TC02840

Appeal number: LON/2008/01294

VAT – input tax – involvement in MTIC transactions – denial of repayment on Kittel grounds – position of contra-trading transactions after Mahagében – whether taxpayer knew or should have known of connection to fraudulent VAT evasion – appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

PELIX LIMITED (in administration) **Appellant**

- and -

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

TRIBUNAL: JUDGE PETER KEMPSTER
TYM MARSH

Sitting in public at RCJ, Strand, London on 5 to 23 September and 7 October 2011

Mr Paul Hynes QC and Ms Rebecca Norris of counsel (instructed by The Khan Partnership LLP) for the Appellant

Mr Jonathan Hall and Mr Howard Watkinson of counsel (instructed by the General Counsel and Solicitor to HM Revenue and Customs) for the Respondents

DECISION

1. By a decision issued on 2 April 2008 the Respondents ("HMRC") refused repayment claims totalling £960,389 by the Appellant ("Pelix") relating to nine purchases of goods made by Pelix in the VAT periods 04/06, 05/06 and 06/06 ("the Disputed Transactions"). The grounds given for the decision were that the Disputed Transactions were connected with the fraudulent evasion of VAT (generally known as missing trader intra-community ("MTIC") fraud) and that Pelix, through its directors and senior employees, knew or should have known of such a connection.

Background

2. Pelix was incorporated on 20 September 2002. Mr Darren Brown was appointed director and company secretary on 11 August 2003 and Mr Jamie Gibson was appointed director on 10 June 2005. On 3 October 2003 Pelix's registered office was changed to Mr. Brown's home address. Mr Gibson and Mr Brown held 60% and 40% of the shares in Pelix respectively.

3. Mr Brown applied for Pelix to be registered for VAT on 17 January 2005.

4. On 25 April 2005 HMRC Officers Paul Christopher and Carolyn Walkerdine visited Pelix at its principal place of business. At the date of the visit Pelix had not yet made any supplies. Both Mr Brown and Mr Gibson were present at the visit. Mr. Brown was interviewed by the officers and stated that the company's business activity would be export sales of CPUs to named customers based in the US and the Far East (although in fact Pelix never made any sales to those named companies.) Mr. Brown did not expect Pelix to make any UK sales. CPUs were to be sourced in the UK from IT Wholesale Ltd, Rapid Global Ltd and Multisystems International Limited and would be stored, inspected and delivered by Forward Logistics. The company would be run from a virtual office at Harwell Innovation Centre. The source of start-up capital for the business was a joint £100k investment raised through refinancing. Mr. Brown intended that Pelix would make a mark up of between 3-6% on its sales. The officers discussed: MTIC fraud; verification of VAT registration numbers through HMRC's Redhill office; due diligence; and the joint and several liability legislation. Mr Brown and Mr Gibson advised that they were aware of the issues as they were currently running two companies selling the same commodities: Pexum Limited and PGT Limited. Mr. Brown advised the officers that KPMG would be responsible for carrying out the background checks on Pelix's counterparties and gave them a copy of a deal check sheet.

5. The officers noted that Pexum owed HMRC £303,662.73 and that Mr Brown and Mr Gibson were associated with another company that owed significant VAT (Quest Trading Company Ltd) and therefore requested that security action be taken and Pelix be placed under MTIC monitoring. Pelix was registered for VAT with effect from 25 April 2005 and submitted returns on a monthly basis. After registration Pelix was dormant with its first six VAT returns showing that it had made no sales. Pelix's outputs commenced in period 11/05.

6. On 13 December 2005 Ms Walkerdine again visited Pelix. Mr. Brown confirmed that the company had completed one deal in CPUs in November 2005 in which it had purchased from Culmain Ltd and sold to Right Deal Limited (Hong Kong). On 5 February 2006 Pelix's registered office was changed to Harwell Innovation Centre. On 13 February 2006 Ms Walkerdine returned to Pelix. Pelix had carried out two deals in VAT period 01/06 purchasing CPUs from Multisystems and selling them to Bergmann (Switzerland). Pelix's repayment claim for around £35,600 in relation to the two transactions was paid on 17 February 2006 without prejudice to any further enquiries that HMRC may undertake. On 15 March 2006 Mr Christopher visited Pelix to verify the company's claim for repayment of around £258,000 for VAT period 02/06. Pelix had made nine sales of CPUs to: Tech Trader LLC, Brisk Business LLC, Admicro Ltd (Hong Kong), All Trading Worldwide BV, Tradius GmbH and Tradius BV. Pelix had purchased the CPUs for those sales from Sound Solutions and Multisystems. Pelix's repayment claim was again paid on a without prejudice basis. Pelix's VAT return for VAT period 03/06 was a repayment claim for around £352,000 which was paid on a without prejudice basis.

7. This appeal concerns the reclaims denied in relation to VAT periods 04/06, 05/06 and 06/06. Pelix's VAT return for period 04/06 was submitted on 2 May 2006 and on 30 May 2006 HMRC informed the company that the return would be subject to verification. Pelix's VAT return for period 05/06 was submitted at the beginning of June 2006 and on 20 June 2006 HMRC informed the company that the return would again be subject to verification. On 14 August 2006 HMRC informed Pelix that its VAT return for period 06/06 would be subject to extended verification.

8. On 2 April 2008 HMRC issued their formal decision letter denying the refunds. Pelix entered administration on 18 April 2008 and was deregistered for VAT with effect from 19 April 2008. Pelix appealed against the formal decision to the former VAT & Duties Tribunal and the appeal now comes before this Tribunal.

The Disputed Transactions

9. Pelix accepted the following description of the Disputed Transactions except in relation to certain aspects of Deals 6, 7 & 9. Those challenged aspects are covered fully later in this decision notice.

10. "Deal 1" was a purchase by Pelix in VAT period 04/06 from Text XS Limited. Text XS Limited was a defaulting trader, having unpaid VAT liabilities of over £1.3 million. In 2010 the director of Text XS Limited, Mr Graham McCulloch, was disqualified as a director for 13 years for his involvement in MTIC fraud.

11. "Deal 2" was a purchase by Pelix in VAT period 04/06 from Multisystems International Limited. HMRC had traced the deal chain back from Multisystems International Limited to a defaulting trader Data Solutions Northern Limited, which latter company had unpaid VAT liabilities of over £12 million. In 2009 the director of Data Solutions Northern Limited, Mr Keith Thelwell, was disqualified as a director for 14 years for his involvement in MTIC fraud.

12. "Deal 3" was a purchase by Pelix in VAT period 04/06 from Culmain Limited. HMRC had traced the deal chain back from Culmain Limited to a defaulting trader

Ability Office Services Limited, which latter company had unpaid VAT liabilities of over £10 million. In 2009 the director of Ability Office Services Limited, Mr Peter Chambers, undertook not to act as a director for 13 years for his involvement in VAT irregularities.

13. "Deal 4" was a purchase by Pelix in VAT period 04/06 from Nulife IT.com. HMRC had traced the deal chain back from Nulife IT.com to a person using a VAT registration number hijacked from a trader called KEP 2004 Limited. HMRC suspect that KEP 2004 Limited may have been more complicit in VAT fraud than merely having its VAT registration number hijacked, but for current purposes the hijacking explanation is sufficient. The unpaid VAT liabilities attributable to the hijacking were many millions of pounds.

14. "Deal 5" was a purchase by Pelix in VAT period 05/06 from Culmain Limited – the same vendor as on Deal 3. As on Deal 3, HMRC had traced the deal chain back from Culmain Limited to the defaulting trader Ability Office Services Limited

15. "Deal 6" was a purchase by Pelix in VAT period 05/06 from Nulife IT.com - the same vendor as on Deal 4. HMRC had traced the deal chain back from Nulife IT.com to Okeda Limited. Trades undertaken by Okeda were documented using a VAT registration number hijacked from a trader called Jool Limited. The unpaid VAT liabilities attributable to the hijacking were over £28 million.

16. "Deal 7" was a purchase by Pelix in VAT period 05/06 from Nulife IT.com – the same vendor as on Deals 4 & 6. As on Deal 6, HMRC had again traced the deal chain back from Nulife IT.com to Okeda Limited.

17. "Deal 8" was a purchase by Pelix in VAT period 05/06 from Multisystems International Limited - the same vendor as on Deal 2. HMRC had traced the deal chain back from Multisystems International Limited to a defaulting trader Sweetlime Limited, which latter company had unpaid VAT liabilities of over £1 million.

18. "Deal 9" was a purchase by Pelix in VAT period 06/06 from Tradex Corporation Limited. HMRC contend this can be traced to a contra-trader Jag Tec Limited, and that Jag Tec was involved in fraudulent transactions involving contra-trading. This is explored further below (at [24] onwards and [42] onwards).

