# TC03616

**Appeal number: TC/2010/06495 & TC/2010/06596**

***SUMMARY JUDGMENT – Application by Appellant in respect of an appeal against a penalty issued under section 61 VATA 1994 – whether Respondent's case has no reasonable prospect of succeeding – application refused.***

**FIRST-TIER TRIBUNAL**
**TAX CHAMBER**

**UMAAD BUTT** **Appellant**

**- and -**

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

**TRIBUNAL: JUDGE JENNIFER BLEWITT**

**Sitting in public at Manchester on 14 May 2014**

**Mr Rory Mullen leading Ms Harriet Brown, Counsel for the Appellant**

**Mr Jeremy Benson QC leading Ms Karen Robinson, Counsel instructed by HM Revenue and Customs, for the Respondents**

## DECISION

### Introduction

1. This is an application made by the Appellant for summary judgment against HMRC in respect of a penalty issued on 29 March 2010 under section 61 Value Added Tax Act ("VATA") 1994.

2. Prior to the hearing I was provided with the Appellant's written application dated 17 December 2013 and skeleton argument dated 6 May 2014. HMRC provided a written response to the application dated 17 January 2014 and skeleton argument received on 12 May 2014. I was also provided with 4 bundles containing, in the main, the relevant legislation and authorities.

### The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 ("the Rules")

3. Rule 8 (3) (c) provides that the Tribunal may strike out *"the whole or a part of the proceedings if…the Tribunal considers there is no reasonable prospect of the appellant's case, or part of it, succeeding."*

4. Under Rule 8 (7) the Tribunal's powers under Rule 8 (3) apply to the respondent as it applies to an appellant, save that *"a reference to the striking out of the proceedings must be read as a reference to the barring of the respondent from taking further part in the proceedings."*

5. Rule 8 (8) provides as follows:

*"If a respondent has been barred from taking further part in proceedings under this rule and that bar has not been lifted, the Tribunal need not consider any response or other submissions made by that respondent, and may summarily determine any or all issues against that respondent."*

### Background Facts

6. The Statement of Case dated 6 May 2011 sets out in detail the background to the disputed decision, the legislation applicable and issues in the case. In essence HMRC imposed a penalty on the Appellant on 29 March 2010 pursuant to section 61 VATA 1994. The penalty was imposed by reference to the Appellant's conduct as a director of Waterfire Ltd ("Waterfire") which HMRC allege rendered itself liable to a penalty pursuant to section 60 (1) VATA 1994 on the basis that it had entered into various transactions and rendered VAT returns for the purpose of evading VAT. In particular the company made claims to input tax credit when it knew that the underlying transactions were connected with fraud, thereby seeking to evade £6,972,184 in VAT period 04/06. HMRC contend that the conduct giving rise to Waterfire's liability to a penalty was wholly, or in part attributable to the conduct of Mr Butt as a director and 50% shareholder of the company.

7. HMRC allege that Waterfire, through Mr Butt as a director, deliberately and artificially constructed its trading in such a way as to enable what would otherwise give rise to large claims for repayment from HMRC to be offset and made by other companies acting as brokers. It is contended that Waterfire knowingly acted as a contra trader in VAT periods 04/06 and 07/06 as part of a scheme to defraud the public revenue.

8. The issues identified by HMRC as those to be determined by the Tribunal at the substantive hearing which is listed for 16 to 27 June 2014 can be summarised as follows:

(i) Whether the transactions entered into by Waterfire in 04/06 and 07/06 were part of an overall scheme to defraud the public revenue;

(ii) Whether Waterfire, through the Appellant, knew that its transactions were connected to fraud;

(iii) Whether, by entering into its transactions in period 04/06 and making its VAT return for that period on the basis of those transactions, Waterfire was doing acts for the purpose of evading VAT;

(iv) Whether Waterfire, through the Appellant, knew that its transactions in period 04/06 were connected with fraud and its conduct was thereby dishonest;

(v) Whether, in the circumstances set out at 8 (i) – (iv) above, Waterfire was liable to a penalty pursuant to section 60 VATA 1994;

(vi) Whether the VAT sought to be evaded by Waterfire was the amount of the input tax credit claimed by it in its VAT return for 04/06, namely £6,972,184;

(vii) Whether the conduct of Waterfire was wholly or in part attributable to the dishonesty of the Appellant; and

(viii) Whether the quantum of the penalty should be reduced.

**Legislation**

9. Section 60 VATA 1994 provides as follows:

*(1) In any case where-*

*(a) for the purpose of evading VAT, a person does any act or omits to take any action, and*
*(b) his conduct involves dishonesty (whether or not it is such as to give rise to criminal liability),*

*he shall be liable, subject to subsection (6) below, to a penalty equal to the amount of*

*VAT evaded or, as the case may be, sought to be evaded, by his conduct.*

*(2) The reference in subsection (1)(a) above to evading VAT includes a reference to obtaining any of the following sums-*

*(a) a refund under any regulations made by virtue of section 13(5);*
*(b) a VAT credit;*
*(c) a refund under section 35, 36 or 40 of this Act or section 22 of the 1983 Act; and*
*(d) a repayment under section 39,*

*in circumstances where the person concerned is not entitled to that sum.*

*(3) The reference in subsection (1) above to the amount of the VAT evaded or sought to be evaded by a person's conduct shall be construed-*

*(a) in relation to VAT itself or a VAT credit as a reference to the aggregate of the amount (if any) falsely claimed by way of credit for input tax and the amount (if any) by which output tax was falsely understated; and*

*(b) in relation to the sums referred to in subsection (2)(a), (c) and (e) above, as a reference to the amount falsely claimed by way of refund or repayment.*

*(4) Statements made or documents produced by or on behalf of a person shall not be inadmissible in any such proceedings as are mentioned in subsection (5) below by reason only that it has been drawn to his attention-*

