his Witness Statement had been composed. Apparently certain senior and specialist officers had reviewed it. However, Mr Grieve insisted, the authorship was his.

28. While Mr Grieve's personal involvement post-dated the months in issue, we considered his investigation to be thorough and conscientious. We found him credible and reliable and his conclusions to be well-reasoned.

29. The Respondents' third witness was Juan Jose Loureiro, an official of HMRC and previously of HM Customs & Excise since 1990. He explained that since 2006 he has been a specialist officer involved in countering MTIC fraud. Recently he has had to consider data obtained by HMRC from the Netherlands Government relating to records of the FCIB. He noted that its principal shareholder had been arrested on suspicion of money-laundering, and that its banking licence had been withdrawn. Many traders suspected of MTIC fraud had held accounts with the FCIB.

30. Mr Loureiro's Witness Statement required to be revised somewhat in light of certain discrepancies in the numbering of the Deals, but its fundamental conclusions remained constant and he confirmed its accuracy. A revised form was produced for ease of reference for the Tribunal and we understand that the revisals are not controversial. In addition to his Witness Statement Mr Loureiro prepared a series of productions (Vol F) containing comparisons in respect of each deal examined of the invoice chains prepared by Mr Grieve in relation to the sequences of transactions in which the Appellant company took part with corresponding money flows between the bank accounts in the FCIB held by the various participants. Vol F contains details of 11 of the 16 disputed deals in which the Appellant acted as *broker, viz* June Deals nos 4, 5, 6, 7, 9, 11 and 14 and July Deals nos 27, 28, 29 and 30 and details of 11 other deals which are uncontested in which it acted as a *buffer viz* June Deals nos 2, 3, 16, 17, 18, 19, 21, 22, 24 and 25 and July Deal no 26.

31. Most of the productions in Vol F contain 2 diagrams – one showing an invoice chain, the other a corresponding cash flow prepared by reference to FCIB records which HMRC have recovered. (The source of these is admitted in para 10 of the Joint Statement of Agreed Facts). The illustrations of the invoice chains set out

information contained in the invoices themselves. The cash flow diagrams show payments passing between the participants' FCIB records reflecting the consideration recorded in the invoices. The invoices in each chain bear the same day's date in many cases. Otherwise they are all concluded within a few days. Similarly each of the cash flows is completed within a few days. The cash flows are dated only days after the invoice chains, and bear to be for the same amounts or almost the same amounts recorded in the invoices.

32. In respect of certain deal chains it proved impossible to produce cash flow diagrams and in others they are incomplete. What they showed, where complete, Mr Loureiro argued, was a circulation of funds back to an originating financial source based outwith the UK and that in the reverse direction to the invoices and the passing of title to the phones. (The Tribunal notes in the cases of Deals nos 3 and 16 there is a substantial divergence between the amount of cash passing and the consideration recorded on the invoices. In these instances any connection between invoices and cash flow seems at best tenuous. However, recovery of input tax in these deals is not disputed).

33. Mr Loureiro acknowledged that in 5 of the 16 contested deals, *viz* June Deals nos 8, 10, 12, 13 and 15, he had not produced any cash flowchart evidence from FCIB records, while in certain uncontested cases he had prepared such flowcharts. He referred to the Deals Spreadsheet, produced with agreement as a late production. (K/5). He noted particularly Marxman International ("Marxman"), which is based in Dubai, as a party suspected of initiating the circular cash flow. He commented particularly also on 3 other parties which appeared regularly in the flow charts, *viz* MAKS Information Technology ("MAKS"), Kima Estates and Mobile Direct. (Kima is based in the Czech Republic and MAKS and Mobile Direct are both based in Pakistan). These businesses did not appear on the invoice chains and in instances appeared to be no more than a conduit for the circulation of the cash funds. Their presence in the cash chain seemed to serve no purpose and was inconsistent with a dynamic market. As the cash consideration seemed to pass from company to company, it diminished in amount after the payment by Marxman. While there was no documentary evidence clarifying Marxman's possible role, Mr Loureiro believed that a circular cash flow had been shown, which all suggested the involvement of a "controlling mind". (The transaction sheet records recovered for Marxman had been produced after an adjournment of the Hearing. However, that information had been derived earlier from the records of its immediate transacting parties).

34. In cross-examination Mr Loureiro explained that he first became involved in this investigation in about October 2008 when he was instructed to access FCIB records. He was given information about the invoice chains and directed to trace any evidence of a corresponding money flow. He was aware that the FCIB was favoured by MTIC traders. He accepted that he was able to access information not available to traders like the Appellant company. From this he was able to compile the analyses on 22 of the Deals as contained in Vol F. While the information gleaned from FCIB records would not link payments to particular goods or invoices, he had discovered money flows involving the same traders. These in many instances were of amounts corresponding to invoice totals and near in date too. He considered this more than

mere coincidence. Moreover, the cash flows included certain other parties not issuing or receiving invoices. The same names tended to re-appear in that context.

35. Aspects of Mr Loureiro's response were confirmed in re-examination. He agreed with Mr Stone's view that the circularity of the cash flow was by design. The transactions appeared to be structured and organised rather than resulting from a dynamic market place. The regular appearance of Marxman, MAKS, Kima Estates and Mobile Direct called for an explanation. Their recurring presence was inconsistent with a dynamic market. While Mr Loureiro had tried to complete a "circle" in tracing movements of cash, that proved impossible in certain instances. He explained that in each case he tried to add "links" at each end of the chain of known transactions on a progressive basis. Such inferences as he drew from the sums of money traced and the sums recorded on the invoices were a matter of judgement, he accepted. To enable the fraud to work a "clean" chain had to follow on a "dirty" chain in which there had been a loss of revenue to HMRC.

36. We accepted substantially Mr Loureiro's evidence but we would observe particularly in relation to Deals 3 and 16 that we considered his conclusion as to circularity of cash movements somewhat strained.

37. The evidence from Messrs Grieve and Loureiro related to the "clean" chains which had not been the subject of a loss of revenue. However, in a *contra* MTIC scenario the "clean" chains are used to disguise or offset a repayment claim in respect of the "dirty" chains which must be traced back to a fraudulently defaulting or missing trader. The "clean" chains in which the Appellant company became *broker* seeking a repayment of input VAT, were used, according to HMRC, to camouflage the true size of the repayment in certain "dirty" chains in which three other concerns were *brokers*. These three also acted as *acquirers*, initiating the "clean" chains by importing further batches of mobile phones from the EU. They are LHT, RVM, and Optronix.

38. In respect of the first of these concerns, LHT, the Tribunal heard evidence from Richard Taylor, an officer of HMRC, with experience of investigating MTIC *contra* schemes. (Witness Statement no 2). He had been asked by Christopher Grieve in the course of his investigation into the Appellant company to provide information about LHT and the possible relevance of its activities to trading by ARC. Mr Taylor explained that he was responsible for the MTIC verification process for LHT for the three month period ending in June 2006. He had analysed its records and scrutinised its business transactions.

39. Mr Taylor explained that he considered that LHT had acted as a *contra* trader, being the *broker* in "dirty" chains, and also an *acquirer* in "clean" chains, who imported other goods (again mobile phones) and used the output tax charged to its customers to offset and conceal the amount of the repayment claim made in respect of the "dirty" chains. He explained his reasoning helpfully by reference to two diagrams, produced as Vol C, Part 2 Folder 1 tabs 15 and 16. In tab 16 LHT was broker in 31 chains in June 2006. Each of these chains started with a missing trader, whose default was deliberate and fraudulent, he explained. These missing traders

were only three in number, *viz* 3D Animations Ltd, Restar UK Ltd and West I Facilities Management Ltd, and he had confirmed fraudulent default on the part of each of these concerns with the tax officers responsible. He had considered the transactions in detail. In nature they appeared to be inconsistent with a pattern of legitimate commercial trading and bore to be contrived. The deals were "back-to-back", not for a commercial return, and completed within a very short period. The goods were resold to only 3 EU customers.

40. In tab 15 the "acquisition" deals entered into by LHT are shown. Of the 26 such deals entered into in June 2006 ARC was the *broker* in 5. The output tax charged on the resale of the items purchased is thus set against the total repayments claimed by LHT on the "dirty" *broker* deals. Mr Taylor argued that this ploy represented a deliberate attempt to conceal the true nature and value of the repayment sought in respect of the "dirty" chains. *Ex facie* it was thus reduced from about £4M to about £1M. At that reduced level the prospect of an extended verification process being conducted by HMRC was reduced. Viewed in conjunction with tabs 15 and 16 this ploy illustrated a deliberate fraud on public funds according to Mr Taylor. He noted also that the same parties regularly appeared in the chains and that LHT had sold to only 6 *broker* companies, one being ARC, the Appellant.

41. Mr Taylor had considered the sufficiency of the due diligence and verification processes undertaken by LHT in relation to its suppliers and customers. These, he argued, were unsatisfactory. Frequently, these checks or their completion post-dated the start of trading with the particular concern. Trade references were often not pursued and verified. Credit ratings, where obtained, were unsatisfactory. On examination the invoices showed the same profit margins and mark-ups varying only on whether the trader was a *broker* or a *buffer*, the former receiving more. On the other hand profit-margins and mark-ups did not seem to vary according to the type, value and volume of the sales of phones negotiated. All this strengthened the impression that LHT was not dealing in a normal commercial environment.