Law

MTIC fraud and the loss of the right to repayment of input tax

19. By way of background description of MTIC fraud, we adopt the explanation given by Lewison J in *HMRC v Livewire Telecom Ltd* [2009] STC 643 (at [1]):

> "Value added tax ('VAT') fraud is a serious problem for national taxing authorities throughout the European Union. VAT fraud can take a number of forms. The particular form of fraud with which these appeals are concerned is known generically as missing trader intracommunity fraud or MTIC fraud. This is a description coined by Her Majesty's Revenue and Customs ('HMRC'), but is generally used by those who specialise in this area. Even this generic type of fraud can itself take different forms:

> (i) In its simplest form it is known as an acquisition fraud. A trader imports goods from another member state. No VAT is payable on the import. He then sells on those goods to a domestic buyer and charges VAT. He dishonestly fails to account for the VAT to HMRC and disappears. The importer is labelled a 'missing trader' or 'defaulter'.
>
> (ii) The next level of sophistication involves both an import and an export. A trader once again imports goods from another member state. No VAT is payable on the import. Typically the goods are high value low volume goods, such as computer chips or mobile phones. He then sells on those goods to a domestic buyer and charges VAT. He dishonestly fails to account for the VAT to HMRC and disappears. The domestic buyer sells on to an exporter at a price which includes VAT. The exporter exports the goods to another member state. The export is zero-rated. So the exporter is, in theory, entitled to deduct the VAT that he paid from what would otherwise be his liability to account to HMRC for VAT on his turnover. If he has no output tax to offset against his entitlement to deduct, he is, in theory, entitled to a payment from HMRC. Thus HMRC directly parts with money. Sometimes the exported goods are re-imported and the process begins again. In this variant the fraud is known as a carousel fraud. There may be many intermediaries between the original importer and the ultimate exporter. These intermediaries are known as 'buffers'. The ultimate exporter is labelled a 'broker'. A chain of transactions in which one or more of the transactions is dishonest has conveniently been labelled a 'dirty chain'. Where HMRC investigate and find a dirty chain they refuse to repay the amount reclaimed by the ultimate exporter."

20. A VAT registered trader enjoys the right to repayment of input tax where the credit due to him exceeds his output liability: Art 17 EC Sixth VAT Directive, incorporated into UK domestic legislation in ss 24 to 26 VAT Act 1994. However, that right can be lost if the facts fall within the legal principle stated by the Court of Justice of the European Communities ("the ECJ") in a number of cases, and in particular *Kittel v Belgium & Belgium v Recolta Recycling SPRL* (Joined cases C-439/04 and C-440/04) [2008] STC 1537. *Kittel* at [62]:

> "… 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 value added tax, it is for the national court to refuse that taxable person entitlement to the right to deduct."

21. The exact nature of this test was explained by the Court of Appeal in *Mobilx Ltd & others v HMRC* [2010] STC 1436. From *Mobilx* we draw the following points (paragraph references are to the judgment of Moses LJ):

> (1) The Tribunal should refuse to allow the right to deduct where it is established, on the basis of objective evidence, that the right is being relied on for fraudulent or abusive ends. ([39])
>
> (2) This includes a trader who himself had no intention of committing fraud but who is to be treated as a participant by virtue of the fact that he knew or should have known that by his purchase he was taking part in a transaction connected with fraudulent evasion of VAT. ([41] & [43])

(3) A trader who has the means at his disposal of knowing that by his purchase he is participating in a transaction connected with fraudulent evasion of VAT but who fails to deploy means of knowledge available to him, loses his right to deduct. The loss of right of deduction by such a trader is not a penalty for negligence but instead because the objective criteria for the scope of that right are not met. ([52])

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

(5) For the right to deduct to be lost it is not sufficient that a trader should have known that by his purchase it was more likely than not that his transaction was connected with fraudulent evasion of VAT. But a trader may be regarded as a participant where he should have known that the only reasonable explanation for the circumstances in which his purchase took place was that it was a transaction connected with such fraudulent evasion. ([60])

(6) A trader who decides to participate in a transaction connected to fraudulent evasion, despite knowledge of that connection, is making an informed choice; he knows where he stands and knows before he enters into the transaction that if found out, he will not be entitled to deduct input tax. A trader who has the means of knowledge but chooses not to deploy it knows that, if found out, he will not be entitled to deduct. If he chooses to ignore obvious inferences from the facts and circumstances in which he has been trading, he will not be entitled to deduct. ([61])

(7) The ultimate question is not whether the trader exercised due diligence but rather whether he should have known that the only reasonable explanation for the circumstances in which his transaction took place was that it was connected to fraudulent evasion of VAT. ([75])

(8) If HMRC assert that a trader's state of knowledge was such that his purchase is outwith the scope of the right to deduct then HMRC must prove that assertion. ([81])

(9) The surrounding circumstances can establish sufficient knowledge to treat the trader as a participant. The Tribunal should not unduly focus on the question whether a trader has acted with due diligence. Even if a trader has asked appropriate questions, he is not entitled to ignore the circumstances in which his transactions take place if the only reasonable explanation for them is that his transactions have been or will be connected to fraud. The danger in focussing on the question of due diligence is that it may deflect the Tribunal from asking the essential question, namely, whether the trader should have known that by his purchase he was taking part in a transaction connected with fraudulent evasion of VAT. The circumstances may well establish that he was. ([82])

(10) Circumstantial evidence may indicate that a trader has chosen to ignore the obvious explanation as to why he was presented with the opportunity to reap a large and predictable reward over a short space of time. A trader who chooses to ignore circumstances which can only reasonably be explained by virtue of the connection between his transactions and fraudulent evasion of VAT, participates in that fraud and, by his own choice, deprives himself of the right to deduct input tax. ([84] & [85])

22. We consider the current state of the law on these matters requires three issues to be addressed:

(1) Was there a fraudulent evasion of tax?

(2) If so, were the disputed transactions connected with that fraudulent evasion?

(3) If so, did the Appellant know of that connection, or should it have known of that connection?

23. We understand that, subject to the next point concerning contra-trading, both parties accept the above as a fair statement of the relevant law.

Contra-trading transactions

24. Contra-trading was described by the Tribunal in *POWA (Jersey) Limited v HMRC* [2009] UKFTT 360 (TC) (at [9]) as follows:

> "A contra-trader, a broker in one chain of transactions - again adopting the commonly used jargon, a "dirty" chain - in which a default has occurred, buys goods from a supplier in another member State, and sells them to a UK customer; after one or more further sales and purchases they are sold to a customer in another member State. The contra-trader and, usually, all the other traders in this chain account correctly for their VAT liabilities; taken by itself it is a "clean" chain. The acquirer in the clean chain has incurred a liability for output tax which (because the values are engineered to achieve this result) matches the input tax credit due to him (or ostensibly due to him) as the broker in the dirty chain. He does not need to make a large repayment claim, attracting the Commissioners' attention, but instead makes a modest payment, or a minimal repayment claim. The same result may be achieved by undertaking a number of transactions generating an aggregate input tax credit matching the broker's output tax liability for the relevant accounting period. It is then the broker in the clean chain who has an input tax claim which, unless they can establish a link between the clean and dirty chains, the Commissioners must meet since the goods in the clean chain have not themselves been used for fraudulent purposes."

25. Mr Hynes for Pelix advanced some detailed technical arguments that (at least absent actual knowledge by the broker of the fraud) a broker transaction in a clean chain could not be "connected with" (in the *Kittel* sense) a fraudulent transaction (ie one giving rise to a fraudulent VAT loss) contained in a dirty chain. We do not recite those arguments here as we consider the point has been settled – at least as far as the First-tier Tribunal is concerned – by the ECJ caselaw referred to below, as interpreted

by the Upper Tribunal and the Court of Appeal. If Mr Hynes' arguments may be relevant to any further stage of these proceedings then he would no doubt wish to refine them in the light of the ECJ cases and we would not presume how leading counsel would state his case at that time.

26. Pelix requested that the Tribunal hold its decision until after issue of the decisions of the ECJ in the cases of *Mahagében kft v Nemzeti Adó- és Vámhivatal Dél-dunántúli Regionális Adó Főigazgatósága & Dávid v Nemzeti Adó- és Vámhivatal Észak-alföldi Regionális Adó Főigazgatósága* (C-80/11 & C-142/11) [2012] STC 1934 and *Tóth v Nemzeti Adó- és Vámhivatal Észak-magyarországi Regionális Adó Főigazgatósága* [2013] STC 185.

27. We have considered those ECJ cases and also have the benefit of two recent pronouncements on the application of *Mahagében* from the Upper Tribunal and the Court of Appeal respectively. We consider that *Tóth* (which was also referred to by the Court of Appeal) leads to no different conclusion.