*(a) that, in relation to VAT, the Commissioners may assess an amount due by way of a civil penalty instead of instituting criminal proceedings and, though no undertaking can be given as to whether the Commissioners will make such an assessment in the case of any person, it is their practice to be influenced by the fact that a person has made a full confession of any dishonest conduct to which he has been a party and has given full facilities for investigation, and*

*(b) that the Commissioners or, on appeal, a tribunal have power under section 70 to reduce a penalty under this section,*

*and that he was or may have been induced thereby to make the statements or produce the documents.*

*(5) The proceedings mentioned in subsection (4) above are-*

*(a) any criminal proceedings against the person concerned in respect of any offence in connection with or in relation to VAT, and*
*(b) any proceedings against him for the recovery of any sum due from him in connection with or in relation to VAT.*

*(6) Where, by reason of conduct falling within subsection (1) above, a person is convicted of an offence (whether under this Act or otherwise), that conduct shall not*

*also give rise to liability to a penalty under this section.*

*(7) On an appeal against an assessment to a penalty under this section, the burden of proof as to the matters specified in subsection (1)(a) and (b) above shall lie upon the Commissioners.*

10. Section 61 VATA 1994 provides as follows:

*(1) Where it appears to the Commissioners-*

*(a) that a body corporate is liable to a penalty under section 60, and*
*(b) that the conduct giving rise to that penalty is, in whole or in part, attributable to the dishonesty of a person who is, or at the material time was, a director or managing officer of the body corporate (a "named officer"),*

*the Commissioners may serve a notice under this section on the body corporate and on the named officer.*

*(2) A notice under this section shall state-*

*(a) the amount of the penalty referred to in subsection (1)(a) above ("the basic penalty"), and*
*(b) that the Commissioners propose, in accordance with this section, to recover from the named officer such portion (which may be the whole) of the basic penalty as is specified in the notice.*

*(3) Where a notice is served under this section, the portion of the basic penalty specified in the notice shall be recoverable from the named officer as if he were personally liable under section 60 to a penalty which corresponds to that portion; and the amount of that penalty may be assessed and notified to him accordingly under section 76.*

*(4) Where a notice is served under this section-*

*(a) the amount which, under section 76, may be assessed as the amount due by way of penalty from the body corporate shall be only so much (if any) of the basic penalty as is not assessed on and notified to a named officer by virtue of subsection (3) above; and*
*(b) the body corporate shall be treated as discharged from liability for so much of the basic penalty as is so assessed and notified.*

*(5) No appeal shall lie against a notice under this section as such but—*

*(a) where a body corporate is assessed as mentioned in subsection (4)(a) above, the body corporate may appeal against the Commissioners' decision as to its liability to a penalty and against the amount of the basic penalty as if it were specified in the assessment; and*
*(b) where an assessment is made on a named officer by virtue of subsection (3) above,*

*the named officer may appeal against the Commissioners' decision that the conduct of the body corporate referred to in subsection (1)(b) above is, in whole or part, attributable to his dishonesty and against their decision as to the portion of the of the penalty which the Commissioners propose to recover from him.*

*(6) In this section a "managing officer", in relation to a body corporate, means any manager, secretary or other similar officer of the body corporate or any person purporting to act in any such capacity or as a director; and where the affairs of a body corporate are managed by its members, this section shall apply in relation to the conduct of a member in connection with his functions of management as if he were a director of the body corporate.*

**Submissions on behalf of the Appellant**

11. Mr Mullen submits that HMRC have no legal basis for imposing the penalty which is the subject of the appeal and that the Tribunal should summarily determine the appeal in favour of the Appellant as HMRC's case has no reasonable prospect of success.

12. The issues can be categorised as follows:

(i) As a matter of construction and interpretation of VATA 1994 did HMRC have power to issue a penalty under section 61 on the basis of the facts alleged in the Statement of Case (which are not accepted); and

(ii) If there was, prima facie, power to issue the penalty, was that power restricted by human rights legislation under the relevant provisions of the ECHR and EU Charter.

13. As to the first issue, namely whether HMRC had the power to impose a penalty under section 61 VATA 1994 Mr Mullen submits that no such power existed for the following reasons:

- Waterfire did not evade VAT within the meaning of section 60 VATA 1994;
- Waterfire and/or the Appellant cannot be regarded as having been dishonest in making a claim for repayment of VAT on supplies which were genuinely made to Waterfire. Participation in a wider VAT fraud is irrelevant to that issue;
- There was no VAT falsely claimed; and
- Legislation is required to enable a penalty to be imposed in the circumstances set out in HMRC's Statement of Case.

14. As regards whether any such power, if found to exist, was restricted by the ECHR and EU Charter Mr Mullen submits that:

- The scope of the penalty was widened by case law that postdates the events which are said to give rise to the penalty. Imposition of a penalty is therefore in breach of the prohibition on retrospective criminalisation;

- The refusal of the right to deduct has been classified as a penalty by the CJEU and therefore the imposition of a further penalty would be in breach of Article 50 of the EU Charter; and

- The penalty is in any event disproportionate.

15. It was clarified by Mr Mullen that although the facts set out in HMRC's Statement of Case are not accepted, this application can be determined on the basis of legal submissions made were the facts alleged proved.

*The Penalty Provisions*

16. In order for Waterfire to be liable to a penalty under section 60 VATA 1994 it must be shown that:

- Waterfire intended to evade VAT;

- It did so dishonestly; and

- An amount of input tax was falsely claimed.

17. Mr Mullen submits that HMRC's case is based on the premise that Waterfire was not entitled to claim input tax in respect of supplies made by it in the period from 1 February 2006 to 31 July 2006 as a result of the decision by the CJEU in *Kittel v Belgium, Belgium v Recolta Recycling* [2008] STC 1537*("Kittel")* and the Court of Appeal in *Mobilx Ltd v HMRC ("Mobilx")* [2010] EWCA Civ 517. He contends that the Statement of Case appears inconsistent with the skeleton argument which extended the scope of HMRC's case against the Appellant such that it remains unclear what the case to be met is. Mr Mullen also notes that the Statement of Case is replete with terminology said to derive from case law without any explanation of what the terminology means, although no specific examples were given.