42. The circumstances of a loan of £875,000 by Sotodelia Investments SL, a Spanish company, to LHT was considered. (Sotodelia was subsequently de-registered in Spain as a missing trader associated with MTIC fraud in September 2006). This sum was banked with the FCIB as "an advance for stock". Yet Sotodelia does not appear as a customer or supplier of LHT in the various deal chains examined. However, it is associated with IH Technologies Ltd, which does feature in deal chains involving ARC. In cross-examination Mr Taylor acknowledged that his description of *contra* trading corresponded with the narrative of other tax officers. (This appears to have been taken from an internal guidance manual). He indicated that he had examined all the deal chains of LHT in which ARC was involved. He had noted the increase in LHT's level of trading in early 2006 but accepted that the repayment for the period 03/06 had been made after investigation. It appears that LHT had appealed belatedly against the refusal of the repayment for the period 06/06. (The Tribunal notes that leave to appeal late was refused: reported at [2010] UK FTT 374(TC)). In view of that, Mr Taylor accepted, the merits of that dispute had not been addressed judicially. Mr Taylor accepted too that consideration of the Appellant's (LHT's) disputed Return would indicate the full amount of the repayment sought. In re-examination Mr Taylor

clarified a further matter that had been raised in cross-examination. He confirmed that the total value of repayment claims of all LHT's customers, including ARC, would not exceed £3,101,345.63, and that was less than the tax lost on the broker deals concluded by LHT which amounted to £3,132,882.19. In other words viewing the repayment claims of LHT's customers individually or collectively, these would not exceed the tax lost to HMRC on the "dirty" chains in which LHT had been the *broker*.

43. Finally Mr Taylor confirmed that his inferences had been drawn not from individual factual aspects but from their totality.

44. We found Mr Taylor's account credible and reliable and his reasoning and conclusions seemed sound.

45. The fifth witness for HMRC was Mrs Lesley Camm, a higher officer specialising in MTIC fraud. (She completed three Witness Statements, nos 3, 15 and 15A). Initially she was involved in investigating the activities of only Optronix, one of the *contra* traders, which initiated "clean" chains as "acquirer", in which ARC was ultimately the *broker*, seeking repayment of input VAT on export of the goods. Subsequently she took on the further responsibility of analysing data recovered from FCIB computer records, relating to transactions concluded not only by Optronix, but also by RVM and LHT so far as relevant to *broker* deals concluded by ARC in June and July 2006. For the purpose of this exercise she had access to Officer Loureiro's records and some further computer information recovered by another colleague. Mrs Camm read firstly her Witness Statement dated 28 May 2010 as amended in October 2010. She spoke to analyses prepared by her in respect of certain of Optronix's transactions as *broker* in June and July 2006, the two months in question for the disputed repayments sought by ARC. (These are produced in Vol G/1/1-17). Essentially these individually contain a spreadsheet recording the series of transactions affecting the goods, then a flowchart showing the invoice sequence and the movement of the cash consideration. (The traders had, of course, FCIB accounts). Significantly in Mrs Camm's view, the invoice dates coincide or are immediately consecutive. So too are the dates of the payments. Moreover, she concluded that there was a *circularity* of payment. She explained that in the circulation of cash in respect of the deal chains the role of one trader, Marxman, was pivotal. The pattern was of its receiving ultimately the exact sum which it had paid out. In response to the Tribunal's questioning Mrs Camm accepted that the immediately preceding participant, frequently MAKS, seemed to derive the profit in the circulation of cash, but she explained that other payments could be traced which tended to pass the profit element also to Marxman. (In the event it would seem that it is the circulation of cash which was significant rather than the identity of the party deriving the gain). Both Marxman's and MAKS's directors live near each other in Islamabad, according to Mrs Camm's information (see para 22 of her third Witness Statement dated 17 December 2010).

46. In a further series of sample chains Mrs Camm examined sequences of deals in which LHT was broker in June 2006. Similar documentation, particularly spreadsheets of invoices and flowcharts of money paid, are produced (G/1/27-30 and

G/2/31-34). Her conclusion again was that there had been a circularity of payments, with Marxman being in the pivotal position.

47. Finally, Mrs Camm considered 10 broker deals concluded by RVM in June and July 2006 (G/2/37-46). These also, she argued, showed the same circularity of payment, with again Marxman in the pivotal position.

48. Mrs Camm spoke to information recovered from other computer records relating to various parties which featured repetitively in the transaction "chains" spoken to. Her overall conclusion was that there was an "extreme similarity" shared by the supply chains of Optronix, LHT, and RVM.

49. At the conclusion of this Witness Statement (no 3 para 73A) Mrs Camm refers to Officer Loureiro's diagrams showing money movements in 9 of ARC's broker deals. These, she argued, bore similarities to RVM's and LHT's chains, with Marxman being pivotal and including MAKS too. There was a circularity of payment indicative of orchestration. Holding FCIB accounts was a common factor, raising her suspicion. The chains were contrived, with the purpose of defrauding HMRC, she believed.

50. As noted *supra* Mrs Camm's initial involvement had been to investigate the pattern of trading and VAT Returns of Optronix. That was the subject of her initial Witness Statement dated 8 December 2008 and its contents so far as admitted and agreed are reflected in the terms of a Joint Minute of Admissions (K-2). Optronix's Return for 08/06 which sought a repayment of VAT was subjected to the process of extended verification. The first Witness Statement records that in the critical period 08/06 the VAT recoverable on Optronix's exports was approximately equal to that charged on re-selling its imports. In particular all the 103 chains in which it acted as broker in June and July commenced with a tax loss by a defaulting trader. These losses totalled slightly in excess of £10m. (We refer to paras 30-36 of the Joint Minute). The manner of Optronix's trading was indicative of a scheme to defraud HMRC. She inferred that there was a "link" between the *dirty* and *clean* chains (para 63). All goods exported by Optronix during this period (the *dirty* chains) were the subject of a tax default. All goods imported by Optronix (the *clean* chains) were subsequently exported (paras 47-48).

51. This Joint Minute of Admissions notes also Optronix's officers' awareness of the prevalence of MTIC fraud prior to the material period, a sudden increase in turnover (paras 5-10), a lack of adequate "due diligence" and credit checks on suppliers and customers, and the pattern of the transactions in the chains, being "back to back" and often conducted on the same day, invariably profitable, with a similarity in mark-ups, often the same order of participants, and the absence of any manufacturing source or authorised distributor at the start and the absence of any consumer or small retailer at the end of the "chain" (paras 52-58). This was not consistent with commercial trading in her view. Rather Optronix had acted as a *contra* trader to disguise repayment claims made by it in respect of "dirty" chains in which it had acted as *broker*. By disguising a repayment claim in this way, the likelihood of the particular taxpayer's Returns being subjected to extended verification by HMRC was reduced. She

identified ARC as variously a *buffer* and a *broker* in several chains involving Optronix in the relevant months (see paras 26-29).

52. Recently Mrs Camm prepared a third Witness Statement dated 17 December 2010 setting out further conclusions from the FCIB records recovered. She noted that Optronix's account was always in credit as a result of its manner of trading. Acquisition or *contra* deals were concluded before *broker* (tax loss/default) purchases, with the result that additional finance to fund payment of VAT was not required. Also she detected what seemed to be a circularity of funds in other transactions entered by Optronix in June 2006 with Marxman again featuring in a pivotal position.

53. In cross-examination Mrs Camm conceded that in her cashflow diagrams the Electronic Banking ("EB") numbers are not in sequence although they would have been issued sequentially. She suggested that they might possibly have been issued in advance for a later payment. She accepted too that it was not sinister for a trader to maintain a cashflow in credit, although in the case of Optronix no loans or cash injections were required, of course. She acknowledged that the Datastore information referred to by her was available only to HMRC, not the wider public.

54. While Mrs Camm's conclusion narrated in para 63 of the Joint Minute of Admissions in respect of her evidence is not the subject of admission, it is by consent open to the Tribunal to concur with that. We do so, and that on the basis that all the evidence available supports that conclusion. Having heard her oral evidence we found Mrs Camm credible and reliable.

55. While she did not give evidence orally it seems appropriate at this stage to note the evidence of Sangita Parmar, which is the subject of admission in another Joint Minute of Admissions (K3). She also is an HMRC officer in the MTIC fraud team and since April 2007 has been allocated as a special responsibility the VAT liability of RVM, including in particular for the period 08/06, which covers the relevant months of June and July. In particular para 31 traces the background to RVM's *broker* deals in which the goods were sold, zero-rated, to EU customers. These all bear to be in supply chains tainted by deliberate default in payment of VAT. (Certain of these chains pass via Optronix transactions, some being "dirty" chains, others being tainted by *contra* trading. We refer especially to paras 31-38 of the Joint Minute).

56. Mrs Parmar considered also the pattern of trading of RVM. This was consistent in her view with an overall scheme to defraud HMRC of VAT due. The company had knowledge of the nature and characteristics of MTIC fraud prior to June 2006. Trading was wholesale and "back to back". Its "due diligence" and verification procedures appear to have been unsatisfactory. Transactions in the deal chains took place on the same day or closely consecutive days. No losses were ever sustained. No stock was held. There were no returns of stock. Often there was the same sequence of traders in the chains, with similar mark-ups. Commonly the traders had FCIB accounts. (Paras 41-52). There was a lack of normal contractual documentation. She noted ARC's involvement as *broker* in a number of RVM's deal chains (para 26).

57. RVM did not appeal against the refusal by HMRC to repay its input tax claim for 08/06 and the company was dissolved in December 2008. (Para 54). It may be noted that the total input tax paid by it was almost equal to its admitted output tax liability.