28. In refusing an application for permission to appeal by the taxpayer in *Softhouse Consulting Limited v HMRC* (PTA/333/2013 – unreported at time of finalisation of this decision notice) the Upper Tribunal (Judge Berner) stated:

> "[19] There is therefore, in my view, nothing in *Mahagében* that can disturb the weight of authority that fraud conducted through contra-trading can be connected with a taxable person's transactions such that, if the taxable person knew or should have known of the fraud, the right to deduct VAT may be denied. That much is clear from *Mobilx*, as noted in the Upper Tribunal by Roth J in *POWA (Jersey) Ltd* [2012] STC 1476 at [53]:
>
> > "... it is clear from the Court of Appeal judgment in *Mobilx*, where one of the cases under appeal was *Blue Sphere Global*, that no special approach is required in a case involving contra-trading. The correct test as regards knowledge is always the same. It is the test derived from *Kittel* as set out in para [59] of Moses L J's judgment."
>
> [20] Application for permission to appeal to the Court of Appeal in *POWA (Jersey)* was refused by Moses LJ [2013] EWCA Civ 225."

29. In *POWA* (as cited above) Moses LJ stated:

> "11. Of course the question of connection or involvement must be judged transaction by transaction. The question must be asked whether a particular transaction was connected with fraud at an earlier stage in the chain of supply or whether that transaction was involved with, to use Mr Patchett-Joyce's [counsel for taxpayer's] translation, an earlier transaction in the chain of supply. But it seems to me quite clear that, whilst it is true that from to time the court [ie the ECJ in *Mahagében*] referred to another trader at an earlier stage in the transaction, it was accepting the principle that, so far as participation in the fraud was concerned, if a person had knowledge or the means of knowledge that fraud was being carried out at an earlier stage in the chain of supply, that would denote that he was a participant in the fraud and thereby loses his right to deduct. That is plain from *Optigen*; it is plain from

> *Kittel*; and the court in *Mahageben* was saying nothing different. Indeed those references on which Mr Patchett-Joyce relies at paragraph 45 and at paragraph 59 must be read in the context of what it clearly says in paragraph 49. If the court intended to cut down the principle it had identified in the case-law exemplified in *Kittel* and was changing the law, it would have said so. On the contrary it was not. It was merely applying it."

30. Those authorities are, of course, binding on this Tribunal and we conclude that where HMRC can demonstrate (to the necessary standard of proof) that (a) one chain (the dirty chain) contains a transaction giving rise to a fraudulent VAT loss, and (b) another chain (the clean chain) is linked to the dirty chain, then transactions in the clean chain are "connected with" the fraud (within the meaning in *Kittel*).

Parties' Cases in Outline

31. HMRC's case was as follows. All nine Disputed Transactions were connected with identified VAT fraud, and Pelix (through its directors Mr Gibson and Mr Brown) either knew of that connection or (in the alternative) should have known of that connection. The Tribunal should form an overall picture from the accumulation of details presented in the evidence. As Christopher Clarke J stated in *Red 12 Trading Ltd v HMRC* [2010] STC 589 (approved by Moses LJ in *Mobilx* (at [83])):

> "[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 pattern of transactions of which the individual transaction in question forms part, as to its true nature eg 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."

32. Pelix's case was as follows. Pelix accepted that HMRC had established that third parties had committed VAT fraud. However, Pelix (through Mr Gibson and Mr Brown) had no awareness of that fraud, nor should they have been aware of that fraud. In relation to Deals 1, 2, 3, 4, 5 & 8 it was accepted that the transactions were "connected with" the frauds, in the sense required by *Kittel*. However, that was not accepted in relation to Deals 6, 7 & 9. HMRC's case had been compiled with the considerable benefit of hindsight. There had been a painstaking analysis of the deal chains, the bank payments, the circumstances of third parties (often at several stages of remove from Pelix), and numerous other factors. That was now all presented – some five years after the events – as a picture of the situation in early 2006. The Tribunal's viewpoint, however, should be that of Mr Gibson and Mr Brown in early 2006.

Evidence

33. There was presented a large volume of documentary evidence.

34. We took oral evidence as follows. Each witness adopted and confirmed one or more formal witness statements and answered questions in cross-examination by counsel for the other party.

(1) For Pelix:

(a) Mr Darren Brown - director of Pelix.

(b) Mr Jamie Gibson - director of Pelix.

(c) Mr Liban Ahmed – director of Controlled Tax Management Limited ("CTM"), which performed some of the due diligence checks made by Pelix on its trading counterparties.

(2) For HMRC:

(a) Dr Kevin Findlay – an expert witness whose evidence concerned the market for Intel CPUs.

(b) Mr Peter Dean – an HMRC officer who was the designated case officer for Pelix.

(c) Mr Nigel Humphries – an HMRC officer who had investigated the VAT affairs of Jag Tec Limited (a party in the chain involving Deal 9).

(d) Mr Matthew Elms – an HMRC officer who had also investigated the VAT affairs of Jag Tec Limited.

(e) Mr Terence Mendes – an HMRC officer who had investigated the affairs of First Curacao International Bank ("FCIB"), through which passed most of the funds in the chains involving the Disputed Transactions.

(f) Ms Carolyn Walkerdine – an HMRC officer who dealt with Pelix's VAT affairs.

(g) Mr David Ball – an HMRC officer who had also investigated the affairs of FCIB.

(h) Mr Fu Sang Lam – an HMRC officer who had also investigated the affairs of FCIB.

(i) Ms Karen McDonald – an HMRC officer who had investigated the VAT affairs of Text XS Limited (a party in the chain involving Deal 1).

35. There were also witness statements from a further seven HMRC officers who were not called to give oral evidence.

Consideration

36. As stated at [22] above, we address three issues:

(1) Was there a fraudulent evasion of tax?

(2) If so, were the Disputed Transactions connected with that fraudulent evasion?

(3) If so, did Pelix know of that connection, or should it have known of that connection?

Was there a fraudulent evasion of tax?

37. Pelix accepts that HMRC have proved that there was a fraudulent loss of VAT in relation to all the Disputed Transactions. We agree and we record that we would have reached that conclusion on the evidence had the assertion been disputed.

Were the Disputed Transactions connected with that fraudulent evasion?

38. Pelix accepts that six of the Disputed Transactions (Deals 1, 2, 3, 4, 5 & 8) were "connected with" the VAT frauds, in the sense required by *Kittel*. We agree and we record that we would have reached that conclusion on the evidence had the assertion been disputed.

39. Pelix submits that the remaining three of the Disputed Transactions (Deals 6, 7 & 9) were not "connected with" the VAT frauds, in the sense required by *Kittel*. That position is based on two arguments. First, on Deal 9 only, a technical argument that transactions in a clean chain cannot be connected with fraud in a linked dirty chain – for the reasons detailed at [24-30] above, we do not accept that argument. Second, on all three contested deals, an argument that HMRC have not proved the fact of connection to the required standard of proof - we consider together Deals 6 & 7, then Deal 9.

Deals 6 & 7

40. To quote from Mr Hynes' opening submissions, "In the case of Deals 6 & 7, it is said [ie by HMRC] that the fraudulent evasion of VAT was effected through the use of a hijacked VAT [registration number] by [Okeda]. It seems, therefore, that whilst there is some circumstantial evidence to support the link between Okeda and Pelix, it is not of itself compelling to the required standard."

41. For each of Deal 6 and Deal 7 the chain of events was the same: the CPUs were purchased by Pelix from Nulife ITT.com, who had bought the same goods from 21st Trading Limited, who had bought the same goods from QIASS, who had bought the same goods from Decode Direct Marketing Limited, who had bought the same goods from Time Corporates Limited, who had bought the same goods from Okeda Limited. HMRC ascertained during separate investigations that trades undertaken by Okeda were documented using a VAT registration number hijacked from a trader called Jool Limited. Okeda itself was never registered for VAT; the use of another person's registration number was an attempt to escape detection by anyone checking whether the number had really been issued by HMRC (it had, but to Jool Limited). Having collected VAT from its customers Okeda pocketed the money for itself and the unpaid VAT liabilities attributable to the hijacking were over £28 million. We consider it plain that Okeda was a fraudster and also that there is a direct deal chain connection from Pelix to Okeda. The fact that Okeda hid behind another's trader's registration number does not break that connection. Accordingly, we have no difficulty in deciding that Deals 6 & 7 were connected with VAT fraud.

Deal No 9

42. HMRC allege that Deal 9 was a contra-trading transaction – ie one comprising a clean chain (with no fraud) and one or more dirty chains involving VAT fraud. We divide HMRC's argument into three assertions:

(1) *Deal 9 was in a clean chain.* This was the purchase of CPUs by Pelix from Tradex Corporation Limited, who had bought the same goods from Stardex UK Limited, who had bought the same goods from Jag Tech, who had bought the same goods from Korn Team SARL. We understand this is not contested by Pelix but for the avoidance of doubt we make a finding of fact that we are satisfied that the clean deal chain was as stated above.

