TC07990

VAT – scheme to avoid irrecoverable input tax on supplies of advertising services to loan broking business – establishment of loan broking business in Jersey with processing services provided by UK business – whether advertising services supplied to UK business – whether UK business made supplies of loan broking services – whether scheme an abuse of law

FIRST-TIER TRIBUNAL
TAX CHAMBER

Appeal number: MAN/2003/0234

BETWEEN

WILMSLOW FINANCIAL SERVICES PLC
(IN ADMINISTRATION) **Appellant**

-and-

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

TRIBUNAL: JUDGE JENNIFER DEAN

Sitting in public at Manchester on 17, 18 & 19 September and 21 & 22 November 2019

Mr Gibbon, Omnis VAT Consultants Ltd, for the Appellant

Ms McArdle, Counsel instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

INTRODUCTION

1. The initial appeal was made by Freedom Finance Limited in respect of assessments to VAT which disallowed input tax in periods 11/00 and 02/01. Thereafter HMRC notified further decisions to Freedom Finance Limited on the same grounds and which disallowed input tax and assessed for output tax for additional VAT accounting periods. 27 appeals in total were subsequently consolidated and the Appellant's name amended from Freedom Finance Limited to Wilmslow Financial Services Plc.

2. The consolidated appeal by Wilmslow Financial Services plc (in administration) (hereafter "the Appellant") concerns the disallowance of input tax and assessments for output tax for the period 11/00 to 08/09.

3. I was not asked to determine the quantum of the assessment and therefore the Decision which follows is one of principle only at this stage.

4. The delay in this case arises, in the main, from the appeal being stayed pending the outcome of the Court of Appeal's judgment in *HMRC v Newey T/A Ocean Finance* [2018] EWCA Civ 791.

5. The appeal concerns tax planning arrangements of the Appellant relating to its loan broking activities, which are exempt services for the purposes of VAT, and the use by the Appellant of a business structure involving a Gibraltar entity.

6. The issues arising in the appeal can be summarised as follows:

   (1) What is the proper characterisation of supplies of loan broking services; HMRC contend that the Appellant was the supplier and the Appellant contends that the Gibraltar entity, Karakus Limited ("Karakus") was the supplier;

   (2) Was the Appellant the recipient of advertising supplies or, as the Appellant contends, was Karakus the recipient of such supplies;

   (3) Did the scheme amount to an abuse of law, as HMRC contends, by:

      (a) Having a tax advantage as its essential aim; and

      (b) By virtue of its artificiality and/or by virtue of it being contrary to VAT legislation which provides that it is a tax on consumption.

7. I was provided with a substantial amount of documentary evidence. Neither party relied on or called any witness evidence.

8. HMRC submitted that important factual matters are not supported by any or adequate evidence and should be rejected. HMRC applied for disclosure of various information which was not received. In those circumstances HMRC invited the Tribunal where evidence was absent to draw an adverse inference that either the documents do not exist or that they do not support the Appellant's case as no satisfactory explanation has been provided as to why the documents or information were not disclosed.

9. The Appellant explained that where there is an absence of evidence, this is because the joint liquidators have not received co-operation from the officers of the company at the relevant time. The Appellant submitted that HMRC have sought to cherry pick the evidence, relying on parts of the evidence but not others. In those circumstances the Tribunal should not draw any adverse inferences.

10. I approached this issue by applying the following well-known principles set out by Broke LJ in *Wisniewski v Central Manchester Health Authority* [1998] PIQR 324:

> "(1) In certain circumstances a court may be entitled to draw adverse inferences from the absence or silence of a witness who might be expected to have material evidence to give on an issue in an action.
> (2) If a court is willing to draw such inferences, they may go to strengthen the evidence adduced on that issue by the other party or to weaken the evidence, if any, adduced by the party who might reasonably have been expected to call the witness.
> (3) There must, however, have been some evidence, however weak, adduced by the former on the matter in question before the court is entitled to draw the desired inference: in other words, there must be a case to answer on that issue.
> (4) If the reason for the witness's absence or silence satisfies the court then no such adverse inference may be drawn. If, on the other hand, there is some credible explanation given, even if it is not wholly satisfactory, the potentially detrimental effect of his/her absence or silence may be reduced or nullified."