18. The only basis upon which HMRC can show that Waterfire was not entitled to an input tax credit is by reference to *Kittel* and *Mobilx*. Without any such reference it cannot be said that Waterfire was not entitled to an input tax credit and the statutory requirements of section 61 VATA 1994 would not be met.

19. Mr Mullen contends that MTIC case law forms an important part of the background to this appeal as HMRC must rely on it as the foundation for the imposition of the penalty under appeal. Without the cases there can be no question of a penalty. In those circumstances it is relevant to consider the development of the law in this area and the dates upon which judgments were handed down. The fact that the transactions entered into by Waterfire were conducted in the context of the law as it was understood at the time is relevant to the issue of dishonesty. Mr Mullen contends that it cannot be dishonest to do an act which was understood to be legal at the time.

The development of the law is also relevant to the issue of whether the penalty amounts to retrospective criminalisation.

20. Section 26 VATA 1994 concerns the right to deduct input tax:

*(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 (that is input tax on supplies, acquisitions and importations in the period) as is allowable by or under regulations as being attributable to supplies within subsection (2) below.*

*(2) The supplies within this subsection are the following supplies made or to be made by the taxable person in the course or furtherance of his business-*

*(a) taxable supplies;*
*(b) supplies outside the United Kingdom which would be taxable supplies if made in the United Kingdom;*
*(c) such other supplies outside the United Kingdom and such exempt supplies as the Treasury may by order specify for the purposes of this subsection.*

21. Prima facie the Appellant had a right under section 26 VATA 1994 to claim input tax. It must therefore follow that the claim was not falsely made.

22. Mr Mullen outlined the increasing scope of MTIC fraud which led to the introduction of joint and several liability legislation, the requirement for security and reverse charge provisions. On 12 January 2006 the CJEU handed down its judgment in *Optigen Ltd and Fulcrum Trading Co (UK) Ltd* (VATD 18113) in which the Court concluded:

*"… transactions such as those at issue in the main proceedings, which are not themselves vitiated by VAT fraud, constitute supplies of goods or services effected by a taxable person acting as such and an economic activity … where they fulfil the objective criteria on which the definitions of those terms are based, regardless of the intention of a trader other than the taxable person concerned involved in the same chain of supply and/or the possible fraudulent nature of another transaction in the chain, prior or subsequent to the transaction carried out by that taxable person, of which that taxable person had no knowledge and no means of knowledge. The right to deduct input VAT of a taxable person who carries out such transactions cannot be affected by the fact that in the chain of supply of which those transactions form part another prior or subsequent transaction is vitiated by VAT fraud, without that taxable person knowing or having any means of knowing".*

23. Mr Mullen argues that this represented a new development in the law at the relevant time, the scope of which was unclear as was the issue of how it interacted with domestic law.

24. On 14 March 2006 the Advocate-General gave his opinion in *Kittel* and the judgment of the CJEU was given on 6 July 2006. At paragraph 59 the Court stated:

*"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."*

25. Mr Mullen submits that the Appellant could not have been expected to know the position under EU law at the date of the relevant claim.

26. Furthermore Mr Mullen submits that HMRC cannot rely on *Kittel* and *Mobilx* which had no direct or binding effect as a matter of UK law. In order to rely on the *Kittel* jurisprudence it is necessary to construe the right to reclaim input tax in section 26 VATA 1994 as limited in circumstances where a supply is connected with fraud. The wording of the statute is clear and there is no suggestion that any such limitation can be read in to it. It could not have been clear that *Kittel* had any consequence for UK taxpayers.

27. Mr Mullen acknowledges that Moses LJ rejected in *Mobilx* (at paragraphs 46 – 49) the argument that *Kittel* could not be applied as part of UK domestic law without specific legislation:

"A*ccordingly, the objective criteria which form the basis of concepts used in the Sixth Directive form the basis of the concepts which limit the scope of VAT and the right to deduct under ss. 1, 4 and 24 of the 1994 Act. Applying the principle in Kittel, the objective criteria are not met where a taxable person knew or should have known that by his purchase he was participating in a transaction connected with fraudulent evasion of VAT. That principle merely requires consideration of whether the objective criteria relevant to those provisions of the VAT Act 1994 are met. It does not require the introduction of any further domestic legislation...*

*It is the obligation of domestic courts to interpret the VATA 1994 in the light of the wording and purpose of the Sixth Directive as understood by the ECJ (Marleasing SA 1990 ECR 1-4135 [1992] 1 CMLR 305) (see, for a full discussion of this obligation, the judgment of Arden LJ in Revenue and Customs Commissioners v IDT Card Services Ireland Limited [2006] EWCA Civ 29 [2006] STC 1252, §§ 69-83). Arden LJ acknowledges, as the ECJ has itself recognised, that the application of the Marleasing principle may result in the imposition of a civil liability where such a liability would not otherwise have been imposed under domestic law (see IDT § 111). The denial of the right to deduct in this case stems from principles which apply throughout the Community in respect of what is said to be reliance on Community law for fraudulent ends. It can be no objection to that approach to Community law that in purely domestic circumstances a trader might not be regarded as an accessory to fraud. In a sense, the dichotomy between domestic and Community law, in the circumstances of these appeals, is false. In relation to the right to deduct input tax, Community and domestic law are one and the same.*

28. However he submits that the judgment noted the obligation to construe UK legislation in conformity with the Directives to which it gives effect and applied a conforming interpretation whereby the principles in *Kittel* were implied into the UK tax code. Such conforming interpretation is limited to civil liabilities and therefore can have no application to the imposition of a criminal penalty.

*Construction of the penalty provisions*

29. It is not disputed that the penalty gives rise to "criminal charges" for the purposes of the European Convention on Human Rights ("ECHR") and the Charter of Fundamental Rights of the European Union ("the EU Charter") (*Jussila v Finland* [2009] STC 29)

30. On the basis that *Mobilx* was restricted to the consideration of civil as opposed to criminal liability, it cannot be relied upon by HMRC as authority to support the proposition that UK law can be interpreted consistently with *Kittel* such as to permit the imposition of a penalty.