(2) *There were transactions (outside the clean chain) involving VAT fraud – the dirty chains.* We make a finding of fact that we are satisfied from the evidence that Jag Tech was involved in transactions involving VAT fraud:

(a) in the 06/06 VAT period Jag Tech made 37 UK purchases and HMRC have traced every one of those to a fraudulent tax loss;

(b) the director and main shareholder of Jag Tech was Mr Noel Dingwall and in October 2010 Mr Dingwall was disqualified as a director for 13 years (from January 2011) because (to quote from a letter from the Insolvency Service dated 5 April 2011):

> "During the period of at least 4 May 2006 to 30 September 2006 he caused [Jag Tec] to undertake a method of trading which involved it in, and put [HMRC] at risk of being subject to, a [MTIC] fraud. If he did not so know, then he was reckless or grossly negligent as to whether Jag Tec was concerned in such a fraud."

(c) HMRC produced copious other information (presumably derived from the proceedings which resulted in the court imposing the disqualification order on Mr Dingwall) which point to Jag Tec being knowingly complicit in VAT fraud. We do not need to go that far but we are satisfied that all or almost all of Jag Tec's business activity from at

least the start of 2006 to its liquidation (when it owed HMRC around £9.5 million) was directly involved in MTIC fraud.

(3) *The clean chain was linked to the dirty chains.* We consider that from our findings on (1) and (2) above alone it is a reasonable inference that the clean chain is linked to the fraudulent transactions simply by the presence of Jag Tech (which never seems to have transacted any business not connected to VAT fraud) in the clean chain. However, HMRC also presented convincing evidence which showed a more direct link between the funds involved in Deal 9 and contra-trading by Jag Tec. That evidence was not perfect – part of the obfuscation employed by buffers in a chain is to use payments which are of slightly different amounts from their receipts, or to split or combine amounts, and one of the buffers (Stardex) chose not to number any of its invoices – but we are satisfied from scrutiny of HMRC's detailed analysis of the FCIB records that there is a circularity of funds, commonality of parties and precision of timing that can only realistically be explained by a carefully contrived dirty chain that is inextricably linked to Deal 9. In fact, in our view, it is even arguable that Deal 9 is itself in a dirty chain but HMRC do not make that leap and so we take the point no further. We are certainly satisfied that Deal 9 is linked to one or more dirty chains.

43. Accordingly, we find that Deal 9 is connected with VAT fraud.

Did Pelix know of that connection, or should it have known of that connection?

44. Given the overwhelming evidence that behind every one of the nine Disputed Transactions there lies a carefully orchestrated VAT fraud, we must decide whether Pelix was, as Mr Hall termed it, "an innocent dupe" or instead a knowing participant in the fraud. If we find that Pelix did not have actual knowledge of the VAT fraud then we must make a further finding as to whether Pelix should have known that the Disputed Transactions were connected with VAT fraud.

45. It was common ground that in determining the knowledge of Pelix we should look to the knowledge of Mr Gibson and Mr Brown. Mr Hall for HMRC submitted that we should also take into account the knowledge of other employees of Pelix, in particular Mr Richard Lunn; Mr Hynes for Pelix challenged that submission. We have been able to reach a firm conclusion on the knowledge point by considering only the knowledge of Mr Gibson and Mr Brown; accordingly we consider it unnecessary to look to the knowledge of other persons, even if, as contended by HMRC, that is permissible.

46. We find that Pelix had actual knowledge that all of the Disputed Transactions were connected with VAT fraud. That finding is based on the following factors all taken together. Each factor is detailed further below together with the basis for our findings on that factor.

(1) Mr Gibson and Mr Brown had already had a VAT repayment of over £1.5 million denied during their involvement with Pexum. They were fully aware of the risks involved in dealing in the CPU grey market and that fraudsters were active in that market.

(2) Neither Mr Gibson nor Mr Brown had any real commercial knowledge of the Intel CPU market nor the goods in which Pelix purported to make profitable transactions on a significant scale.

(3) Mr Gibson and Mr Brown continued to trade with persons who had a connection with the fraudster who had caused the VAT loss to Pexum.

(4) Mr Gibson and Mr Brown ignored warnings sounded by the due diligence undertaken by Pelix.

(5) Mr Gibson and Mr Brown ignored warnings arising from the freight forwarders.

(6) Mr Gibson and Mr Brown were unconcerned that insurance cover may be inadequate.

(7) Mr Gibson and Mr Brown were unconcerned about the creditworthiness of their counterparties, including their overseas customers.

(8) There were no meaningful negotiations of purchases or sales, other than fine-tuning of the profit margin to be achieved by Pelix as its fee for participating as broker in frauds.

(9) Pelix took funding that had no commercial purpose and was designed to enable Pelix to continue to operate as a broker and participate in frauds.

(10) The elaborate orchestration of the transaction chains in terms of circularity of goods, circularity of funds and timing of payments and receipts is inexplicable except by the knowing involvement of the broker, Pelix, in the frauds.

Previous experience with Pexum

47. Mr Gibson and Mr Brown had previous experience of the risks of trading in the CPU grey market, from their involvement with Pexum. Both individuals were directors of Pexum which traded in CPUs from January 2004 until the VAT period 10/04. In December 2004 HMRC informed Pexum that reclaims totalling over £1.5 million for the periods 07/04, 09/04 and 10/04 were being denied and that decision was appealed to the VAT & Duties Tribunal, which heard the appeal in October 2005 and December 2006 (VATTR 20083). Both Mr Gibson and Mr Brown gave oral evidence at that hearing. The VAT Tribunal dismissed the appeal on the basis that Pexum did not hold valid VAT invoices to support the reclaims (at [122]). We consider that the findings of fact of the VAT Tribunal are telling in the context of the current case.

> "[7] Between January 2004 and October 2004, Pexum carried on the business of buying and selling CPUs or, at least, goods that purported to be CPUs. It made purchases from UK VAT registered traders, and sold to traders outside the United Kingdom.
>
> [8] Having been notified of Pexum's intention to trade in CPUs, on 3 February 2004 HMRC wrote to it concerning MTIC (missing trader intra-community) fraud, that being a particular and rapidly increasing problem to them at the time. Their letter also gave an indication of the information which Pexum should obtain in relation to

new or potential customers or suppliers with which it intended to trade, and required it to provide monthly purchases and sales listings.

[9] As part of HMRC's programme to combat MTIC fraud, Mrs Teal visited Pexum on 1 March 2004. She issued Notices 726 (Joint and several liability in the supply of specified goods) and 700/52 (Notice of Requirement to give security to Customs and Excise), and HMRC's statement of practice entitled "VAT Strategy: Input Tax deduction without a valid VAT invoice". She also informed the company that further investigations would be carried out in relation to its suppliers. The issue of the two Notices was standard practice in the case of new traders in CPUs …"

48. We pause there to note that those events were almost two years before Pelix's Disputed Transactions. Returning to the Pexum findings:

"[10] As we have indicated, the deals giving rise to the disputed decisions were undertaken by Pexum in accounting periods 07/04, 09/04 and 10/04. In them Pexum claims to have bought goods either from ITW [IT Wholesale Limited] or Kwik Move Limited ("Kwik Move"), both UK VAT registered traders, and in all cases sold and purportedly exported those goods to Best Concord Technology Limited ("Best Concord"), of Hong Kong. The goods involved in all the deals were purportedly P4 2.8GHz 800 CPUs manufactured by Intel Corporation ("Intel"), the world's largest manufacturer of CPUs."

49. The business method was similar to that of Pelix – buy Intel CPUs from UK trader and export to overseas purchaser. The way in which Pexum sourced its sales was unusual: the customer was identified for it by its own supplier.

"[14] Most of the deals Pexum entered into were with ITW. In evidence, Mr Auletta of that company claimed that in trading in IT components ITW sourced supplies from within the United Kingdom and sold them mainly outside the European Union. In any given period he said that ITW traded with only one or two customers. Between July and October 2004 the only customer with which it dealt was Evergreen Technology Enterprise Ltd ("Evergreen") of Hong Kong, a company described as a "sister company" of Best Concord, each company having a single, common director. The reason for that, he claimed, was ITW's "need to cover the negative situation which arises from exporting goods and the depletion of funds resulting from certain deals last year [2004] in respect of which ITW was not paid for goods it supplied". He explained the "negative situation" as being represented by the difference ITW had to pay for the goods purchased in the UK (i.e. with VAT) and the price it received on their sale, either to a company in another Member State or outside the European Union (i.e. without VAT). ITW therefore sought other companies to export to customers on its behalf. Pexum agreed to assist in that process. It began trading with ITW in July 2004, their first deal taking place on 8 July.