11. The reason given for the absence of any witness evidence on behalf of the Appellant was that the liquidators had received no cooperation from the relevant company officers. However, no cogent reason was given as to why this was the case or whether any steps had been taken to address the reluctance of the parties involved, such as consideration of a witness summons. I was satisfied that the company officers who had been involved during the relevant period might properly be expected to have material evidence to give on matters in issue. I did not determine the appeal solely on the basis of adverse inferences but from my cumulative findings on the evidence as a whole taking into account that adverse inferences drawn may strengthen the evidence adduced by HMRC on an issue or weaken the evidence of the Appellant.

12. In those circumstances I took the view that there was reason to refrain from drawing adverse inferences where appropriate and after careful consideration of the evidence.

13. A further ancillary matter arose at the resumed part heard hearing. Mr Gibbon sought to rely on an additional ground of appeal which, in brief, contended that the arrangements could not be abusive if domestic law could have legislated to allow the arrangements but that such legislation simply had not been passed. HMRC objected to the new ground of appeal submitting that there was no compelling reason to allow a new ground of appeal and further, it would be contrary to the principles in *Halifax Plc and others v CCE* [2006] STC 919 to accept the submission that in order to prove abuse domestic law must clearly legislate against it.

14. I concluded that it was not in the interests of justice to allow the new ground of appeal. This appeal has been ongoing for a substantial period of time and I considered that there was no satisfactory explanation as to why the point had not or could not have been raised earlier and I agreed that there was no compelling reason to admit the new ground at this late stage. Furthermore, on the basis of my findings on the issues of the proper characterisation of the supplies and artificiality, the new ground if admitted would not alter the decision.

BACKGROUND

15. Although this appeal relates to the period 11/00 to 08/09, it is relevant to set out further background and non-contentious facts which led to the matters under appeal.

16. The Appellant, which operated as a loan broker, is a limited company in liquidation. This appeal is brought by the joint liquidators. The Appellant was placed into administration on 17 May 2011 and moved to a voluntary creditors' liquidation on 4 May 2012.

17. The Appellant was incorporated on 28 December 1983. On 23 February it changed its name to Freedom Finance Limited. On 29 November 2002 it was re-registered as a public

limited company, Freedom Finance PLC. On January 2010 it changed its name to Wilmslow Financial Services PLC (hereafter "the Appellant"). The Appellant operated as a loan broker, providing loan broking services to a panel of lenders in the UK.

18. The Appellant's arrangements which form the subject of this appeal began on 1 May 1997 when it entered into arrangements with Karakus Limited, a company registered in Gibraltar. Karakus was subsequently renamed Bespoke Finance Limited but for the purposes of this Decision I will refer to it as Karakus.

19. Karakus was a licensed credit broker which engaged the Appellant to supply it with loan broking services to enable it to supply the loan broking to the UK lenders. Karakus also engaged Mediability Limited ("Mediability") a UK media advertiser which had formerly been engaged by the Appellant to supply UK media advertising to it.

20. Karakus was set up by Mr Rupert Webb, the principal shareholder of the Appellant, who was the beneficial owner of the shares in Karakus using an Isle of Man Nominee Company (Jordan Nominees (IoM) Limited ("Jordan Nominees")) from May 1997. Mr Webb was sole signatory to the Karakus bank account.

21. On 1 November 1999 Mr Webb was removed as sole signatory to the bank account and two new directors were appointed who were partners in BDO Fidecs, a Gibraltar based financial services/accountancy firm.

22. On 18 September 2000 Mr Webb gifted the shares in Karakus to the ARK Trust, a charitable trust. In a note dated 2 August 2000, Jordan Nominees resigned as director. On 20 June 2003 the shares in Karakus were sold to Fidecs Group SA, a company based in Luxembourg.