31. HMRC's approach in this case breaches the principle found in Article 7 of the ECHR which provides that:

*"No one shall be held guilty of any criminal offence on account of any act or omission which did not constitute a criminal offence under national or international law at the time when it was committed. Nor shall a heavier penalty be imposed than the one that was applicable at the time the criminal offence was committed."*

32. Applying the principles set out in *Mobilx* to section 61 VATA 1994 would widen the scope of an existing offence, contrary to the established principle that courts do not:

*"...have some general or residual power either to create new offences or so to widen existing offences as to make punishable conduct of a type hitherto not subject to punishment." (R v Knuller (Publishing, Printing and Promotions) Ltd* [1973] AC 435

33. Consequently, absent reliance on *Kittel* and *Mobilx,* there can be no legal basis for the imposition of a penalty and therefore HMRC's case has no reasonable prospect of succeeding.

*Meaning of tax evasion*

34. Mr Mullen submits that the term *"evasion"* is more limited in scope than the extended definition applied by HMRC to cover a situation whereby input tax is claimed which subsequently proves not to be due. He contends that there are, in effect, three meanings of the word which are used interchangeably by HMRC:

- To "dodge" a liability;
- The statutory meaning within section 60 VATA 1994; and

- Following the principles in Kittel whereby the evasion is via a link to a missing trader.

35. The extension set out in section 60 (2) by reference to a VAT credit is required because a claim for input tax which is falsely made would not fall within the natural meaning of "evasion" which should be read as "dodging a liability" (citing *R v Dealy* [1995] STC 215 in support.) By way of example Mr Mullen submits that the extended meaning would apply in situations whereby a supply took place but VAT was not accounted for or claiming input tax where there was no supply; in both instances the evasion relates to a claim which is plainly false. The term *"evasion"* cannot extend to every situation where VAT credits are claimed, particularly where input tax was incurred. In this case the Appellant did not dodge any liability; to the contrary by making a claim he "put himself in the headlights."

36. In the circumstances of the present appeal it cannot be said that there was evasion of tax for the purposes of section 60 VATA 1994 by Waterfire and it follows that HMRC's case has no reasonable prospect of success.

*Dishonest conduct*

37. Mr Mullen submits that the dishonesty required by statute must relate to Waterfire's specific conduct whereby it sought to deduct VAT, namely acquiring the supplies and claiming VAT incurred on them. HMRC have wrongly assumed that an awareness of a connection with fraud is sufficient to satisfy the legislation. Mr Mullen disputes that *Megtian*, cited by Mr Benson QC, supports HMRC's case in this regard.

38. Dishonesty in relation to a wider series of transactions (if proved), even if the Appellant could be shown to be fully aware of an MTIC fraud connected to its supplies, is irrelevant for the purposes of section 61 VATA 1994. Mr Mullen contends that if the Appellant was entitled to make a claim to input tax it matters not whether he was dishonest. Mr Mullen argues that there a distinction can be drawn in that the right to make a claim which can be denied is not a false claim but rather a conditional claim.

*The amount of VAT falsely claimed*

39. As there was nothing in the VAT return or accompanying leaflets which indicated any limitation on Waterfire's right to reclaim VAT, it cannot be said that there was no right to deduct.

40. A false claim is one which has no basis as distinct from a claim which has a legitimate basis but is potentially liable to be refused. Waterfire's claim cannot therefore be said to be false.

*Breach of human rights legislation*

41. Even if power exists to impose the penalty appealed against, to do so breaches the ECHR and EU Charter.

42. Article 49 of the EU Charter provides:

"*No one shall be held guilty of any criminal offence on account of any act or omission which did not constitute a criminal offence under national law or international law at the time when it was committed. Nor shall a heavier penalty be imposed than that which was applicable at the time the criminal offence was committed. If, subsequent to the commission of a criminal offence, the law provides for a lighter penalty, that penalty shall be applicable.*

*2. This Article shall not prejudice the trial and punishment of any person for any act or omission which, at the time when it was committed, was criminal according to the general principles recognized by the community of nations.*

*3. The severity of penalties must not be disproportionate to the criminal offence."*

43. HMRC's reliance on *Kittel* and *Mobilx*, together with the extended meaning it has given to the term *"evasion"* as the reasons why the Appellant was not entitled to claim input tax is reliance on the widened scope of an existing offence which is prohibited.

44. *Kittel* represented a novel development in the law and provided a new ground upon which a right of deduction could be refused (see *Mobilx* and *Mahageben* Joined Cases C-80/11 and C-142/11 for support). As such the penalty, which is based on that decision, cannot relate to activities which predate *Kittel*. The penalty under appeal was imposed in breach of Article 7 ECHR.

45. Furthermore Article 49 imposes a directly enforceable right that a penalty must not be disproportionate to the offence. Mr Mullen queries the economic benefit said to have been obtained by the Appellant. He submits that the penalty in this appeal in the sum of £3,137,483.03 is manifestly disproportionate and vastly exceeds the amount by which Waterfire could have profited from its transactions or the amount of VAT jeopardised.

*Right not to be punished twice*

46. Article 50 of the EU Charter provides:

"*No one shall be liable to be tried or punished again in criminal proceedings for an offence for which he or she has already been finally acquitted or convicted within the Union in accordance with the law."*

47. The refusal of the right to deduct has been described by the CJEU as a penalty on numerous occasions (*Mahageban, LVK* Case C-643/11, *Bonik EOOD* Case C-285/11 and *Evita-K EOOD* Case C-78/12). It is to be assumed that the word was used with a degree of care. A penalty on Waterfire under section 60 VATA 1994 would involve a second penalty for the same conduct and as a lawful penalty on Waterfire is a prerequisite to a penalty on the Appellant it follows that there is no power to lawfully impose a penalty upon the Appellant.