58. While Mrs Parmar's conclusion narrated in para 53 of "her" Joint Minute of Admissions *viz* that RVM was involved in MTIC fraud and was or should have been aware of that, and that it acted as a *contra* trader, is not the subject of admission, it is by consent open to the Tribunal to concur with that. Again we do so, and that on the basis that all the available evidence supports such a conclusion.

59. HMRC's penultimate witness was James McGee, a retired officer at their Ayr MTIC office. His evidence (essentially uncontroversial and comparatively brief) was taken in cross-examination. Mr McGee had accompanied a senior colleague, Spencer Vaughan, to visit ARC. He had met Mr Rakhra there and had collected paperwork relating to the Appellant company's VAT Returns. His last visit was in May 2006 when Mr Rakhra was not present. Having read his Witness Statement, his evidence was not disputed in re-examination for HMRC.

60. The final witness for HMRC was John Fletcher, CA, MBA, presently a director in the London offices of KPMG. He gave expert evidence about the telecommunications industry, its development and marketing, in which he has extensive experience. In the course of his career he has considered especially the European, Middle East and Asian markets. The volume of these markets increased substantially in the 1990s.

61. He confirmed the terms of his two Witness Statements, the first being essentially a consideration of the *grey* market in telecoms, the opportunities it offers and its distinctive features, the second being a response to the Witness Statement of Mr Rakhra the director of ARC.

62. Essentially the *white* market is controlled closely by the manufacturers, who sell to major outlets and chains and otherwise to their authorised distributors. The *grey* market is not unlawful as such but is not controlled by the manufacturers. It exists because of the failures and limitations of the *white* market. The *grey* market is complementary to the *white* market. For instance, as manufacturers will not deal directly with small retail outlets, the *grey* market fulfils this need. According to Mr Rakhra ARC was a wholesaler and direct retailer trading in the *grey* market.

63. Mr Rakhra indicates in his Witness Statement (para 17) that the basis of his trading was *arbitrage*. Mr Fletcher described this concept as exploiting price differences for phones between different territories. It, he considers, is one trading opportunity offered by the *grey* market, the others being "box-breaking", exploiting volume shortages, and "dumping". He explains the characteristics of each of those *grey* market opportunities and identifies factors tending to exclude their presence.

64. Mr Fletcher noted that ARC did not hold stock. That is consistent with *arbitrage*. However, trading in Nokia merchandise was a strong negative indicator. Nokia, he explained, had at the material time a policy of common pricing across all its different

territorial markets. (This policy, it seems, was a consequence of its having a potentially dominant market share). *Arbitrage* opportunities from different price structures could not arise as most of the merchandise dealt in by ARC was Nokia's. Currency *arbitrage* too, in his opinion, was unlikely to have been worthwhile in 2006.

65. Further, it was significant in Mr Fletcher's view that ARC did not deal directly with any manufacturer, authorised distributor or a retailer. It would have been clear to Mr Rakhra that he was one of several "middle men" in a chain. He could increase his share of profit by seeking to eliminate other middle men. (A process described – albeit inelegantly – as "deintermediarising" by Mr Fletcher). There is relatively a free flow of information within the *grey* market, Mr Fletcher explained, such as via the website, IPT.cc, which Mr Rakhra acknowledged he used. Furthermore, it was difficult to discern an "added value" in ARC's dealings. ("Added value" could even take a marketing form, such as providing a variety of phone models within a small batch to a modest retail outlet). All this tended to undermine the transactions as "arm's length" commercial trading.

66. Mr Fletcher considered too the level of turnover of ARC. This seemed exceptionally large for a modest business operation. At its peak its turnover was about half of that of well-known major participators in the market such as Virgin Media. This, Mr Rakhra claimed, had been achieved by ARC's widening its customer base and providing new services. These, Mr Fletcher noted, had not been identified.

67. Other possible forms of *grey* market trading were considered by Mr Fletcher. None of these seemed compatible with ARC's operations. "Box-breaking" (or "unlocking"), common in the UK because of the availability of handset subsidies, was not likely. It involved the re-configuring of phones to suit different service providers. The procedures involved require a large expert staff. Storage and technical facilities were necessary too. ARC did not have these.

68. "Volume shortages" and "dumping" (of excess stock) arise when manufacturers or distributors fail to estimate correctly the level of demand. These both can afford profitable opportunities to *grey* market traders. However, Mr Fletcher did not consider that either was present in this case. He identified negative indicators tending to exclude the exploitation of such opportunities. In any event Mr Rakhra's own evidence did not suggest the pursuit of these trading strategies.

69. Mr Fletcher did not consider the IMEI checks described by Mr Rakhra to be adequate to ensure that the handsets met the required specification and condition. Mr Rakhra claimed that dealing in phones of other than UK specification could be commercially viable. A replacement charger, he said, could render them compatible for sale in other markets. However, Mr Fletcher considered that even the need to replace chargers for particular markets, however modest the cost, would significantly reduce an already small profit margin. He failed too to appreciate why phones should be imported physically into the UK only to be re-exported within days.

70. Mr Fletcher noted also the "UK deals", *viz* the *buffer* deals, which are not contentious for this Appeal. These cannot be *arbitrage* as they arise in the same market, *viz* the UK. This, in his view, did not seem to be rational commercial trading.

71. We considered Mr Fletcher's evidence to be credible and fair-minded. He presented a sound analysis of the w*hite* and g*rey* markets in the telecoms industry, and had taken into account the implications of Mr Rakhra's Witness Statement.

72. Finally, on behalf of the Appellant company, ARC, Mr Robertson called Mr Satnam Rakhra. He is a director of the company and in effect has controlled its business operations throughout. He was ARC' s sole witness. He confirmed the terms of his Witness Statement and elaborated it in evidence.

73. Mr Rakhra outlined his career and business background. He worked at various stages in the family business, Weatherwear Glasgow Ltd, a clothing manufacturer. Also he had traded as a stall-holder selling clothing. Mr Rakhra had added a telecommunications "arm" to Weatherwear, trading as "Easy Talk Communications", before setting up ARC as an independent company in 2002. He had gained experience in that field in the course of his employment with DX Communications Ltd between 1992 and 1998. He had worked for that company in retail sales, eventually having been promoted to branch manager of one of its retail outlets.

74. Although Mr Rakhra had not personally completed the VAT registration document (B/I/1) he had approved the estimate of annual turnover of £60,000 and the indication that European sales of any significant volume were not expected. In cross-examination Mr Rakhra was questioned about the prodigious increase in the level of sales thereafter. Within a year turnover was £14M. (This was never satisfactorily explained). While Mr Rakhra's initial experience in telecommunications was in the retail market, he considered that there was a business opportunity in relation to the wholesale market. There, his business philosophy was "piling them high and selling them cheap". Volume of turnover and dealings in high value phones compensated for the low margin of profit, he explained. It may be noted that while Mr Rakhra aimed to achieve a profit of 6% on export deals, in Table A annexed to his Witness Statement, only 3-5% was achieved. On purchases and re-sales within the UK an even lower profit margin was achieved. Mr Rakhra felt that such deals were commercially justified, however. There was a profit ultimately and the deals maintained his company's profile.

75. In essence, Mr Rakhra explained, ARC's activity was "matching" buyers and sellers of quantities of phones. He did not buy speculatively and he never held unsold stock. He had regular business contacts and also used well-known websites. He described this business activity as "arbitrage". (Mr Fletcher explained this term as descriptive of a more limited, sophisticated activity. This was pursued further in cross-examination – *infra*).

76. There is no doubt – indeed it was not disputed – that Mr Rakhra had a general awareness of the prevalence of MTIC fraud in the telecommunications trade in the period proceeding the relevant months of June and July 2006. In particular he had

received about fifteen "Redhill" letters before then advising of de-registrations for VAT purposes.

77. Also, Mr Rakhra indicated that he had become aware of "joint and several" liability as arising potentially from this type of trading. (WS para 13). He then had thought it necessary to have professional help in relation to the maintenance of VAT records and Returns. He had engaged for this purpose Mr Holmes, of Border VAT Services. However, while he had regular monthly contact with HMRC's officers, he did not receive a copy of Notice no 726 until April 2007, some 10 months after the crucial period of June and July 2006. (This Notice sets out HMRC's policy on joint and several liability of members of a supply chain giving rise to tax losses and warns of the existence of MTIC fraud). Officers Vaughan and McGee had visited ARC in the period preceding. They had never criticised ARC's procedures. (This, Mr Rakhra considered, confirmed the effectiveness of ARC's due diligence procedures – *infra*). This contrasted with the attitude of Officer Grieve, who had not been involved in the company's affairs until after June and July 2006. Mr Grieve, Mr Rakhra considered, had little understanding of ARC's business activities.

78. Mr Rakhra explained his system of "due diligence" which had been applied in relation to his three suppliers in the contested deals, *viz* Optronix, LHT and RVM. He referred to the relative files (SR/9/10 and 11). He confirmed that such procedures had been pursued in relation to the three customers in the contested deals *viz* EC Trading ApS, Francphone SARL, and La Parisienne Du Commerce. (SR/12, 13 & 14). He acknowledged that his due diligence procedures in respect of foreign business contacts were not as thorough. He explained that HMRC had indicated to him that the risk of VAT loss arose in the UK, not abroad. Mr Rakhra spoke also to the paperwork arising in relation to the 16 contested deals.

79. Mr Rakhra was insistent that he had knowledge of only his immediate trading partners. He was satisfied that his suppliers had accounted for output VAT (paid by him on purchases). He was unaware of any scheme to defraud HMRC, he maintained strenuously. No concern with which he had traded had been de-registered before June and July 2006. He had carried out certain IMEI checks. These did not disclose anything untoward about the merchandise or his dealings. He had opened an account with FCIB as his original (UK based) bank account had been closed.