[15] Mr Auletta claimed to have become aware through Evergreen that Best Concord wished to purchase stock both from ITW and from Pexum. As a result of its funding problems, he further claimed that ITW was not in position to export goods to Best Concord. Consequently, he said he approached Pexum "to see if it could export

goods to Best Concord on ITW's behalf", confident that Pexum would not "steal" ITW's customer by cutting it out of the supply chain.

[16] Essentially, we were told, the oral agreement reached between ITW and Pexum, which incidentally contradicted ITW's written terms and conditions of trade, provided for ITW to supply goods to Pexum, and for Pexum to supply them onward to Best Concord, payment only becoming due from Pexum to ITW on Pexum being paid by Best Concord. The goods were to be supplied at "market prices"; there were no special deals or discounts. From the documentary evidence before us, we are satisfied that the payment arrangements explained by Mr Auletta were in fact implemented. In Mr Auletta's evidence there were no indications of how or when ITW paid for the goods it bought, or from whom it made purchases. In the absence of any such indications, we are not satisfied that its purchases were genuine. Neither ITW nor Pexum ever carried out any checks on Best Concord, both apparently considering themselves at no commercial risk in dealing with it.

[17] We were told that when Best Concord wished to purchase stock it placed a purchase order with Pexum, having previously ascertained from ITW what stock was available on the market. Once Pexum received the purchase order, it would contact ITW and check the market price of the products required. ITW would report to Pexum, and Pexum would submit its purchase order to ITW. Having ascertained the availability of the required goods in the market, ITW would then send a pro-forma invoice for Pexum to sign confirming that ITW was to purchase the stock. We find that Pexum never came into physical possession of or itself inspected the goods, nor did ITW; and on Pexum supplying them to Best Concord, they were carried by air from the UK to Hong Kong by FedEx Corporation ("FedEx"), the world's largest express transportation company. In all the deals, other than numbers 26 and 31, the documents show that some or all of the goods were dispatched to Best Concord at an address other than that to which the associated documents were addressed. We accept that the documentation relating to each deal was as described to us, but not that it correctly identified the goods in fact consigned to Best Concord."

50. On the personal recommendation of Mr Auletta of ITW, Pexum used a freight forwarder called Allways:

"[18] When Pexum first commenced trading with ITW, on the instructions of ITW it used a company called Hawk as freight forwarder. Pexum was unhappy with that choice as Hawk was unable to carry out open box tests and chip tests. (A chip test involves a chip being inserted into a CPU tester to ensure that it is fully functioning). Consequently, Mr Auletta suggested that Allways be substituted for Hawk. He said he did so because he knew Allways' directors; it had a secure bonded warehouse; and ITW's suppliers' stock was always held by Allways. Pexum agreed, and we find that all the transactions the subject of this appeal involved Allways as freight forwarder. We also find that throughout Pexum's "ownership" of goods purchased from ITW for onward sale to Best Concord they were held by Allways; Pexum never inspected the goods, nor did ITW."

51. The VAT Tribunal describes (at [20] to [25]) how Mr Brown visited what purported to be Allways' warehouse but the visit was a trick, in that the premises belonged to a third party; it appeared that in fact Allways operated out of the house of one its directors. The VAT Tribunal concluded:

> "[28] We find that Allways had no "secure bonded warehouse"; indeed it had no warehouse. We were provided with a number of documents, including photographs said to have been the results of checks by Allways of goods the subject of Pexum's deals with ITW and Kwik Move. Against the background of facts we have found about Allways, we are unable to accept any of them as the true results of checks carried out by Allways, if indeed any checks were carried out by that company. We agree with Mr Anderson [counsel for HMRC] that Allways' inspection reports to Pexum were "entirely fictitious", so that we place no reliance whatever on any of them. Nor are we prepared to rely on any other documents prepared or completed by ITW for Pexum. We consider the facts we have found about Allways to speak for themselves. None of the documents prepared by Allways can be relied upon to establish the true nature of the goods supplied by Pexum."

52. We acknowledge that the VAT Tribunal based its decision on the invalidity of records, rather than on *Kittel* grounds. Also, that the VAT Tribunal decision was not issued until March 2007, which was after the Disputed Transactions. However, we are satisfied that by the time of the Disputed Transactions Mr Gibson and Mr Brown were fully aware of MTIC fraud, had actually been involved in a fraud themselves, and stood to be £1.5 million out-of-pocket.

Market knowledge

53. We are not satisfied that either Mr Gibson or Mr Brown had any genuine knowledge of the market for CPUs or the constituent goods. Mr Brown was clear that he relied on the knowledge of Mr Gibson. Mr Brown said he had no knowledge of the workings of the grey market for CPUs – he was aware of what a grey market involved because there was apparently one in batteries, where he had an earlier commercial involvement. Mr Brown said he had no knowledge of the particular types of CPUs or how they were traded. He repeatedly stated that he relied on Mr Gibson's expertise in the CPU market, and he repeatedly deflected questions of detail towards Mr Gibson.

54. However, when Mr Gibson was questioned on his knowledge of the market and the goods he too fell far short of any demonstration of competence, let alone expertise. We have made allowances for the fact that Mr Gibson was being questioned on events that happened several years before the hearing; also, that he described himself as a dealer rather than a technologist. Even having granted those allowances, we are not satisfied that he had any genuine knowledge of the market for CPUs or the constituent goods. To cite two important instances:

> (1) Mr Gibson had no real product knowledge on the specifications of the Intel CPUs that Pelix traded by the thousand. He admitted having no knowledge of basic information that, we consider, would be essential for even a non-expert to have in order to be able to effectively participate in a legitimate

market for technological goods, such as "bus speed" or "cache" of the CPUs. For example, we had the unchallenged expert evidence of Dr Findlay that one of the chips involved in the Disputed Transactions (an Intel SL7Z9) was never produced with a 1MB cache, as stated on the deal documentation. Mr Gibson accepted that he had no knowledge whether that was correct but maintained that he could deal in the goods without that basic knowledge. We do not consider it credible that a legitimate trader could survive in a genuine, competitive market for technological products without at least knowing the basic specifications of the products involved. We conclude that this lack of knowledge did not matter to Pelix because its deals were not legitimate commercial transactions, but instead just steps in the orchestrated VAT frauds.

(2) Mr Gibson was apparently unaware of the difference between trays of CPUs and retail boxed products (for example, the latter have a cooling fan attached). Again, we do not consider it credible that a legitimate trader could participate in a genuine market if he could not be sure whether he was buying/selling trays or retail boxes – he would be in constant danger of buying one description from his supplier when his customer really wanted the other description. Again, we conclude that this lack of knowledge did not matter to Pelix because its deals were not legitimate commercial transactions, but instead just predetermined steps in the orchestrated VAT frauds.

Continued trading with untrustworthy persons

55. We have gone into some detail above on the problems encountered by Pexum because, as well as showing the awareness of Mr Gibson and Mr Brown of the existence of fraudsters in the grey market, the persons who cheated Pexum reappear later in the trading activities of Mr Gibson and Mr Brown. We consider one instance is particularly important. It is clear that the freight forwarder Allways was deceitful; Mr Brown accepted that in his evidence. That would have been obvious to Pelix before the Disputed Transactions, and should have been obvious no later than October 2005 (when all the evidence was concluded in Pexum's VAT Tribunal appeal). That deceit cost Pexum and its owners some £1.5 million. However, the due diligence reports prepared by CTM in relation to Multisystems in January 2006 and March 2006 identify that Multisystems used Allways as a freight forwarder – a fact that would cause a legitimate trader who had already been "burned" once to walk away from any further involvement – but instead Pelix decided to trade with Multisystems (Deals 2 & 8). Mr Brown stated that, despite his frequent emphasis of the rigour, depth and thoroughness of Pelix's due diligence, he had not read that content but instead had relied on CTM's conclusion that Multisystems was a suitable trading partner. Having carefully considered all the evidence together, we do not accept that this was an innocent oversight; Multisystems was one of the players in the frauds involving the Disputed Transactions and it was important for the execution of the frauds that Pelix should be able to contract with that company, so it deliberately chose to go ahead in circumstances where a legitimate trader would have simply refused to do any business.

56. We record that HMRC also put forward evidence that Mr Brown and Mr Gibson – through PGT – had continued to deal with ITW (one of Pexum's suppliers) whose proprietor Mr Auletta persuaded Pexum to use Allways as freight forwarder (switching from a company called Hawk) because he knew the directors of Allways –

see [50] above. Also, that a company involved in Deals 6 & 7 (21st Trading Limited) was controlled by the same person (Mr Al Hasani) who was behind Pexum's other supplier, Kwik Move. HMRC submitted that legitimate traders would not choose to continue their business relationships with anyone close to the events that led to Pexum being defrauded. Having carefully considered all that evidence and the responses of Mr Brown and Mr Gibson we have decided not to draw any conclusions adverse to Pelix from that evidence; we feel that, on balance, there is too much uncertainty as to timing and detail of knowledge for us to conclude confidently that the untrustworthiness of Mr Auletta and Mr Al Hasani, and their continued involvement, would have been clear to Pelix before the Disputed Transactions.