**HMRC's Submissions**

48. HMRC's position can be summarised as follows:

- The Appellant's repeated assertion that the penalty imposed upon him pursuant to *Section 61* of the *Value Added Tax Act 1994* was imposed by reference to the *Kittel* decision and subsequent case-law, or the input tax claimed by Waterfire Ltd which was disallowed, fundamentally misunderstands the nature of, and basis for, the penalty;

- The basis for the decision to penalize the Appellant was not the fact that Waterfire Ltd had been denied its entitlement to claim input tax credit in accordance with *Kittel* principles; rather, the basis for the penalty is the fulfillment of the statutory criteria set out within *Section 61(1)* of the *Value Added Tax Act 1994*;

- Waterfire Ltd rendered itself liable to a penalty on the basis that it had entered into various transactions, and rendered VAT returns including those transactions, for the purpose of evading VAT. The transactions entered into by by Waterfire were themselves fraudulent (including its actions as a contra-trader) having been entered into "for the purposes of evading VAT", they were connected to a tax loss which was known to Waterfire and it was therefore a knowing and dishonest participant of a fraudulent scheme to defraud the Revenue. The conduct giving rise to Waterfire Ltd's liability to a penalty was wholly or partly attributable to the conduct of the Appellant;

- A taxpayer who actively and knowingly participates in a fraudulent scheme and makes a VAT return based upon his transactions loses his right to deduct, and any claim to input tax credit based upon such transactions must be false;

- It has long been established by the CJEU that the objective criteria for identifying supply of goods or services and economic activity are not met where tax is evaded by the taxable person himself;

- The imposition of a penalty under section 60 (1) VATA 1994 gives rise to "criminal charges" within the meaning of Article 6 (1) of the ECHR (*Han and Yau v HMCE* [2001] 1 WLR 2253, CA);

- The classification of the provisions of section 60 (1) VATA 1994 is a classification for the purposes of the ECHR only such that Article 7 applies to the statutory provision;

- The penalty does not breach the provisions of Articles 6 or 7 of the ECHR;

- Both section 60 and 61 of VATA 1994 were in force at the time of the transactions in question. Therefore the law at the relevant time was clear and the issue of retrospective punishment does not arise;

- The requirements of section 61 (1) VATA 1994 are met;

- The input tax claim in the circumstances alleged by the Respondents may properly be considered evasion, consistent with the statutory provisions;

- The refusal of the right to deduct input tax is not a penalty; rather it is the loss of a right, such that any penalty imposed pursuant to *Section 60* of the *Value Added Tax Act 1994* does not breach the provisions of the EU Charter;

- The quantum of the penalty is proportionate because the civil penalty scheme (which allows for exposure of the taxable person to a penalty in the maximum sum of 100% of the tax alleged to have been evaded or sought to have been evaded) is a just balance between the legitimate interests of HMRC and the taxpayer.

*The Penalty Provisions*

49. On behalf of HMRC Mr Benson QC submits that the penalty appealed against was not imposed by reference to the input tax disallowed or the case law in *Kittel* and *Mobilx* but rather by reference to the VAT evaded or sought to have been evaded.

50. A finding that the imposition of a penalty gives rise to a criminal charge is the threshold condition for application of the substantive provisions of Article 6 to the civil penalty procedures under section 60 VATA 1994. The concept of "criminal charge" under Article 6 has an "autonomous" Convention meaning. Three criteria are applied by the Strasbourg Court to determine whether a criminal charge has been imposed (*AP v Switzerland* (1998) 26 EHRR 541):

- The classification of the proceedings in domestic law;

- The nature of the offence; and

- The nature and degree of severity of the penalty that the person concerned risked incurring.

*Development of the Refusal of the Right to Deduct*

51. The prevention of tax evasion, avoidance and abuse has always been an objective recognised and encouraged by the Sixth Directive. Where the right to deduct has been exercised fraudulently, the tax authorities have always had the authority to claim repayment of the deducted sums retroactively or refuse the right to deduct. Pre-*Kittel* there were a number of authorities which supported the principle that the Sixth Directive must be interpreted as precluding any right of a taxable person to deduct input VAT where the transactions from which the right derives constitute an abusive practice.

52. *Kittel* developed a principle already long established in CJEU jurisprudence (referred to at paragraph 55 of the judgment) to include the taxable person who knew *or should have known* that by his purchase he was taking part in a transaction connected with the fraudulent evasion of VAT. The development related to the issue of constructive knowledge of a taxable person as opposed to actual knowledge.

53. In *Halifax and others* [2006] ECR I/1609 the Court emphasised that the objective criteria which form the basis of the entitlement to deduct input tax are not satisfied where tax is evaded:

*"It is true that those criteria are not satisfied where tax is evaded, for example by means of untruthful tax returns or the issue of improper invoices..."*

54. In *Mobilx* Moses LJ held that the principles in *Kittel* could be applied as part of UK domestic law without the introduction of further UK legislation. In response to the Appellant's contention that this conforming interpretation by the Court of Appeal was limited to civil liabilities, HMRC submits that the Appellant has misunderstood the nature of and basis for the penalty imposed on the Appellant which derives from statute.

*Meaning of "Evasion"*

55. The Appellant's reliance on *R v Dealy* provides little assistance as the Court of Appeal in that case was asked to provide a definition of "evasion" in section 39 VATA 1983 in a particular factual context which is distinguishable from the circumstances of the Appellant's case.

56. Evading VAT, or seeking to do so, can include obtaining or seeking to obtain a VAT credit where the person concerned is not entitled to that sum. In this case the Appellant's attempt to obtain input tax in respect of transactions which were and which the Appellant knew to be connected with fraud is an act for the purpose of evading VAT and amounts to a false claim for input tax credit. Such an interpretation is consistent with the statutory criteria set out in section 60 VATA 1994.

*Dishonest Conduct*

57. The dishonest conduct alleged is that Waterfire knowingly entered into transactions, which were fraudulent in nature and formed part of a scheme to defraud the Revenue, and rendered VAT returns which included those transactions. (See *Megtian Ltd (In Administration) v HMRC* [2010] EWHC 18 (Ch)).