80. Mr Rakhra sought to explain away the "back to back" pattern of dealing. It was common in this trade, and there was a commercial risk in holding stock as prices could fall suddenly and without warning. He accepted that there had been no returned goods from dissatisfied customers. However, these were new stock, carrying a full guarantee. While some phones in which he traded did not suit the UK market, they could be readily and cheaply adapted, he maintained. Further, the UK was very suitable as a commercial and logistical base for the nature of ARC's trading.

81. Mr Rakhra was cross-examined in great detail for over a day. (His evidence in its entirety was not concluded until a fourth day). He acknowledged that his Witness Statement, while fully approved by him, had been based on his advisor's Mr O'Donnell's, draft. Essentially it was a response to Mr Grieve's allegations.

Mr O'Donnell had not acted for Mr Rakhra until about August or September 2006, after the period in which the contentious transactions took place.

82. Mr Rakhra was asked about the physical extent of ARC's premises. He estimated these at about the floor area of the Hearing room – relatively modest – in which both its wholesale and retail business was conducted. Surprisingly Mr Rakhra was not able to indicate the *ratio* of wholesale to retail activity. While he had described his manner of trading as "arbitrage", Mr Rakhra seemed to have only a vague understanding of the concept. In response to cross-examination he explained it simply as dealing in excess stock on the *grey* market. He could not explain satisfactorily how ARC could handle about half of the turnover of Virgin Media, which had over 1500 employees and extensive premises. ARC had in addition to Mr Rakhra only three other employees and that at various times. One was a secretary: another handled retail sales: a third did some sourcing work. Mr Rakhra himself concentrated on the company's wholesale operations with the employee, Sam, who helped to source stock. All necessary finance for the company's operations had been provided by Mr Rakhra alone.

83. Mr Rakhra was invited to explain by Mr Gray why he did not intend to call any witnesses such as the employees mentioned or Mr Holmes of Borders VAT Services (to whom a monthly fee of £1000 had been paid). (Admittedly, Mr McGee, the HMRC officer, had been called by them at his request). Also, he was asked why telephone bills with records of calls, documents of negotiation in deals which had not been concluded, and receipts for the IPT website and for advertisements in mobile trade magazines had not been produced. There was no real attempt to explain all this away.

84. When pressed by Mr Gray about the suggested lack of commerciality in his pattern of trading as being "risk free" and with a low profit margin, Mr Rakhra insisted that the extent of his knowledge was only of his immediate trading partners and that he believed his trading was legitimate and untainted by fraud. He was unaware of the length of the chains, he claimed. He did acknowledge the absence of any ultimate consumer in these. Again, when pressed by Mr Gray, Mr Rakhra could not explain satisfactorily his apparent lack of any detailed enquiry to his advisors about the nature and characteristics of MTIC fraud.

85. The adequacy of ARC's due diligence procedures was then scrutinised. When ARC was dealing with a new customer or supplier Mr Rakhra would check its VAT particulars, its Companies House registration and have a Creditsafe check done. References would be sought and enquiry made of freight forwarders. He also instructed reports from a concern, The Security People, (each costing about £1000) which had tended to confirm the results of his own enquiries. Given their cost, these reports seemed to the Tribunal to be of only limited value. Mr Rakhra indicated that he did not consider that his procedures could be improved. He was again referred to the "Redhill" letters (notification of de-registration). He accepted that for a period, before receiving the relative letters of de-registration, he had traded with several businesses, such as Samova Ventures, Electron (GB) Ltd, Kwik Projects Ltd, and

Dualite Ltd. Nothwithstanding, he still considered his due diligence procedures had been sufficient.

86. Mr Rakhra was then invited to scrutinise the company's due diligence procedures in relation to its three suppliers at the material time, *viz* Optronix, LHT and RVM and its customers, *viz* EC Trading ApS, Francphone SARL and La Parisienne Du Commerce. Mr Rakhra rejected the suggestion by Mr Gray that ARC's procedures were simply "going through the motions". It seemed in several instances that the date of due diligence procedures and their completion post-dated significantly the start of trading. The premises of certain trading partners according to photographs produced to the Tribunal seemed to be quite modest, and of a temporary nature. All this apparently had not concerned Mr Rakhra. He felt that ARC's interests were protected sufficiently by its practice of not releasing goods until receipt of payment.

87. ARC, it appeared, had expected its customers to complete a "trade credit application". This, Mr Gray suggested, was wholly inconsistent with ARC's apparent policy of not allowing credit. Mr Rakhra could not explain this.

88. Mr Rakhra was asked about ARC's trading terms. It seemed that these were wholly incorporated in the purchase order forms and customer declarations noted in the documentation produced for the contentious deals. Of greater concern was the lack of specification in respect of merchandise. Apart from the model of phone, its colour could be important, Mr Gray suggested. After extended questioning Mr Rakhra did acknowledge that trading in pink, as well as black and silver coloured phones was typical in the market in which he operated.

89. Mr Rakhra was asked about the extensive use made by ARC of one particular freight forwarder, AFI Logistics. He responded that ARC used 3 freight forwarders commonly – Paul's and Interken too. The choice of freight forwarder was often dictated by the supplier, if he had stock in particular premises. In conclusion, notwithstanding the factors raised in cross-examination, Mr Rakhra was insistent that his pattern of trading was not inconsistent with legitimate commercial business.

90. We approached the assessment of Mr Rakhra's testimony with considerable care. It was obviously crucial in addressing the implications of *Kittel* and especially so given that there was no supporting evidence – even documentation – on various aspects on which reasonably it might have been available. (We comment further on this *infra*). We make due allowance for Mr Rakhra's lack of understanding of certain technical terms used in his evidence (especially the concept of *arbitrage* referred to in his Witness Statement). However, he could not provide convincing explanations about the increasing scale of his business operations and the nature and pattern of his trading. In considering the level of knowledge and understanding of MTIC fraud which might reasonably be imputed to Mr Rakhra (and ARC) at the crucial period, we did not find his account of a lack of awareness credible or convincing.

91. On the basis of that evidence we make the following Findings-in-Fact:-

(a) The Appellant company, ARC, was incorporated on 30 July 2002 and carried on business initially at 31 Alloway Drive and later and at the material time at 151 Oxford Street, Glasgow. Its premises there consist of a small retail area and a small office. Mr Rakhra is its director and his wife is the company secretary. It has never had more than two other employees at any one time and only three in total since it started trading. It was registered for VAT with effect from 30 July 2002 (Vol B/1). In terms of its registration its annual turnover was estimated at about £60,000 per annum. Repayments of excess input tax were not expected. Its business was described as being in distribution telecommunications.

(b) In each of the years since registration for VAT ARC's turnover substantially exceeded the estimate of £60,000 per annum. In the year to 31 August 2003 its turnover exceeded £14m. In the year to 31 August 2004 it exceeded £30m. In the year to 31 August 2005 it exceeded £69m. In the year to 31 August 2006 it exceeded £278m. And in the year to 31 August 2007 it exceeded £3m.

(c) Having completed Returns for VAT on a three-monthly basis ARC was allowed from November 2005 to make monthly Returns as it had started to export supplies. Each Return since May 2005 was for a repayment as input tax paid exceeded output tax due.

(d) Trading wholesale in mobile phones in bulk quantities is conducted in two markets. The official (or *white*) market is authorised and approved by the manufacturers, and phones are distributed either directly by them or via their authorised distributors. In addition, although not formally approved by the manufacturers, trading is conducted on the *grey* or unofficial market. It is not unlawful. It complements the system of distribution afforded by the *white* market, and facilitates distribution to smaller retailers in particular. ARC traded in the grey market.

(e) The structure of an MTIC fraud involves typically the following stages:

(i) the purchase and importation of the goods into the UK;

(ii) the re-sale of the goods to a UK customer, subject to the imposition of VAT;

(iii) the failure by the party importing (i.e. the *defaulting* or *missing* trader) to account to HMRC for the VAT output tax on re-sale;

(iv) a sequence of sales and purchases of the goods within the UK and subject to VAT regulation by parties known as *buffers*; and

(v) the sale and export of the goods by the final UK purchaser, the *broker*, zero-rated.

These stages, by virtue of the default, are known as the "dirty" chain.

In a *contra* trading scenario there is an additional "clean" chain:-

(vi) the *broker* exporting in (v), who ordinarily would have a repayment claim for input VAT, imports other goods into the UK. He thus becomes also an *acquirer*;

(vii) these other goods are re-sold within the UK incurring liability to output VAT, which crucially is offset against the repayment claim on the "dirty" chain and serves to disguise a suspect repayment; and

(viii) after a brief sequence of sales and purchases in the UK, within the VAT system, the other goods are re-exported, with a (potential) claim for repayment of input tax.

Essentially the *contra* trade, and its "clean" chain, serves to "distance" a repayment claim for VAT at the conclusion of the "clean" chain from the default at the start of the "dirty" chain.

(f) In its Returns for 06/06 and 07/06 ARC sought repayments of respectively £1,015,826.88 and £198,975, which HMRC refused. Reference is made to the terms of their letter dated 25 April 2008 (A/120). The repayments sought related to purchases of mobile phones, and in particular to 16 deal chains in which ARC acted as *broker* noted in Finding no (i) *infra*.

(g) On about 13 April 2007 and subsequent dates Christopher Grieve and Paul Russell, both HMRC officers, visited ARC's premises at 151 Oxford Street, Glasgow, and discussed its VAT liability with its Director, Mr Rakhra. Notes of their questions and Mr Rakhra's replies are noted in B83. In the course of their visits they uplifted extensive documentary records, certain of which are produced in process. Only then did Mr Rakhra receive a copy of Notice 726.