Warnings in due diligence ignored

57. We are conscious of Moses LJ's warning in *Mobilx* (at [82]) of the dangers of unduly focusing on the due diligence conducted by a trader on its suppliers and customers:

> "… tribunals should not unduly focus on the question whether a trader has acted with due diligence. Even if a trader has asked appropriate questions, he is not entitled to ignore the circumstances in which his transactions take place if the only reasonable explanation for them is that his transactions have been or will be connected to fraud. The danger in focussing on the question of due diligence is that it may deflect a tribunal from asking the essential question posed in *Kittel*, namely, whether the trader should have known that by his purchase he was taking part in a transaction connected with fraudulent evasion of VAT. The circumstances may well establish that he was."

58. We concentrate on instances where, in our view, the answers Pelix received to "appropriate questions" should have alerted a legitimate trader to the existence of fraud but Pelix ignored those warnings, or where Pelix traded without having any answers. As referred to at [34(1)] above, Pelix employed Controlled Tax Management Limited ("CTM"), the proprietor of which was Mr Liban Ahmed, to carry out some of the due diligence checks made by Pelix on its trading counterparties.

(1) CTM visited Culmain Limited (supplier on Deals 3 & 5) in January 2006 – the company secretary denied any knowledge of HMRC Public Notice 726 and refused access to any deal documentation or details of due diligence he had performed. CTM again visited Culmain in March 2006 – this time CTM were shown two deal files but were again refused access to any details of due diligence; CTM took some photographs of the company's offices. Culmain told CTM that its turnover was £20 million per month – ie an annualised turnover approaching a quarter of a billion pounds. CTM reported all this back to Pelix, who decided to trade with Culmain.

(2) Tradex (supplier on Deal 9) told CTM that its turnover was £20 million per month – ie an annualised turnover approaching a quarter of a billion pounds. CTM reported this back to Pelix, who decided to trade with Tradex.

(3) CTM's due diligence report on ASAP Trading (customer on Deal 5) was obtained by Pelix only after the date of the transaction.

(4) CTM's due diligence on Incoparts (customer on Deal 2) was performed only after Pelix had entered into trades with the company.

(5) Pelix authorised the shipment of goods with value in excess of £500,000 to High Level Trading (customer in Deal 8) despite identity documentation for the customer being produced only the previous day (and so not realistically checked) and a trading application form arriving after the goods had been authorised for despatch.

(6) The Global Asset Management check on CEMSA (customer on Deal 9) stated that the company was not listed on Spanish or European databases. The CTM due diligence report was not received until after the date of the transaction (value £1.3 million) and revealed that CTM had been refused access to any trading details, and that the company claimed turnover of €100 million per month - ie an annualised turnover of approximately one billion pounds sterling.

(7) CTM visited Text (supplier on Deal 1) in February 2006 and reported back that Pelix should not trade with Text. CTM revisited Text in the following month and found the proprietor without a permanent office and no telephone line, operating from a wine bar, unable to produce for examination any due diligence paperwork, and stating he had no knowledge of HMRC Public Notice 726. He stated that the company's turnover was £50 million per month – ie an annualised turnover exceeding half a billion pounds. CTM made a further visit at the end of March. CTM reported all this back to Pelix, who decided to trade with Text. There was some discrepancy in the evidence as to whether CTM stated to Pelix that in CTM's view it was in order to trade with Text; we do not need to explore that point further because of our comments in [59] below concerning Pelix's responsibility for decisions on whether to trade.

59. HMRC chose not to ask questions of Mr Ahmed challenging the quality of the due diligence he performed, and thus Mr Ahmed did not have an opportunity to explain or justify his work. We will confine ourselves to the single observation that no matter how good or bad the work performed by CTM, and whatever conclusion or recommendation was made by CTM, the decision whether or not to trade with the subject of the CTM report was always and solely that of Pelix.

60. We need to deal with one discrepancy in the evidence. Pelix contended that Ms Walkerdine "praised" the company's due diligence procedures. Ms Walkerdine's evidence was that she would have followed her invariable practice of not commenting to taxpayers on the adequacy of their books and records. CTM's own note of a meeting on 19 June 2006 records:

> "[Mr Ahmed] invited [Ms Walkerdine] to comment on the PGT and Pelix due diligence procedures. [Ms Walkerdine] declined to comment on the due diligence stating that, "It would be more than my jobs worth". [Mr Ahmed] sympathised with [Ms Walkerdine's] position, but stated that some VAT Officers had elected to comment on due diligence procedures. [Ms Walkerdine] elected to maintain her original position."

Further, in a letter dated 17 August 2006 from Ms Walkerdine to Pelix's solicitors she stated, "I have advised the company that I cannot comment on the due diligence

checks and have referred to Notice 726." We find that HMRC did not praise Pelix's due diligence procedures.

61. Part of the due diligence was said to be the obtaining of credit checks on counterparties. We deal with those separately below (at [72-74]) and our findings reinforce our conclusions below.

62. Taking all the above instances in the round, the picture we form is that Pelix on numerous occasions chose to trade with persons that a legitimate trader would avoid at all costs. The due diligence was an elaborate cosmetic exercise designed to provide a picture of a conscientious business carefully operating in an area known to carry high risk of fraud, when in fact Pelix deliberately chose to ignore obvious warnings because it intended all along to participate in certain deals with those persons.

Warnings from freight forwarders ignored

63. We consider that any legitimate trader in technological goods such as Intel CPUs would be keen to ascertain that the goods were:

(1) of the exact specification as contracted for;

(2) in the exact quantities contracted for;

(3) so far as could be reasonably ascertained, in good working order; and

(4) in good saleable condition.

64. Given the past experience of Mr Brown and Mr Gibson with Pexum, where they lost a large amount of money on a fraud involving non-existent goods and fictitious inspection reports, we consider they would be especially vigilant in relation to the checks performed on the goods they were trading. As Pelix never took physical delivery of goods to its own premises, it was reliant on its freight forwarder agents to perform those important tasks on its behalf at the agents' warehouses.

65. Mr Brown's evidence was that Pelix's freight forwarders would conduct a professional examination of the goods on Pelix's behalf which involved:

(1) generally X-raying the boxes (his first witness statement said that *all* boxes were X-rayed but his second witness statement says *generally*);

(2) opening every box;

(3) electronically testing at least one CPU from each tray;

(4) listing the box numbers on the inspection report; and

(5) giving on the inspection report a report of their findings.

66. Mr Brown stated that he would scrutinise every inspection report. He also said that Mr Gibson would look at the inspection reports but Mr Gibson said he did not look at them.

67. However, there were a number of anomalies on the inspection reports that were either not spotted or ignored by Pelix. We consider that, taken together, these instances are convincing evidence that Pelix was not a legitimate trader. We

concentrate below on the instances on which we have placed particular weight in reaching our conclusion.

(1) From the copy documents presented in evidence, we cannot see that any of the goods in any of the deals were X-rayed. If the goods had been electronically tested then that may not have been too serious an omission (although it does run counter to Mr Brown's evidence) but on Deal 2 there was no electronic testing, the explanation being that the goods were packaged in retail boxes that would be rendered unsaleable by being opened - we concur with the statement on the inspection report: "No guarantee can be given that the contents are as stated on the outside of the box."

(2) On Deal 4:

(a) The inspection report was not received by Pelix until three days after the goods had already left the UK – obviously, Pelix had no comfort before selling the goods that it held the correct stock.

(b) The inspection report listed the CPUs as having a 1MB cache, whereas the specification ordered by Pelix was for 2MB CPUs – so the goods were of a different (and inferior) specification. Further, Dr Findlay's evidence was that Intel never manufactured a 1MB SL7Z9 chip – so the goods as described could not have existed. We also note that Pelix's customer (Allcom APS) was apparently unconcerned by any of this.

(c) The inspection report stated that the CPUs had not been subject to any form of testing – contrary to Mr Brown's understanding that at least one CPU from each tray would be electronically tested.

(3) On Deal 9 Pelix instructed (by a fax dated 1 June 2006) the freight forwarder (1st Freight) to conduct an open box inspection, electronically test one chip per tray, and take photographs of the boxes. From the inspection report it appears that no photographs were taken, despite Pelix's express instruction. HMRC also submitted that the testing purported to be done by 1st Freight was impossible, given the timing of the movement of the goods; we do not feel we have sufficient evidence on that matter to reach a conclusion on that point.