*Right not to be punished twice*

58. Mr Benson QC submits that the refusal of the right to deduct cannot properly be regarded as a penalty such that any penalty subsequently imposed upon Waterfire pursuant to section 60 VATA 1994 cannot be regarded as a "second penalty".

59. The description of the refusal of the right to deduct as a penalty in *Mahageben* does not accord with the description applied earlier in the same authority (at

paragraph 45) nor descriptions elsewhere. By way of example Mr Benson QC cited *Mobilx* (at paragraphs 64 and 65) in which Moses LJ considered this specific issue and concluded that the loss of the right to deduct cannot properly be considered a penalty. On that basis the penalty imposed cannot be said to have been imposed in addition to an earlier penalty.

60. Furthermore the right to deduct was denied to the company Waterfire and the penalty was imposed on the Appellant; two separate legal entities.

*Proportionality*

61. HMRC submit that, if the allegations are proved, the penalty is proportionate. I was referred to *Han and others v C&E Commissioners* [2001] EWCA Civ 1040 at paragraph 48:

"*The function of civil penalties is not compensatory. They are imposed in addition to the assessed liability for tax and the interest recoverable therein…the function of the penalties is one of punishment and deterrence vis the individual and general deterrence so far as taxpayers at large are concerned."*

62. The VAT sought to be evaded by Waterfire was the amount of input tax credit claimed by it in its VAT return for 04/06, namely £6,972,184. The statutory provisions are not said by the Appellant to be disproportionate per se and the Appellant has not identified any reasons why the penalty should be further reduced.

**Discussion and Decision**

63. I considered all of the submissions, documents and authorities to which I was referred. In order to expedite the release of this decision to assist the parties in their preparation for the forthcoming substantive hearing I will not refer to each and every authority in detail.

64. I also pause to observe that this decision does not pre-judge any of the issues to be determined at the substantive appeal. The Tribunal heard no evidence and I make no findings of fact. This decision is premised on the basis that the burden of proof rests with HMRC to prove the facts alleged.

65. My starting point is the basis of HMRC's decision to impose a penalty. Section 61 VATA 1994 provides for the liability of directors (of which there is no dispute that the Appellant was) where it appears to HMRC that, in the instant case, Waterfire is liable to a penalty under section 60 VATA 1994 and the conduct giving rise to Waterfire's penalty is attributable to the dishonesty of the Appellant.

66. Putting aside the issue of dishonesty for a moment, Section 60 provides for a penalty to be imposed against Waterfire where:

"*(a) for the purpose of evading VAT, a person does any act or omits to take any action, and*
*(b) his conduct involves dishonesty (whether or not it is such as to give rise to*

*criminal liability)…"*

67. Guidance is given as to the meaning of *"evading VAT"* in section 60 (2) which includes:

*"…reference to obtaining any of the following sums-*

*(a) a refund under any regulations made by virtue of section 13(5);*
*(b) a VAT credit;*
*(c) a refund under section 35, 36 or 40 of this Act or section 22 of the 1983 Act; and*
*(d) a repayment under section 39,*

*in circumstances where the person concerned is not entitled to that sum."*

68. HMRC's case, as pleaded in the Statement of Case, is that Waterfire's act of attempting to obtain a VAT credit took place in circumstances in which Waterfire was not entitled to such credit. I do not accept, as contended by Mr Mullen, that HMRC's case has been extended by the skeleton argument or that the skeleton argument is inconsistent with the case pleaded; the relevant paragraphs of the Statement of Case are set out in square brackets at (a) to (d) below. The circumstances are alleged to be that:

(a) Waterfire knew that its transactions in 04/06 were connected to the fraudulent evasion of VAT [48, 49];

(b) During the course of its trading history Waterfire acted as a contra trader by deliberately and artificially constructing its trading in such a way that enabled what would otherwise give rise to large claims for repayment from HMRC to be offset and made by other companies acting as broker traders [30, 31 – 47, 72];

(c) By entering into those transactions and making VAT returns which included those transactions Waterfire had done an act by which it was not entitled to the right to deduct input tax [4, 74];

(d) As Waterfire was not entitled to obtain a VAT credit, it had done an act for the purpose of evading VAT [74].

69. That Waterfire's entitlement to the right to deduct was lost in such circumstances was a principle recognised in law at the relevant time. The prevention of tax evasion has always been an objective under the Sixth Directive. Whilst I accept that case law was developing at the time when Waterfire carried out its transactions, jurisprudence was already in existence which had already established the principles relating to the refusal of the right to deduct. This was recognised by Moses LJ in *Mobilx:*

*"This approach is the basis of the Court's approach not only in Kittel but in C-354/03 Optigen Limited v Customs and Excise Commissioners [2006] ECR I-483. The judgment in Optigen was handed down on 12 January 2006 by the third chamber of the court, four out of the five judges of which heard the case of Kittel and handed*

*down their judgment six months later, on 6 July 2006. It is, therefore, not surprising that the court's reformulation of the questions in Kittel and its answers depended strongly on its approach in Optigen.*

*The scope of VAT is identified in Art. 2 of the Sixth Directive…The scope of VAT, the transactions to which it applies and the persons liable to the tax are all defined according to objective criteria of uniform application…*

*The principle of legal certainty requires that the application of Community legislation is foreseeable by those subject to it (see, e.g., the Advocate General's opinion in Optigen, § 42). The principle demands that when a taxable person enters into a transaction he should know that the transaction is within the scope of VAT and that his liability will be limited to the amount by which the output tax on his supply exceeds the input tax he has paid. In Optigen the court set out the criteria which identify the scope of VAT (see §§ 38-41). It emphasised the importance of the objective nature of those criteria (§§ 44-46). Once a transaction meets those criteria, it follows that the right to deduct for which Art. 17 provides must be recognised (§§ 52-53).*