(h) Juan Josè Loureiro, another HMRC officer, accessed bank records of the FCIB in which the participants in the chains of transactions noted *infra* had accounts, from which he prepared records of cash flows as set out in Vol F.

(i) Details of the 16 contested deal chains are set out on spreadsheets lodged by HMRC and prepared by Mr Grieve. (See B/II/108, pages 4 to 15 inclusive for deal nos 4-15 and B/II/109 pages 2, 3, 4 and 5 for deal nos 27-30). Separate files in respect of each deal containing relative documentation including invoices etc are produced. (These are identified in a Reference Table provided by HMRC). Reference is made to paragraphs 7 and 8 of the Statement of Agreed Facts. Flowcharts prepared by Mr Loureiro showing the sequence of invoices in each *chain* and their dates and, also, the flow of money in payment with dates are produced (F/I 18-23, 25, and 27-30). In particular:–

(i) in Deal 4 ARC bought 1500 Nokia N91 phones from Optronix which it re-sold to a Danish customer EC Trading APS. ARC seeks a repayment of VAT of £80,850. The net cost was £462K. ARC made a "mark-up" of 3.89% on re-sale. The dates of invoices are between 7-9 June 2006 and all cash payments in both the related *dirty* and *contra* chains were made on 12 June 2006 via FCIB.

(ii) in Deal 5 ARC bought 2300 Nokia 9500 phones from Optronix which it re-sold to EC Trading APS. ARC seeks a repayment of VAT of £116,725. The net cost was £667K. ARC made a mark-up of 4.13% on re-sale. The dates of the invoices are 9 June 2006 and all payments in the chain were made on 12 June 2006 via FCIB.

(iii) in Deal 6 ARC bought 1000 Nokia N80 phones from Lighthouse Technologies which it re-sold to Francphone SARL. ARC seeks a repayment of VAT of £55,938.75. The net cost was £319,650. ARC made a mark-up of 4.02% on re-sale. The dates of the invoices are 12 June 2006 and all payments in the chain were made on 13 June 2006 via FCIB.

(iv) in Deal 7 ARC bought 2500 Nokia 9300i phones from Lighthouse Technologies which it re-sold to Francphone SARL. ARC seeks a repayment of VAT of £107,034.38. The net cost was £611,625. ARC made a mark-up of 4.02% on re-sale. The dates of the invoices are 12 June 2006 and all payments in the chain were made on 13 June 2006 via FCIB.

(v) in Deal 8 ARC bought 1000 Nokia N70 phones from Lighthouse Technologies which it re-sold to Francphone SARL. ARC seeks a repayment of VATof £31,438.75. The net cost was £179,650. ARC made a mark-up of 4.09% on re-sale. The dates of the invoices are 12 June 2006 and all payments in the related chain were made on 13 June 2006 via FCIB.

(vi) in Deal 9 ARC bought 2100 Nokia 8800 phones from RVM which it re-sold to EC Trading APS. ARC seeks a repayment of VAT of £124,950. The net cost was £714K. ARC made a mark-up of 3.97% on re-sale. The dates of the invoices are 14 June 2006 and all cash payments in the chain were made on 16 June 2006 via FCIB.

(vii) in Deal 10 ARC bought 2300 Sony Ericsson W900i phones from Optronix which it re-sold to EC Trading APS. ARC seeks a repayment of VAT of £119,945. The net cost was £685,400. ARC made a mark-up of 4.026% on re-sale. The dates of the invoices are 14 June 2006 and all payments in the chain were made on 16 June 2006 via FCIB.

(viii) in Deal 11 ARC bought 1800 Nokia 9300i phones from Optronix which it re-sold to EC Trading APS. ARC seeks a repayment of VAT of £55,755. The net cost was £318,600. ARC made a mark-up of 3.95% on re-sale. The dates of the invoices are 14 June 2006 and all payments in the chain were made on 16 June 2006 via FCIB.

(viiii) in Deal 12 ARC bought 2050 Nokia N70 phones from RVM Ltd which it re-sold to EC Trading APS. ARC seeks a repayment of VAT of £65,292.50. The net cost was £373,100. ARC made a mark-up of 4.01% on re-sale. The dates of the invoices are 15 June 2006 and all payments in the chain were made on 16 June 2006 via FCIB.

(x) in Deal 13 ARC bought 3000 Nokia N90 phones from Lighthouse Technologies which it re-sold to EC Trading APS. ARC seeks a repayment of VAT of £140,700. The net cost was £804K. ARC made a mark-up of 3.99% on re-sale. The dates of the invoices are 15 June 2006 and all payments in the chain were made on 16 June 2006 via FCIB.

(xi) in Deal 14 ARC bought 1900 Nokia 6280 phones from RVM Ltd which it re-sold to EC Trading APS. ARC seeks a repayment of VAT of £54,197.50. The net cost was £309,700. ARC made a mark-up of

3.98% on re-sale. The dates of the invoices are 15 June 2006 and all payments in the chain were made on 16 June 2006 via FCIB.

(xii) in Deal 15 ARC bought 2000 Sony Ericsson W810i phones from LHT which it re-sold to EC Trading APS. ARC seeks a repayment of VAT of £63,000. The net cost was £360K. ARC made a mark-up of 4% on re-sale. The dates of the invoices are 15 June 2006 and all payments in the chain were made on 16 June 2006 via FCIB.

(xiii) in Deal 27 ARC bought 1500 Samsung P300 phones from Optronix which is re-sold to La Parisienne du Commerce. ARC seeks a repayment of VAT of £47,512.50. The net cost was £271,500. ARC made a mark-up of 4.97% on re-sale. The dates of the invoices are 18 July 2006 and all payments in the chain were made on 19 July 2006 via FCIB.

(xiv) in Deal 28 ARC bought 1800 Samsung E900 phones from RVM which it re-sold to La Parisienne du Commerce. ARC seeks a repayment of VAT of £55,125. The net cost was £315K. ARC made a mark-up of 5% on re-sale. The dates of the invoices are 18 July 2006 and all payments in the chain were made on 19 July 2006 via FCIB.

(xv) in Deal 29 ARC bought 1500 Nokia N71 phones from RVM which it re-sold to La Parisienne du Commerce. ARC seeks a repayment of VAT of £52,237.50. The net cost was £298,500. ARC made a mark-up of 5% on re-sale. The dates of the invoices are 18 July 2006 and all payments in the chain were made on 20 July 2006 via FCIB.

(xvi) in Deal 30 ARC bought 1400 LG KG800 phones from Optronix which it re-sold to La Parisienne du Commerce. ARC seeks a repayment of VAT of £44,100. The net cost was £252K. ARC made a mark-up of 5% on re-sale. The dates of the invoices are 19 July 2006 and all payments in the chain were made on 20 July 2006 via FCIB.

(j) Of the 30 deals concluded by ARC in June and July 2006 the remaining 14, in which it acted as a *buffer*, are uncontested for the purposes of this Appeal.

(k) The characteristics of the pattern of trading which emerges from the 16 contested Deals are:-

(i) that ARC was purchasing from one seller a substantial quantity of one type of mobile phone and re-selling them all to one purchaser on the same day;

(ii) that ARC was deriving a mark-up of about 4-5% without adding to the value of the phones on its re-exporting them;

(iii) that ARC's purchases of the phones were each a link in a clean/*contra* chain, linked to a "dirty" chain;

(iv) that the linked transactions in each of the related "clean" and "dirty" chains had all been concluded within a few days; and

(v) that the payments for the sequence of sales and purchases of the phones had all been made shortly after, within about one day, and via the individual traders' accounts with the FCIB.

The total of the above repayments sought in respect of the 16 contested deals equals the sum of input tax presently withheld by HMRC.

(l) Further, ARC had only three suppliers in relation to these 16 batches of mobile phones *viz* Optronix, LHT and RVM, all UK companies. Each of these suppliers was a *contra* trader, starting a "clean" chain to disguise or offset a repayment claim on a "dirty" chain on which there had been an earlier default. ARC had three customers on re-sale *viz* La Parisienne du Commerce, EC Trading APS, and Francphone SARL, respectively French, Danish and Luxembourg companies. Each batch of these phones was the subject of a *contra* chain initiated by the supplier. That *contra* chain was an extension to a "dirty" chain in which the supplier was *broker*. There was a failure to account for output tax at the start of each "dirty" chain, which was fraudulent.

(m) In June 2006 LHT was *broker* in 31 "dirty" chains seeking repayment of input VAT on export. Each of these chains started with a missing trader, causing a fraudulent default and loss to HMRC. However, LHT acted also as *acquirer* in 26 "clean" chains in that month. In five of these ARC acted as *broker*. LHT had only one supplier, Northcom Handels, and sold to only six *brokers*, one being ARC. Accordingly LHT had acted as a *contra* trader in June 2006. The amount of tax not accounted for in respect of the "dirty" chains is at least equal to the amount of input tax on LHT's "clean" chains, of part of which ARC seeks recovery. By offsetting the output tax due by it on selling newly imported goods LHT reduced its repayment claim for VAT from about £4m to about £1m, camouflaging the full amount of the fraudulent claim in respect of the "dirty" chains. LHT knew or ought to have known that it was involved with MTIC fraud.