23. In addition to the directors, Mr Alan Kentish and Mr Tim Revill, Karakus initially employed 3 members of staff, which later rose to 7 or 8.

24. Until 1 April 2002 Mediability was engaged by Karakus as a media agent which placed advertising for Karakus in the UK media. From that date, Mediability's role changed to an intermediary which negotiated for media advertisements on behalf of a Gibraltar media agent, ESP. ESP was engaged by Karakus to source UK media advertising. Mediability's role ceased in February 2008. The advertisements placed in UK publications on behalf of Karakus were under the name of the Appellant.

25. In 2008 HMRC made enquiries in respect of the two main lenders, First National Bank ("FNB") and Blemain Finance ("Blemain") to ascertain the relationships and arrangements in place with the Appellant and Karakus. The information provided by FNB was that the National Account manager met with the Appellant on a monthly basis, usually at the Appellant's premises. Where significant changes were proposed, for instance commission rate renegotiation, the managing director of the Appellant was likely to be involved. The account manager had limited knowledge of Karakus's role in arrangements and his understanding was that Karakus formed part of the Appellant's group and that commission rates negotiated by the Appellant were also applied to Karakus. The account manager was not aware of anyone from Karakus having attended meetings with FNB and there was no evidence of any direct communication or correspondence between FNB and Karakus save for an occasional email concerning incorrect commissions. Operationally FNB dealt with the Appellant and Karakus as one but settled commission to the two parties individually.

26. As regards Blemain, the Divisional Sales Manager met the Appellant on a monthly basis, again at the Appellant's premises, to discuss commission rates, benefits, policy changes and packaging arrangements. Blemain started work with Karakus in 2003 when they were approached by the Appellant who stated that they were going to start packing loans for

Karakus and wanted to operate the same broker deal previously enjoyed by the Appellant since 1995. Any Karakus "packaging" queries were communicated by Blemain to the Appellant and direct contact between Blemain and Karakus was minimal, for instance Lisa McKenna of Karakus attended a meeting with Blemain in September 2007 to review processes and gain feedback on the quality of packaging provided by the Appellant.

27. In relation to advertising, the Appellant had a UK based marketing director who was responsible for advertising strategy in the UK who liaised regularly with Mr Ian Farr of Karakus in Gibraltar. Mr Farr had previously been employed by the Appellant in the UK.

LEGISLATION AND AUTHORITIES

28. The Sixth Directive was the relevant legislation at the start of the material time and is, in the main, the relevant legal framework. Article 13A 1 provided exemptions from VAT for certain supplies including certain supplies of financial services. Articles 17 to 20 provided for the deduction of input tax insofar as such input tax has been used for the purposes of taxable but not exempt transactions. Therefore, irrecoverable VAT is borne on inputs used for exempt supplies.

29. The Principal VAT Directive ("the PVD") (2006/112/EC) contains equivalent provisions relating to exempt services of loan broking at Article 135 (1) (b) and Title X relating to deductions (Articles 167 – 192)

30. At Article 1(2) of the PVD the overall purpose of VAT is stated as:

> "The principle of the common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, however many transactions take place in the production and distribution process before the stage at which the tax is charged."

31. The underlying territorial scope of VAT is given by articles 5 to 8 of PVD, (Sixth Directive, Article 3). As Article 28 of the Accession Treaty of 1972 excluded Gibraltar, Article 1(2) of PVD (Article 2 Sixth Directive) therefore provides that VAT is intended to be a general tax on consumption of goods and services in the EU, including the United Kingdom but not Gibraltar.

32. The rules relating to the place of supply of services for VAT purposes are found in Article 9 of the Sixth Directive. Advertising services supplied to business customers are treated as supplied where the recipient belongs (PVD Article 44 and Sixth Directive Article 9(2)(e)).