*…Since the right arises immediately the taxable person pays tax (input tax) to his supplier, the principle of legal certainty demands that he knows when he enters into the transaction that it is within the scope of the tax and that his liability will be limited to the amount by which any output tax he may be liable to pay, on making a supply, exceeds the input tax he has paid. The objective criteria determine both the scope of the tax and the circumstances in which the right to deduct arises.*

*It was with those principles in mind that the ECJ in Optigen rejected the contention that the transactions of innocent parties could not be regarded as economic activities if they formed part of a series of transactions with a fraudulent objective (the argument which found favour before the Tribunal recited § 20). The Court repeatedly distinguished the transactions in which the innocent parties had entered from transactions "vitiated by VAT fraud" (see §§ 51, 52 and 55). It thus endorsed the view, expressed by the Advocate General, that regard must be had to the objective character of the concept of economic activity (§ 37 Advocate General's Opinion). It was the fact that the transactions of the unwitting traders in Optigen met the objective criteria which formed the basis of the ECJ's rejection of HMRC's attempt to deny repayment:-*

*"Therefore, the answer to the first question referred for a preliminary ruling in each case should be that transactions such as those at issue in the main proceedings, which are not themselves vitiated by VAT fraud, constitute supplies of goods or services effected by a taxable person acting as such and an economic activity within the meaning of Articles 2(1), 4 and 5(1) of the Sixth Directive, where they fulfil the objective criteria on which the definitions of those terms are based, regardless of the intention of a trader other than the taxable person concerned involved in the same chain of supply and/or the possible fraudulent nature of another transaction in the chain, prior or subsequent to the transaction carried out by that taxable person, of which that taxable person had no knowledge and no means of knowledge. The right to*

*deduct input VAT of a taxable person who carries out such transactions cannot be affected by the fact that in the chain of supply of which those transactions form part another prior or subsequent transaction is vitiated by VAT fraud, without that taxable person knowing or having any means of knowing. [emphasis added]" (§ 55)*

*It will be noted that the court in Optigen qualified its statement of principle by reference to the state of knowledge of the taxable person as to the fraudulent nature of another transaction."*

70. In those circumstances I do not accept that the entire premise upon which HMRC imposed the penalty under section 61 VATA 1994 was based on *Kittel* or *Mobilx,* but rather well-established principles by which the right to deduct can be lost.

71. Although prima facie the right to deduct arises where the requirements of section 26 VATA 1994 are satisfied, it is clear that the principle had already been established prior to the decision in *Kittel* that the objective criteria which determine the scope of VAT and the right to deduct must have been met:

*"In Kittel the Court adopted an identical approach to that which it had adopted in Optigen, emphasising the importance of the objective criteria which are met where a taxable person did not and could not know that the transaction was connected with fraud (§§ 39-52). Paragraph 52 (cited here at § 19) owes everything to Optigen's § 55."*

72. The development in *Kittel* was simply consideration of the "*obverse of the question in Optigen"* (per Moses LJ in Mobilx at 34.) As such I reject the argument advanced on behalf of the Appellant that the penalty imposed by HMRC has no legal basis as the relevant transactions pre-dated *Kittel.*

73. I should note that the second question posed by *Kittel,* namely that relating to constructive knowledge, is not relevant to the issues to be determined in this case nor is it pleaded as part of HMRC's case. The case advanced is that the Appellant knew that its transactions were not only connected to fraud but that they formed part of that fraud. In this regard I adopt the words of Briggs J in *Megtian* at 21 – 25 in support of this contention:

*"It is important to bear in mind, although the phrase "knew or ought to have known" slips easily off the tongue, that when applied for the purpose of identifying the state of mind of a person who has participated in a transaction which is in fact connected with a fraud, it encompasses two very different states of mind. A person who knows that a transaction in which he participates is connected with fraudulent tax evasion is a participant in that fraud. That person has a dishonest state of mind. By contrast, a person who merely ought to have known of the relevant connection is not dishonest, but has a state of mind broadly equivalent to negligence."*

74. It therefore follows that if HMRC prove actual knowledge on the part of Waterfire, through the Appellant as a director, the element of dishonesty is satisfied.

75. Further, if the Appellant is proved to have the requisite knowledge and thereby his act of seeking to obtain input tax credit in such circumstances is an act for the purpose of evading VAT in that the entitlement to do so was lost, I am satisfied that the claim would be false. I do not agree with the submission on behalf of the Appellant that *"a false claim is one which has no basis whatsoever."*

76. In relation to this case, Mr Mullen argues that the Waterfire's claim does have a basis, namely input tax which was incurred, and therefore cannot be said to be false. In my view, to accept such a proposition would lead to the untenable conclusion that where a trader deliberately acts as a contra-trader for the purpose of dishonestly evading VAT, the claim would not be false. In my view this cannot be a proper interpretation or application of the legislation.

77. As to the issue of *"evasion"* I considered the narrow interpretation that Mr Mullen seeks to apply. Section 60 (2) specifically includes the obtaining of a VAT credit *"in circumstances where the person concerned is not entitled to that sum."* No further limitation is placed on the provision. I agree with the submissions on behalf of HMRC that the case of *Dealy* adds little by way of assistance on this issue; that case involved wholly different facts and the Court of Appeal was specifically concerned with section 39 VATA 1983. No consideration was given as to the meaning of *"evasion"* in the context of the circumstances in this case.

78. I do not accept Mr Mullen's submission that it *"can be seen by Kittel itself, the CJEU did not consider that persons denied input tax were engaged in evasion, but rather that such transactions were connected with evasion."* In rejecting this submission, I would again refer to Briggs J in *Megtian* (cited at paragraph 73 above) in which it is clear that where a person's actual knowledge is established (as is alleged in this case) that person has a dishonest state of mind and is deemed to be a participant in the fraudulent evasion of tax. In those circumstances I am satisfied that the provisions of section 60 can include situations whereby a taxpayer seeks to obtain a VAT credit where that taxpayer is not so entitled by reason of his knowledge of and participation in fraud.