(n) In June and July 2006 (VAT period 08/06) Optronix was *broker* in 103 *dirty* chains, seeking to offset input tax (otherwise potentially recoverable) on export. These related to electronic goods, not mobile phones. In each of these chains there was a defaulting trader at the start, causing a tax loss to HMRC of just over £10M. Optronix acted also as *acquirer* in June in 66 deals, and in July in 36 deals involving mobile phones. In 4 of the deals in June and in 2 in July ARC acted as *broker*. Optronix acted as a *contra* trader in these two months. In VAT period 08/06 Optronix's trading was such that its imports and exports were of almost equal value, with output and input tax almost cancelling out each other. From the nature and pattern of its trading Optronix knew or ought to have known that it was involved in MTIC fraud.

(o) In June and July 2006 (VAT period 08/06) RVM was *acquirer* in 16 deals, purchasing mobile phones from EU traders. In 5 of these ARC acted as *broker* re-exporting the goods to the EU. In all 16 deal chains the *broker* re-sold the goods to an EU customer on the same day as they were purchased. Also, in June and July RVM acted as *broker* in 12 deals, exporting to EU customers goods purchased from UK suppliers. Seven of these deals lead back through the UK supply chain to a deliberate tax loss by a defaulting trader. In the other 5 deals RVM purchased from Optronix. All 103 deals in 08/06 in which Optronix purchased from a UK supplier and re-sold to an EU customer, can be traced back to a deliberate tax loss either directly or indirectly via *contra*

trading. RVM acted as a *contra* trader during these 2 months. In 08/06 its trading was such that its output and input tax almost cancelled out each other. From the nature and pattern of its trading RVM knew or ought to have known that it was involved in MTIC fraud.

(p) The due diligence checks taken by ARC in relation to its suppliers and customers were not adequate or taken timeously having regard to the value of the goods in which they were transacting. In particular they were not undertaken before starting trading. Moreover, ARC apparently disregarded them by continuing to trade even when the financial status, credit-worthiness, and business structures of these parties were commercially suspect.

(q) Parties negotiated and agreed in relation to the Appeal a Statement of Agreed Facts and three Joint Minutes of Admission relating to additional evidence of Lesley Camm, the evidence of Sangita Parmar, and that of other officers of HMRC in relation to defaults in payment of VAT. (These are produced as K/1, 2, 3 and 4).

(r) Failing actual knowledge, Mr Rakhra (and hence ARC) knew or ought to have known that the disputed transactions were connected with the fraudulent evasion of VAT. That was the only reasonable explanation for the increased volume and nature and pattern of trading at the material time and for these transactions in particular. They did not have the characteristics of arms-length commercial trading.

Submissions

92. Counsel provided helpfully Written Submissions which they presented and in turn responded to at the Hearing (K8 and 9). These deal with both the legal and factual issues arising. To a great extent the legal aspects were not controversial and accordingly it may be useful to set out these relevant principles at this stage. Essentially, HMRC has to demonstrate, firstly, a loss of revenue, then that that was deliberate and attributable to fraud, and, thirdly and crucially, that the taxpayer (here ARC) knew or ought to have known of the fraud. This final element of actual or imputed knowledge is critical to the outcome of the present appeal. It was prescribed by the ECJ in *Kittel* and, recently, interpreted by the Court of Appeal in *Mobilx* (and certain conjoined cases). Moses LJ in *Mobilx* (para 59) opined that, short of actual knowledge, the *Kittel* test was satisfied where the "only reasonable explanation" for the disputed transaction was fraud. Moreover, he approved dicta of Christopher Clarke J in *Red 12 Trading Ltd*, which set out characteristics typical of MTIC trading.

93. Mr Gray conceded that the burden of proof here rested on HMRC but that the standard of proof was the civil standard, *viz* the balance of probabilities. He invited the Tribunal to infer actual knowledge of a fraud from the circumstances here. We would observe that, if we are to rely on imputed knowledge, the test of "the only reasonable explanation" denotes in our view a high level. Indeed, Mr Gray acknowledged that cogent evidence was required to satisfy the *Kittel* test. He referred to the characteristics of MTIC fraud set out in *Euro Stock Shop Ltd.*

94. Two other legal principles were emphasised in HMRC's Submissions, which apply in cases of *contra* dealings. While the *dirty* and *clean* (or *contra*) chains will occur in the same Return period, so as to disguise the fraudulent claim, one need not precede the other. (*Blue Sphere Global Ltd)*. Further, the consequence of the *Kittel* rule is that an offending trader loses his entitlement to make a repayment claim. In effect he takes himself outwith the VAT system and the benefit under Section 26 VATA of recovering input tax. In particular it is not necessary for the amount of the refused repayment to be restricted to the amount of tax loss sustained by HMRC (*Pars Technology Ltd).*

95. In the *contra* trading scenario in the present appeal, Mr Gray submitted, there were 3 *contra* traders, viz LHT, Optronix and RVM. In June and July 2006 they each had acted as *brokers* exporting goods at the conclusion of *dirty* chains in which there had been earlier defaults in payment of VAT. These failures were deliberate and the pattern of trading in each case fraudulent. Mr Gray referred to the evidence of Mr Taylor in relation to LHT, the oral evidence of Lesley Camm and the Joint Minute of Admissions anent her (further) evidence and opinion (K2) in relation to Optronix, and the Joint Minute of Admissions anent the evidence and opinion of Sangita Parmar (K3) in relation to RVM. Their opinions were that the *clean* chains initiated by each of LHT, Optronix and RVM, and in which ARC was *broker*, were *contra* dealings to disguise fraudulent repayments on *dirty* chains in which they, ie LHT, Optronix and RVM, had acted as *broker*. In effect the *clean* chains involving ARC and in respect of which repayments of input tax are sought, were extensions of *dirty* chains in which the *contra* traders, ie LHT, Optronix and RVM, had acted as *brokers*. All the transactions formed part of an organised scheme to defraud HMRC. (While in terms of the Joint Minutes of Admission Mr Robertson did not concur with that opinion, he conceded that it was a conclusion with which the Tribunal might competently agree).

96. Factors recognised as indicative of MTIC trading in the decisions in *Euro Stock Shop Ltd* and *Red 12 Trading Ltd* are itemised towards the conclusion of Mr Gray's summary of the legal aspects arising.

97. At Sections 6 and 7 of his Written Submissions Mr Gray addresses the factual aspects, assessing Mr Rakhra's evidence and thereafter considering the circumstances peculiar to ARC's appeal as against the factors suggestive of MTIC trading identified earlier. As the critical issue to be determined by the Tribunal in this appeal is what inferences as to the taxpayer's knowledge – actual and imputed – may properly be inferred, these matters are addressed more fully in our conclusion *infra*.

98. On behalf of ARC Mr Robertson submitted essentially that the disputed transactions were not part of a scheme to defraud HMRC but that in any event the circumstantial evidence was insufficient to impute the necessary degree of knowledge to the company and Mr Rakhra. At most Mr Rakhra was an "innocent dupe".

99. Mr Robertson referred to essentially the same body of case-law and noted in particular from the judgment in *Kittel* that "traders who take every precaution which could reasonably be required of them to ensure that their transactions are not

connected with fraud…must be able to rely on the legality of those transactions without the risk of losing their right to deduct the input VAT…".

100.The benefit of deducting input tax in terms of Section 26 VATA, Mr Robertson submitted, should not be withheld from a taxpayer "who did not and could not know that the transaction concerned was connected with a fraud committed by the seller".

101.He noted too the decisions in *Brayfal Ltd* and *Emblaze Mobility Solutions Ltd*, which, he argued, supported his contention that *Kittel* had set a high test for the denial of Section 26 entitlement.

102.Mr Robertson then reviewed the witness evidence. He contrasted the "professional" evidence of HMRC's witnesses. Mr Stone and Mr Grieve were Government officials, versed in technical practice. They were professional and in certain respects defensive in their approach and tended to speak in technical jargon. They spoke of "best practice" rather than taking into account the realities of commerce. Mr Fletcher, while an impressive professional, had not addressed the practicalities of ordinary trading. Mr Robertson questioned the sufficiency of his evidence relating to Nokia's having a common pricing policy at the material time.

103.Mr Rakhra on the other hand had frankly acknowledged that the technical language in his own Witness Statement had been prompted by his professional adviser, Mr O'Donnell. The Tribunal in assessing his evidence should not expect of him the same level of technical knowledge and sophistication shown by HMRC's "professional" witnesses.

104.Mr Robertson then considered the presence and absence, so far as ARC was concerned, of certain features considered in the relevant case-law as indicative or suggestive of MTIC trading. Certain features, he argued, were absent: others he sought to explain away. (These *indicia* were, of course, addressed by Mr Gray, and we set out in some detail in the **Decision** *infra* our own view of their presence individually and what significance we attach to them).

105.Mr Robertson referred us to Mr Rakhra's description of trading as "arms-length" and independent. He had experience as an employee, then as branch manager of a shop, then as sole trader in the telecoms industry. He acknowledged that the estimated turnover of £60K fell far short of that achieved shortly after, but that estimate had not been adversely commented on by HMRC's Mr Vaughan and Mr McGee. Deal packs supporting this pattern of trading were produced.

106.Mr Rakhra, Mr Robertson argued, did not have the resources and advantages available to HMRC and knew little, if anything, of the "chains" beyond the identity of his immediate supplier and customer. Although there was speculation on the part of HMRC about an overall controlling mind, no evidence directly in support of this had been produced.

107.ARC had a system of "due diligence". It had engaged a specialist advisor. It kept business records. These had been scrutinised yet never criticised in the period preceding June 2006 by HMRC. Nor had HMRC warned ARC about particular

customers or freight forwarders. Even where ARC's "due diligence" checks had not been completed before trading, they were of value where there was a pattern of continuing trading. ARC was not simply "going through the motions", Mr Robertson submitted.