(4) On Deal 3 the inspection report was not received by Pelix until several hours after Pelix had already instructed the freight forwarder to ship out the goods – although the time gap was not as extreme as in Deal 4 (above), again Pelix had no comfort before selling the goods that it held the correct stock.

(5) There was no evidence of electronic testing on several of the deals involving trays of CPUs (as opposed to retail boxed CPUs) which, given the Pexum experience, was something Mr Brown should have identified and challenged with the freight forwarders.

(6) The inspection reports for several of the deals (Deals 3, 5, 6, 7 and 8) clearly reported damaged trays. On Deals 6 & 7 Admicro's purchase orders stated as a term, "Product must be original package, full label, unmarked and undamaged." Even if a customer did not specify that term, no legitimate purchaser would tolerate damaged goods. We simply do not accept Mr Brown's attempted explanations for why this did not concern him. A legitimate trader

would certainly be concerned because he would be alerted that he may be in a position where he could not honour his commitments to his customers, or face quality control complaints from those customers. We note that there were other instances where the *boxes* were reported damaged but we have decided not to place any weight on those as it could be that a legitimate trader would be prepared to accept scuffed or marked external cartons provided the trays inside were perfect.

68. Mr Brown's evidence concerning the inspection reports was confused. We have made allowances for the fact that Mr Brown was being questioned on documents relating to events that happened several years before the hearing. Even making that allowance we did not find his description of the documents and the use made of them to be convincing. We conclude from the evidence that it is clear that what the freight forwarders were doing is to inspect goods when they first arrived at their warehouse but then as the same goods were traded between the parties in the chain (including the broker, Pelix) they did not bother to re-inspect the same goods – after all, the boxes had not moved from their warehouse floor. Instead the forwarder copied the previous inspection report and amended details as necessary; in particular they redacted information about parties earlier in the chain – perhaps for legitimate reasons of customer confidentiality, or perhaps for more nefarious reasons. They also did something similar if consignments were broken into smaller lots for onward sale – redacting the box numbers of the goods that were not being onsold and then reusing the same inspection report. Even if (which HMRC would strongly dispute) the freight forwarder was acting legitimately and merely cutting corners to avoid unnecessary work, the resulting inspection reports should be unsatisfactory and unacceptable to a legitimate trader – especially one who had previous experience of being defrauded by a dishonest forwarder, as had Mr Brown. When questioned on the reports by Mr Hall for HMRC, Mr Brown had no adequate explanation of why several inspection reports had been redacted and/or carried inappropriate dates; indeed Mr Brown continued to maintain that the reports were "unique" and prepared specifically for Pelix.

69. We conclude that the real reason why none of this mattered to Pelix was because it was aware that the goods were just a means to the VAT fraud end, and no one was ever really going to use the CPUs for any legitimate commercial purpose.

Inadequate Insurance

70. There were several contradictions in Mr Brown's evidence concerning the detail of Pelix's insurance arrangements as between his various witness statements and his oral evidence. There were also gaps in the insurance documentation provided by Pelix for the hearing. We do not place great weight on those matters in themselves, as the evidence was compiled some years after the Disputed Transactions. What we do consider important is that in several of the deals (certainly Deals 4 & 9) goods valued at seven figure amounts were shipped internationally without adequate insurance being in place. We understand that Mr Brown eventually accepted that was the case, but for the avoidance of doubt we make such a finding of fact.

71. We are not satisfied that this was an innocent (or even negligent) oversight in a busy commercial environment. One of the major concerns of any legitimate broker would be to ensure that its valuable stock being loaded and unloaded between various

forms of transport and shipped across borders was at all times adequately insured against damage or theft; it is a prime business function of any exporter because of the obvious, real risks. The number of transactions effected by Pelix was small enough for individual attention to be paid to this issue on every transaction, and a legitimate broker would have taken great care to do so. We conclude that in fact the insurance shortcomings were of no concern to Mr Brown and Mr Gibson because they knew there was no real commercial risk involved in the shipment of the goods – as with the lack of concern over damaged trays, none of this mattered to Pelix was because it was aware that the goods were just a means to the VAT fraud end, and no one was ever really going to use the CPUs for any legitimate commercial purpose.

Credit risk

72. We have already commented above on Pelix ignoring warnings flagged by its own due diligence. Part of the due diligence was said to be the obtaining of credit checks on counterparties. Quite apart from the due diligence function, credit checks on customers who are based abroad and are not known to the trader are, of course, an important financial precaution for any legitimate business. Such a business would be anxious to ascertain that it was contracting with an entity that could be expected to honour its commitments. As the Tribunal in *Calltell Telecom Ltd & Opto Telelinks (Europe) Limited* (2007) V20266 put it (at [164]):

> "A trader in a legitimate market trading in goods worth millions of pounds would not deal with others without first satisfying himself that his suppliers could supply what they contracted to supply, and that his purchasers could pay for what they had agreed to purchase. It is not enough, in our judgment, to contend that goods would not be paid for until they had been inspected, nor handed over until paid for. In a genuine market, traders dependent, as the Appellants were, on payment by their purchasers in order that they could themselves pay their suppliers would not commit themselves to a purchase without near certainty that the purchaser would pay, and would not commit themselves to a sale without near certainty that their own supplier was in a position to deliver. Here, neither their due diligence nor their contractual conditions provided the Appellants with any true assurance that, assuming they were genuine, arm's length deals, they would be honoured by their counterparties. Instead, they were exposed to the risk that they would be left with goods for which their purchasers could not pay, or that they would be unable to fulfil orders from their customers."

73. Pelix's credit checks on its suppliers were flawed but we concentrate here on its credit checks on its customers. On almost every one of the customers in the Disputed Transactions Pelix either failed to make any check or ignored warnings flagged by the checks it did perform.

(1) Pelix entered into a trade with Double V (purchaser on Deal 1) to the value of £131,000 without making any credit check on them.

(2) Although Pelix did obtain a credit check on Incoparts (purchaser on Deal 2), that was done only after the companies had entered into trades.

(3) Pelix traded with Mashall (purchaser on Deal 3) prior to obtaining (over one month later) a credit report; when the credit report was obtained it reported that the company was not known.

(4) Pelix traded with Allcom (purchaser on Deal 4) without making any credit check on them.

(5) Pelix traded with ASAP Trading (purchaser on Deal 5) without making any credit check on them.

(6) Pelix traded with Admicro (purchaser on Deals 6 & 7) without making any credit check on them.

(7) The Global Asset Management check on CEMSA (purchaser on Deal 9) stated that the company was not listed on Spanish or European databases.

74. We are satisfied that the true explanation for Pelix's indifference to the commercial status of its customers was because it was aware that the trades were contrived and merely a way of moving funds around as part of a VAT fraud.

No meaningful negotiations

75. There was a complete absence of any evidence showing how Pelix – that is, Mr Gibson – negotiated transactions. That is surprising, given that the deals were purportedly negotiated individually in an open market. Mr Gibson's evidence referred to faxes and emails (as well as telephone calls) being used in the negotiations. The explanation from Mr Brown and Mr Gibson was that all notes and correspondence had been destroyed. Given the subject matter of the trades and the contents of Notice 726 we would have expected some form of record showing how the pricing (and other relevant terms) had been arrived at would have been retained as part of the documentation which might be required to be produced to HMRC after the event.

76. Taken together with the other factors we have described, we are satisfied that there was no meaningful negotiation with either suppliers or customers because Pelix was handed both sides of the trade and allowed to take a fee (which may well have been the subject of haggling by Pelix) for acting as broker on the chain.

Funding

77. Pelix took a loan from Associate Investments Limited (AIL). Having carefully considered all the evidence we are satisfied that there was no commerciality to the funding provided by AIL to Pelix.

(1) Pelix was a poor prospect as a borrower. It had no assets and its cash flow and profitability were entirely dependent on receipt of VAT refunds from HMRC. No security could be offered by Pelix and no personal guarantees were provided by Mr Gibson or Mr Brown. No convincing explanation was given for why any commercial lender would advance significant finance in those circumstances, other than that the terms of the loans gave a significant return to the lender (the AIL loan carried interest expressed as 6% pa plus 50% of gross profits of the borrower).

(2) HMRC advanced convincing evidence that AIL also loaned monies to a number of other companies who had been denied VAT refunds on *Kittel* grounds. The terms of the loans were similar to those for Pelix. We acknowledge that Pelix was not in a position to challenge that evidence and also we do not draw any conclusions about whether Pelix was aware of those other loans. However, we do consider that the evidence of AIL's activities and the other activities of its proprietor (Mr Horlock) demonstrate an attempt to prop up a number of brokers with a view to facilitating their continued involvement in MTIC fraud. Pelix was one of those brokers.