79. The Appellant contends that the conforming interpretation applied by Moses LJ in *Mobilx* was limited to civil liabilities and therefore cannot apply to the imposition of a criminal penalty. It was accepted by HMRC that the imposition of a penalty under sections 60 and 61 VATA 1994 give rise to a criminal charge, however the relevance is referable to (see *Han and Yau*):

*"…the threshold condition for application of the substantive provisions of Article 6 to the civil penalty procedures under s.60 of VATA and s.8 of FA 94. If applicable, there are implicit in the fair trial provisions of Article 6(1) rights which include a right to silence and a privilege against self-incrimination."*

80. The appeal against the penalty to the First-tier Tax Tribunal is governed by civil procedures. Section 72(1) of the Act provides for the criminal liability of a person being knowingly concerned in, or in the taking of steps with a view to, the fraudulent evasion of VAT by himself or any other person. Although Mr Mullen appeared to

suggest that the classification of a section 60 VATA 1994 penalty requires the appeal to be treated as a criminal matter in all respects, I do not accept this to be the case. The distinction was set out in *Han and Yau*:

*"By way of contrast, if, under the prosecution policy criteria, the Customs and Excise consider that a criminal investigation with a view to prosecution is appropriate, and there is sufficient evidence to demonstrate reasonable grounds to suspect fraud prior to approaching the taxpayer, procedures appropriate to a criminal investigation will be followed. Customs investigators have powers to obtain search warrants and access orders and to arrest suspects, which powers are not available in a civil case. In addition, they conduct interviews in accordance with the requirements of the Police and Criminal Evidence Act 1984 ("PACE"), which normally take place in the presence of the taxpayer's solicitor and are conducted under caution without use of, or reference to, the inducement procedure.*

*It by no means follows from a conclusion that Article 6 applies that civil penalty proceedings are, for other domestic purposes, to be regarded as criminal and, therefore, subject to those provision of PACE and/or the Codes produced thereunder, which relate to the investigation of crime and the conduct of criminal proceedings as defined by English law."*

81. In those circumstances I do not agree that the issue of conforming interpretation arises simply because rights under Article 6 are invoked. Even if this is not correct, I am satisfied that the effect of classification of the penalty as a criminal charge is limited to engaging the Appellant's rights under Article 6 and 7 of the ECHR. In so far as Article 6 is concerned, Mr Mullen gave no detail as to the provision that the penalty is said to breach. Having considered the protection afforded by Article 6, I am satisfied that there are no breaches:

- The Appellant will receive a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law;
- The burden of proof lies with HMRC thereby preserving the presumption of innocence;
- The Appellant has been informed promptly and in detail of the nature and cause of the accusation against him in the form of decision letters from HMRC and a significant number of bundles of evidence;
- The penalty was imposed on 29 March 2010 since which date the Appellant has had adequate time and facilities for the preparation of his defence. The Appellant also has the benefit of representation, as I understand on a pro bono basis, by Counsel;
- The case has been allocated sufficient time for all witnesses required by the Appellant to be called to give evidence and examined.

82. That the fraudulent and dishonest evasion of tax could lead to the liability of a company (and its officials as the directing minds) for a penalty is long established by statute and case law. I do not accept that any further specific legislation is required or that the imposition of a penalty requires a conforming interpretation which extends beyond the jurisdiction of the Tribunal. In those circumstances I do not accept that the imposition of a penalty constitutes a breach of either Article 7 of the ECHR or Article 49 of the EU Charter.

83. Articles 49 also provides protection from disproportionate penalties. No specific arguments were advanced as to why the penalty is disproportionate save for references to the amount by which Waterfire could have profited from its transactions or the amount of VAT jeopardised which would require findings of fact. I accept the submissions on behalf of HMRC that the penalty was imposed in accordance with the relevant legislation and that *Han and Yau* provides support for the imposition of civil penalties:

*"…the rationale for the VAT Civil Penalties Scheme was convincingly propounded in the Keith Report as a just balance between the legitimate interests of the Customs and Excise in improving the collection of a tax in relation to which widespread evasion was prevalent, and the interests of the taxpayer in avoiding the travails of a criminal prosecution and the stigma of conviction of a criminal offence of dishonesty in cases of deliberate evasion. It also represented a sensible rationalisation of the schemes for collecting tax and penalising evasion as between the Customs and Excise on the one hand and the Inland Revenue on the other."*

84. In principle I am satisfied, subject to any specific findings of fact made on the evidence, that the penalty is proportionate.

85. Article 50 of the EU Charter provides the right not to be tried or punished twice in criminal proceedings for the same criminal offence. I note and agree with Mr Benson QC's observation that the right to deduct was refused to the company and the penalty was imposed against the Appellant, two distinct legal entities. Furthermore I do not accept that the right to deduct can be properly regarded as a penalty such that any penalty imposed on Waterfire can be regarded as a second penalty; in this regard I respectfully agree with and adopt the comments of Moses LJ in *Mobilx* at paragraphs 64 and 65:

*"On my interpretation of the principle in Kittel, there is no question of penalising the traders. If it is established that a trader should have known that by his purchase there was no reasonable explanation for the circumstances in which the transaction was undertaken other than that it was connected with fraud then such a trader was directly and knowingly involved in fraudulent evasion of VAT. The principle in Kittel, properly understood, is, as one would expect, compliant with the rights of traders to freedom from interference with their property enshrined in Art. I of the First Protocol of the European Convention of Human Rights. The principle in Kittel does no more than to remove from the scope of the right to deduct, a person who, by reason of his degree of knowledge, is properly regarded as one who has aided fraudulent evasion of VAT.*

*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."*

86. I was invited to make references to the CJEU on the issues raised on behalf of the Appellant. Having found the matters acte clair I decline to do so.

87. For the reasons set out above I am not satisfied that the Respondent's case, or part of it, has no reasonable prospect of succeeding such that HMRC should be barred from taking further part in the proceedings. In such circumstances it must follow that the Appellant's application for summary determination is refused.

88. This document contains full 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.

**JENNIFER BLEWITT**
**TRIBUNAL JUDGE**

**RELEASE DATE: 20 May 2014**