108.Mr Robertson then considered the circumstances of the 3 *contra* traders, LHT, Optronix and RVM. ARC had not been involved in the *dirty* chains. How, he asked, could ARC have discovered another allegedly related fraudulent chain. The process of investigation was complicated enough for HMRC with their resources. Apparently when the contested deals were concluded, there had been no default in the *contra* chains. In relation to the deals in which LHT had been broker, the goods concerned had been other than phones. The relative HMRC witness, Mr Taylor, could give only indirect evidence of the enquiries and conclusions drawn by other officers. That information would not have been available to Mr Rakhra. A Joint Minute of Admissions had been negotiated in relation to Optronix and the evidence of the investigating officer, Lesley Camm. Again the sample deals considered did not involve mobile phones. The information derived by Ms Camm was obtained after the months of June and July 2006 and, indeed, a repayment had been made by HMRC to Optronix in July. Similarly a Joint Minute of Admissions had been concluded in relation to RVM and the evidence of Sangita Parmar. Mr Robertson stressed that HMRC did not form a definitive view about fraudulent activity until after June and July 2006. He criticised particularly Ms Parmar's opinion set out at para 53, as having no real basis. There was no evidence of an overall scheme, Mr Robertson submitted, and there was no objective evidence supporting the *clean/contra* chains as extensions of the *dirty* chains. There was nothing to attribute the knowledge or means of knowledge to Mr Rakhra of a fraudulent link.

109.Mr Rakhra, Mr Robertson submitted, had gained an understanding of *contra* trading only after his repayment of input tax was denied. He had received the Notice no 726 only in April 2007. He knew only his immediate trading contacts and that inevitably precluded knowledge of repeated patterns of trading. He (and his advisers) only understood the basis of the allegation of *contra* trading here after hearing Mr Taylor's evidence.

110.Mr Robertson then referred to the flow of money via FCIB accounts spoken to by Mr Loureiro and Ms Camm. He urged us not to draw any sinister inference from the use of the FCIB's facilities. It offered a 24 hour service. Other banks had withdrawn account facilities from traders in the mobile phone sector. The defect in HMRC's analysis was that there was a lack of narrative in the bank records. Inferences had been drawn in the absence of specific information. Significantly, Mr Robertson observed, Mr Loureiro and Ms Camm differed as to which of certain offshore parties had initiated the money-flow. The involvement of ARC was simply in the purchase and sale of the goods in the contested deals, Mr Robertson said.

111.In conclusion, Mr Robertson submitted, there was no evidence of actual knowledge of a fraudulent scheme and no justification for inferring "constructive knowledge" on the part of his client and the Appeal accordingly should succeed. The information available to HMRC was simply not available to his client. His client had

co-operated with HMRC's officers. Its practices, including due diligence, had not been the subject of any criticism or warning. Parties with whom ARC had traded had not been de-registered at that stage. The details of the tax losses and *dirty* chains had been identified by HMRC only after June and July 2006. Further, Mr Robertson submitted, HMRC had not shown that their actual losses exceeded the repayment claims. Steps taken to recover these losses had not been evidenced. This was important as the relevant tax liabilities were joint and several. Liability, Mr Robertson argued, had to be in respect of an actual loss.

112. On an objective view of the circumstances Mr Rakhra had, Mr Robertson submitted, a reasonable basis for proceeding in the belief that the transactions were not affected by fraud. Mr Grieve's assessment should be viewed critically. In cross-examination, Mr Robertson claimed, he had accepted that certain sections of his Witness Statement required to be re-worded. In particular para 101, which contains a seriously prejudicial allegation, was now accepted as being factually unwarranted. Mr Grieve had been prepared to draw definitive conclusions without a sound factual foundation.

Decision

113. Ultimately the nub of this appeal was what actual knowledge or suspicions and concerns might reasonably be imputed to the company, ARC Ltd, and Mr Rakhra as its controlling mind. We have been guided particularly by the decisions of the ECJ in *Kittel*, the Court of Appeal in *Mobilx* and Christopher Clarke J in *Red 12* in formulating the criteria to be applied in relation to the circumstances of this case. However, we have to be satisfied at the outset (i) that there was a loss of revenue to HMRC, (ii) that this was deliberate and fraudulent, and (iii) that the transactions for which the repayments of input tax are presently sought, can be related to the default. We are so satisfied and this is reflected in our Findings in Fact. We accepted the evidence and opinions of the officers of HMRC who investigated the tax affairs of *Optronics, LHT* and *RVM*. The chains in which ARC was involved had no commercial purpose. The obvious and only inference in our opinion is that they were a camouflage to conceal repayments of tax in the "dirty chains."

114. The essence of the ECJ's Decision in *Kittel* is explained thus –

"[55] It is a matter for the national court to refuse to allow the right to deduct where it is established, on the basis of objective evidence, that that right is being relied on for fraudulent ends.

[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'.

[60] It follows from the foregoing that the answer to the questions must be that where a recipient of a supply of goods is a taxable person who did not and could not know that the transaction concerned was connected with a fraud committed by the seller, art 17 of the Sixth Directive must be interpreted as meaning that it precludes a rule of national law under which the fact that the contract of sale is void – by reason of a civil law provision which renders that contract incurably void is contrary to public policy for unlawful basis of the contract attributable to the seller – causes that taxable person to lose the right to deduct the VAT he has paid. It is irrelevant in this respect whether the fact that the contract is void is due to fraudulent evasion of VAT or to other fraud.

[61] By contrast, where it is ascertained, having regard to objective factors, that the supply is to a taxable person who knew or should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of VAT, it is for the national court to refuse that taxable person entitlement to the right to deduct".

115.This has been helpfully explained by Moses LJ in *Mobilx* in which he postulated the "only reasonable explanation" test -

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

[59] The test in *Kittel* is simple and should not be over-refined. It embraces not only those who know of the connection but those who "should have known". Thus it includes those who should have known from the circumstances which surround their transactions that they were connected to fraudulent evasion. If a trader should have known that the only reasonable explanation for the transaction in which he was involved was that it was connected with fraud and if it turns out that the transaction was connected with fraudulent evasion of VAT then he should have known of that fact. He may properly be regarded as a participant for the reasons explained in *Kittel*.

[60] The true principle to be derived from *Kittel* does not extend to circumstances in which a taxable person should have known that by his purchase it was more likely than not that his transaction was connected with fraudulent evasion. But a trader may

be regarded as a participant where he should have known that the only reasonable explanation for the circumstances in which his purchase took place was that it was a transaction connected with such fraudulent evasion".

116.He approved also *dicta* of Christopher Clark J in *RED 12* –

[83]… I can do no better than repeat the words of Christopher Clark J in *Red 12 v HMRC [2009] EWHC 2563:-*

"[109] Examining individual transactions on their merits does not, however, require them to be regarded in isolation without regard to their attendant circumstances and context. Nor does it require the tribunal to ignore compelling similarities between one transaction and another or preclude the drawing of inferences, where appropriate, from a patter of transactions of which the individual transaction in question forms part, as to its true nature e.g. that it is part of a fraudulent scheme. The character of an individual transaction may be discerned from material other than the bare facts of the transaction itself, including circumstantial and "similar fact" evidence. That is not to alter its character by reference to earlier or later transactions but to discern it.

[110] To look only at the purchase in respect of which input tax was sought to be deducted would be wholly artificial. A sale of 1,000 mobile telephones may be entirely regular, or entirely regular so far as the taxpayer is (or ought to be) aware. If so, the fact that there is fraud somewhere else in the chain cannot disentitle the taxpayer to a return of input tax. The same transaction may be viewed differently if it is the fourth in line of a chain of transactions all of which have identical percentage mark ups, made by a trader who has practically no capital as part of a huge and unexplained turnover with no left over stock, and mirrored by over 40 other similar chains in all of which the taxpayer has participated and in each of which there has been a defaulting trader. A tribunal could legitimately think it unlikely that the fact that all 46 of the transactions in issue can be traced to tax losses to HMRC is a result of innocent coincidence. Similarly, three suspicious involvements may pale into insignificance if the trader has been obviously honest in thousands.

[111] Further in determining what it was that the taxpayer knew or ought to have known the tribunal is entitled to look at the totality of the deals effected by the taxpayer and their characteristics, and at what the taxpayer did or omitted to do, and what it could have done, together with the surrounding circumstances in respect of all of them".

117.In the present case it is not claimed that the default and the disputed claim for repayment both arise in the same chain of transactions ie from the import of the goods to their eventual export by the Appellant taxpayer. HMRC's assertion is that the disputed transactions were at the conclusion of a *clean* chain (on which the appropriate VAT had been paid on the occasion of each re-sale), used to disguise at its start (and offset) a repayment at the end of a *dirty* chain. Lewison J in *Livewire Telecom Ltd* opined that in the case of c*ontra trading* knowledge, actual or imputed, of either the default in the *dirty* chain or of the attempt at concealment in the *clean* or *contra* chain was sufficient to refuse payment –

"[103]…it must be established that the taxable person knew or should have known of a connection between his own transaction and at least one of these frauds. I do not consider that it is necessary that he knew or should have known of a connection between his own transaction and both of these frauds. If he knows or should have known that the contra-trader is engaging in fraudulent conduct and deals with him, he takes the risk of participating in a fraud, the precise details of which he does not and cannot know".