78. HMRC advanced evidence concerning the funding of PGT, another company owned by Mr Gibson and Mr Brown. There were several conflicts between the evidence of Mr Brown, Mr Gibson and Mr Ahmed on this matter, and we have concluded that both Mr Gibson and Mr Brown were not straightforward in their answers to Mr Hall under cross-examination. We are satisfied that Vortech Limited who provided funding to PGT was an actual or potential competitor of PGT (and Pelix). Rather than providing a financial lifeline to PGT, one would expect Vortech to benefit from the removal from the market of a competitor. Further, PGT should have been wary of accepting finance from a person who was in commercial competition with it. The explanations provided by Mr Gibson and Mr Brown were convenient rather than truthful. The true position was the same as with AIL's funding of Pelix – there was no commerciality to the loan and the purpose of the funding was to ensure a broker had sufficient liquidity to continue to participate in CPU trading for Vortech's own benefit.

The orchestration of the transactions

79. The deal chain analysis undertaken by HMRC was a meticulous piece of detective work involving (at a rough count) over 60 companies based in 18 countries around the world. We have borne in mind that the analysis is the result of lengthy, painstaking and expert work conducted over several years. Much of that work was not particular to the current appeal – many of the companies under scrutiny by HMRC feature in transactions of interest to HMRC in connection with VAT disputes with other traders. Mr Hynes for Pelix correctly cautions us against assuming that matters which now appear evident from the deal chain analysis would or could have been apparent to Pelix back in early 2006. HMRC advanced convincing evidence as to the circularity of trading of many of the goods involved in the Disputed Transactions, and also the circularity of monies (mainly going through FCIB) on several of the Disputed Transactions. Mr Hynes for Pelix submitted that his client was not in a position to challenge any of that evidence as it had been unaware of any of those details, which had only been uncovered by lengthy and detailed investigation by HMRC. Mr Hynes also urged the Tribunal to again be cautious about applying hindsight to the circumstances of the Disputed Transactions – what mattered was what Pelix knew or should have known at the time off those deals.

80. Having considered all the evidence carefully and in considerable detail, we are satisfied that it would be impossible to have these closed circuits of funds (involving large sums being transferred rapidly and consecutively between apparently unconnected parties) unless there was orchestration with each party being told who to buy from, who to sell to, and at what price. We agree with HMRC that the

orchestration of the funds circularity would be impossible without the knowing complicity of the broker – ie Pelix.

81. Our conclusions after considering the evidence are clear. Movement of both goods and funds was stage managed down to the hour – everyone in the chain, including the broker, must have been aware of the plan and played their part in it. The involvement of an innocent broker who had not been instructed as to seller, buyer and price would at best prejudice the chain and, in fact, make it unworkable. If a bona fide broker chose to sell to a nondesignated person then the goods would leave the circuit and so not be available for continued circularity. If a bona fide broker chose to buy from a nondesignated person then the designated seller would be left without a customer (and potentially unsellable goods) and thus the funds circularity would be broken resulting also in the designated customer being without funds to pay the broker. If a bona fide broker chose to negotiate the price (other than haggling its "fee" for participating in the fraud) then the "wrong" amount of funds would arise and, again, the funds circularity would be broken. Any actions by a bona fide broker in legitimately arranging transactions would destroy the intricate and necessary timing of the chain and defeat the circularity of the funds.

82. We do not suggest that Pelix would have been privy to every detail contained in HMRC's extensive charts, flow diagrams and financial analyses describing the Disputed Transactions. Indeed, the major players behind the frauds would be unlikely to trust that information to a single broker. Rather, we are confident that when playing its important part in the frauds Pelix was aware that it was doing just that and was a willing participator.

Other matters

83. We deal here with a number of matters put to us by Mr Hall for HMRC which we have, for the reasons stated below, decided not to place weight upon in reaching our above conclusion of actual knowledge of connection with fraud.

(1) *Sharing of the "profits" in the chain of transactions* - HMRC submit that the pricing between the parties in a typical chain confers a small (probably, uncommercially small) profit on every participant other than the broker; they suggest that is because it is the broker who bears the biggest risk of being out of funds if the transaction is challenged by HMRC. We agree but consider it is a situation that could apply to an honest broker – the honest broker would be interested in their own profit margin but would not have knowledge about that of their supplier (or earlier participants in the chain).

(2) *The size of the "grey market" for CPUs* – HMRC cite the expert evidence of Dr Findlay that the total grey market in the export from the UK of Intel CPUs for 2006 was £1.4m by value, and submit that as in three months of that year Pelix claims to have exported Intel CPUs worth £4.89m as part of the grey market, Pelix cannot have been operating in the legitimate grey market; also that the explanation for Pelix's sales being so far in excess of the available market is that the CPUs in which it traded were being circulated time and time again in transactions contrived for the purpose of facilitating the fraudulent evasion of VAT. We accept Dr Findlay's evidence but we also acknowledge the point made by Mr Hynes during his cross-examination that much of the information

used by Dr Findlay to estimate the grey market data would be unlikely to have been available to a trader (or at least, a small-scale trader) in early 2006. We are, again, careful not to attribute to Pelix in early 2006 knowledge of facts that, with the benefit of hindsight, now appear clear. We agree with HMRC that Pelix's trades were not within the legitimate grey market – that follows also from our other findings. We also agree that a single small broker achieving annualised export turnover of around £20 million should have had cause to ponder just how large the total market was, and how it could be sustained legitimately. However, we do not consider we should draw the conclusion that Pelix must have been aware of the true size of the legitimate grey market. Because of our findings as to actual knowledge of fraud, that is not material to our decision.

(3) *Dealing below market price* – HMRC submit that significant trades in Intel CPUs at prices which HMRC estimate at being around 15% to 24% below Intel's wholesale prices could not be legitimate or, at least, should have prompted Pelix to conclude the trading was not legitimate. We consider it follows from Dr Findlay's evidence that there was a legitimate grey market in Intel CPUs and the goods could be acquired at discounted prices. As already stated, we do not consider we should draw the conclusion that Pelix must have been aware of the true size of the legitimate grey market. For that reason we do not place weight on this submission. Again, we do consider that a small broker securing significant trading volume in a market apparently sustaining a large number of traders should have had cause to ponder just how large the total market was, and how it could be sustained legitimately.

(4) *"Sham" Redhill validation check applications* – Pelix undertook a large number of Redhill validations – that is, verifications with HMRC of the VAT registration numbers (VRNs) of potential counterparties. Mr Hall for HMRC submitted that this was a deliberate "campaign of disruption" – to quote from his closing submissions, "Pelix swamped the Redhill office with enormous requests for verification amounting to up to 74 pages at a time. … it sent voluminous requests for verification to Redhill for no commercial purpose whatsoever. … the company's actions in attempting to swamp the Redhill office with reams of faxes betray a darker purpose, that of disrupting HMRC's attempt to verify VRNs for those companies that were actually trading." On the evidence available to us, we do not consider that point proven to our satisfaction and, accordingly, we have placed no weight on it in our determinations.

(5) *Third party payment* – On Deal 1 Pelix paid the purchase consideration not to its seller Text but instead, at Text's direction, to a third party (Voltrex Limited). HMRC submit that third party payments are a hallmark of MTIC fraud, as one means of obfuscating the origin and destination of funds flows. Pelix's explanation is that it knew Voltrex to be a FSA regulated foreign currency exchange house, and took it to be acting for Text. Having carefully considered the relevant documentation we have decided not to place weight on the fact of this particular third party payment. However, we record that we do not accept Mr Brown's evidence that he discussed the payment with Ms Walkerdine before making it.

Consideration and Conclusions on Knowledge

84. HMRC accept that the burden of proof in this type of case lies on them. We consider that the standard of proof to be achieved is that of the balance of probabilities. In reaching our conclusion we have viewed the picture formed by all the relevant factors taken together – as advocated by Christopher Clarke J and approved by Moses LJ (see the statement at [31] above).

85. In all the circumstances and for the above reasons HMRC have satisfied us on the balance of probabilities and on the basis of cogent evidence that Pelix knew that all the Disputed Transactions were connected with VAT fraud.

Decision

86. The appeal is DISMISSED.

Costs

87. By Tribunal Directions issued on 11 August 2010 it was directed that "Rule 29 of the Value Added Tax Tribunal Rules [ie reg 29 (awards and directions as to costs) of the VAT Tribunals Rules 1986 (SI 1986/590)] shall apply". In his closing submissions Mr Hall for HMRC applied for an award of costs.

88. The Tribunal ORDERS that the Appellant pays the Respondents' costs of the appeal on the standard basis, the amount unless agreed to be taxed by a Costs Judge of the Senior Courts.

Onward Appeal

89. 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.

PETER KEMPSTER
TRIBUNAL JUDGE

RELEASE DATE: 23 August 2013