118.We have found in fact that the *clean* or *contra* chains originate with three other traders, LHT, Optronix and RVM. There is evidence before us from the testimony of Mr Taylor and the Joint Minutes of Admissions relating to the testimonies of Lesley Camm and Sangita Parmar, that each of these companies had been knowingly involved in a scheme to defraud HMRC of VAT or should have known this. The *clean* or *contra* chains were thus initiated to offset or disguise the repayment claims in respect of *dirty* chains in which these three other companies had been *brokers*. We had the advantage of hearing Mr Taylor, whom we found a persuasive witness, who had addressed the pattern of LHT's trading logically and with care. While the testimony of Lesley Camm and Sangita Parmar is in the form of their Witness Statements, there is no contrary evidence and in a prescribed context is the subject of agreement. Their reasoning too seems compelling and their conclusions logical.

119.The *clean/contra* chains do not appear to be of a commercial nature. Their only conceivable purpose, in our view, is a means of disguising a repayment in a related *dirty* chain, by creating a tax "offset". All this fortifies us in our conclusion that the contested transactions in this appeal are the conclusion of a deliberate scheme to defraud HMRC.

120.We agree with the reasoning of the Tribunal in *Pars Technology* that we do not have to relate in amount the size of the disputed tax repayment to the sum defaulted on. In terms of *Kittel* it is the entitlement to make a repayment claim which is forfeited by furthering the fraud, not a particular amount of tax. Moses LJ observed in *Mobilx* –

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

121.The Tribunal emphasised this principle in *Pars Technology Ltd* by reference to Floyd J's ruling in *Calltell Telecom Ltd* –

"Amount of tax loss

[27] [Counsel] cited *S&I Electronics PLC* 920090 TC76 where the Judge concluded, even where knowledge or means of knowledge of connection to fraud was proved against the Appellant, that unless HMRC can prove the defaulter was an importer only input VAT equivalent to the defaulter's margin should be denied. He also concluded that even where HMRC could prove the defaulter was an importer the input VAT could not be denied to the extent it exceeded the VAT defaulted upon.

[28] This was, however, in the context that there was no finding that any of the chains were orchestrated which distinguishes it from this case (see our findings below).

[29] In any event, we are bound by the ruling of Floyd J in *Calltel Telecom Limited [2009] EWHC 1081 (ch) at paragraphs 83-100:*

> *"(paragraph 96) In my judgment there is no principle which requires HMRC to acknowledge a claim to repayment to the extent that the claim exceeds HMRC's tax loss…(paragraph 97) …none of the statements in* Kittel *suggest that the right is lost only to the extent that tax is lost elsewhere in the chain….*
>
> (*paragraph 99) It seems to me that the objective of not recognising the right to repayment is not simply to ensure that the exchequer is not harmed by fraud: the objective includes combating fraud and discouraging taxpayers from entering into transactions of this nature. In that context, considerations of fiscal neutrality of the impugned transaction are, it seems to me, beside the point".*

[30] We note that this was also the view of the Court of Appeal in *Mobilx* at paragraph 65:

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

[31] It is therefore the law, contrary to [counsel's] assertions, that where a taxpayer knows or ought to have known its transaction was connected to fraud, it loses its right to deduct its input tax *in full*".

122.Accordingly no issue as to *proportionality* arises. In any event creating a *clean* chain without commercial purpose giving rise to a repayment in excess of the tax repayment in the *dirty* chain to be offset and concealed, would serve no purpose.

123.Further, the decision in *Blue Sphere Global* directs that, provided that the *clean* and *dirty* chains can be related, neither one need precede the other. The necessary connection arises where there is an offsetting of input against output tax in a particular

Return period by a party common to the *dirty* and *clean* chains. Sir Andrew Morritt C explained –

"[44]…The nature of any particular necessary connection depends on its context, for example electrical, familial, physical or logical. The relevant context in this case is the scheme for charging and recovering VAT in the member states of the EU. 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 more transactions or chains of transaction in which there is one common party whether or not the commodity sold is the same. If there is a connection in that sense it matters not which transaction or chain came first. Such a connection is entirely consistent with the dicta in *Optigen* and *Kittel* because such connection does not alter the nature of the individual transactions. Nor does it offend against any principle of legal certainty, fiscal neutrality, proportionality or freedom of movement because, by itself, it has no effect".

124.The characteristics identified as indicative of MTIC trading are present too. (We have regard to the *dicta* in *Euro Stock* and *Red 12 Trading as approved by Moses LJ supra*). In particular there is a recurrence of the same parties, a pattern or template of consistent mark-ups and profit margins, the absence of arms-length commercial trading, the absence of added value, and lengthy deal chains without apparent purpose, which do not include manufacturers, retailers or final consumers. A circularity of payments for the goods was shown in many instances also. Certain of these features appear also in ARC's non-contested *buffer* deals.

125.Mr Rakhra argued, of course, that his awareness did not extend beyond his immediate supplier and customer. He did not have the resources of HMRC (which we accept) and, indeed, their information had been collated only long after the dates of the transactions in question. However, Mr Rakhra did acknowledge that he was aware of the prevalence of MTIC fraud in the mobile phones market at the material time, although he did not receive a copy of Notice no 726 until much later. He had regular visits from HMRC officials. He received many "Redhill" letters. He had engaged a professional advisor to assist him in VAT compliance. He had extensive experience of both the retail and wholesale markets in the telecoms industry.

126.In gauging Mr Rakhra's state of mind we view the unexplained, prodigious and sudden increase in turnover as highly significant. In response to one of the Tribunal members Mr Rakhra remarked - "It was a high amount but I never really took into consideration what my turnover was". This seemed curious as the response of the controlling director.

127.Such a market share was comparable to that of a major participant in the sector. Yet ARC continued to trade from the same, small premises, with a minimal staff. Over a period there were only three employees – not all employed at the same time – assisting Mr Rakhra. In our view trading conditions which gave rise to such a sudden and substantially increased turnover should have alerted Mr Rakhra's suspicions.

128.The pattern of the deals, each following only days after another, should have triggered a natural curiosity. Purchases and sales were for matching numbers, possibly explicable for cheap basic models, but less readily so for the high value phones which were traded here. None seemed ever to be faulty. None was ever returned. (In any event ARC did not have service staff or facilities). There was only a limited specification in the invoices which would tend to expose a trader to unsatisfactory commercial risks. Apparently there was no need for storage space as stock was never held by ARC on its premises. Rather it was always at a freight forwarder's.

129.In the view of the Tribunal such a pattern of trading, invariably resulting in a small but assured margin of profit, should surely have seemed "too good to be true". Applying the test prescribed by Moses LJ in *Mobilx*, the "only reasonable explanation" must surely have been that the goods were tainted by MTIC fraud. On any view this pattern of trading is too far removed from ordinary commercial undertakings to be regarded as innocent and legitimate, which points to that one inexorable inference.

130.The system of "due diligence" pursued by ARC was clearly inadequate in a context of "arms-length" trading. The process was often not completed before trading started, but even then it would have had only limited value in relation to subsequent dealings. The information obtained as to the subject's financial resources and credit worthiness was often inadequate and on occasion cautionary. The implications of the de-registration notices for previous trading associates seem to have been ignored. Business premises were often no more than serviced accommodation and of a short-term nature. We agree with Mr Gray's contention that such procedures were no more than "going through the motions". The making of such limited efforts, with no real benefit emerging, arguably is suggestive of actual awareness of MTIC fraud.

131.The manner of conduct of ARC's business was obviously significant. While documentation relating to concluded deals was available, similar records relating to negotiations and dealings which did not reach fruition were not produced. We have in mind items such as jottings, notebooks recording information, records of phone calls, emails, and computer printouts – the basic records of matters too detailed to be committed to memory. Mr Rakhra spoke of receiving and making many phone calls on a daily basis and of using the internet. No phone bills were produced or receipts for websites. The evidence of even one of ARC's employees other than Mr Rakhra or of Mr Holmes of Border VAT Services could have been helpful. The dearth of evidence from such sources, which should have been readily available, raises our concern.

132.We commented earlier (para 90) on the credibility of Mr Rakhra's evidence. Mr Gray in his submissions notes discrepancies in Mr Rakhra's oral evidence and Witness Statement. Minor discrepancies we would consider inevitable, but one aspect not explained away satisfactorily was the Trade Credit Application document. Mr Rakhra claimed not to have granted credit. In that event what was the purpose of this document? It seems to have been part of ARC's documentation. We consider that no satisfactory explanation for this was forthcoming.

133. Our conclusion is that the *Kittel* test as to imputed knowledge is satisfied in this case. While certain factors are arguably indicative of actual knowledge on the part of Mr Rakhra, we have no hesitation in concluding in any event that it should have been clear to him that the "only reasonable explanation" for the nature and pattern of the disputed transactions was that they were tainted with MTIC fraud. The disputed deals do not bear the hallmarks of arms-length commercial trading. Taking all the relevant factors *in cumulo* that is the only and inevitable conclusion in this case. For these reasons we dismiss this appeal.

Expenses

134. The Respondents, HMRC, conceded the expenses of Tuesday and Wednesday, 8/9 June 2010 as their witness, Mr Stone, could not attend the hearing on these days. Because of procedural difficulties they conceded also a half-day's expenses for Friday 8 October 2010 to the Appellant. *Quoad ultra* in view of our decision it is appropriate that expenses be awarded to the Respondents. These are subject to taxation, if necessary, in terms of Rule 29(3) of the VAT Tribunal Rules 1986.

135. Finally we would express our thanks to Counsel and their advisers for the excellent presentation of their detailed arguments and other assistance afforded to the Tribunal in the course of the Hearing.

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

MR KENNETH MURE, QC
TRIBUNAL JUDGE

RELEASE DATE: 28 SEPTEMBER 2011