33. In *Halifax Plc and others v CCE* [2006] STC 919 (at [93]) the Advocate General stated:

> "VAT is, in effect, an indirect general tax on consumption meant to be borne by the individual consumers. Correspondingly the same principle requires that a taxable person must not be entitled to deduct or recover the input VAT paid on supplies received for its exempted transactions. As long as no VAT is charged on the goods or services provided by taxable persons, the Sixth Directive necessarily seeks to prevent them from recovering the corresponding input VAT. This entails the consequence emphasised by the Commission at the hearing that exemption from VAT within the meaning of the Sixth Directive does not mean that the Sixth Directive was intended to free the final consumer completely from every tax burden".

34. The domestic law provisions in relation to VAT on supplies and services are contained within VATA 1994. Section 4(1) VATA 1994 provides:

"VAT shall be charged on any supply of goods or services made in the United Kingdom, where it is a taxable supply made by a taxable person in the course or furtherance of any business carried on by him."

35. Section 7(10) of VATA provides:

"A supply of services shall be treated as made-

(a) in the United Kingdom if the supplier belongs in the United Kingdom; and

(b) in another country (and not in the United Kingdom) if the supplier belongs in that other country."

Subsections 8(1) and (2) of VATA provide:

"(1)…where relevant services are-

(a) supplied by a person who belongs in a country other than the United Kingdom, and

(b) received by a person ("the recipient") who belongs in the United Kingdom for the purposes of any business carried on by him,

then all the same consequences shall follow under this Act (and particularly so much as charges VAT on a supply and entitles a taxable person to credit for input tax) as if the recipient himself supplied the services in the United Kingdom in the course or furtherance of his business, and that supply were a taxable supply.

(2) In this section "relevant services" means services of any of the descriptions specified in Schedule 5 not being services within any of the descriptions specified in Schedule 9."

36. Advertising services are specified at paragraph 2 of Schedule 5. The supply of intermediary services such as loan broking are exempt (see s31 and item 5 of Group 5 of Schedule 9 VATA 1994).

37. I was referred to a number of authorities relevant to the issues in this appeal and which it may be helpful to set out at this point.

Issue (1): Characterisation of the supplies

38. In relation to the issue of the proper characterisation of the supplies for VAT purposes of loan broking services and advertising services, the starting point as to what supplies have been made or what supplies have been received is the statutory definition of what is a supply. This is found in section 5(2) of the VATA, as follows:

"…

(a) supply" in this Act includes all forms of supply, but not anything done otherwise that for a consideration;

(b) anything which is not a supply of goods but is done for a consideration (including, if so done, the granting, assignment or surrender of any right) is a supply of services."

39. VAT is a tax on supplies for consideration. In *Customs and Excise Commissioners v Reed Personnel Services Ltd* [1995] STC 588 the Appellant provided temporary nurses to hospitals. The nurses were self-employed, but Reed retained a high degree of control over their activities. The Appellant argued that it was a recruiting agency and not (as HMRC contended) supplying nursing services to the hospitals. The Tribunal held that the contractual documents between the Appellant and the nurses and between the Appellant and the health authorities led to the conclusion that the Appellant had supplied nursing staff and not nursing

services, and that it's services had been those of agent for which the consideration was the commission received.

40. On an appeal from the Tribunal's decision, in the High Court Laws J made the following comments (at p 591 and 595):

> "I certainly accept that where any issue turns wholly upon the construction of a document having legal consequences, the exercise of construction is one of law for the judge. But for the proper resolution of a case of this kind, there are I think two qualifications. The first is that the concept of making a supply for the purposes of VAT is not identical with the performance of an obligation for the purposes of the law of contract, even where the obligation consists in the provision of goods or services. The second is that, in consequence, the true construction of a contractual document may not always answer the question—what was the nature of the VAT supply in the case?
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> …
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> … in consequence, it is perfectly possible that although the parties in any given situation may conclude their contractual arrangements in writing so as to define all their mutual rights and obligations arising in private law, their agreement may nevertheless leave open the question, what is the nature of the supplies made by A to B for the purposes of A's assessment of VAT. In many situations, of course, the contract will on the facts conclude any VAT issue, as where there is a simple agreement for the supply of goods or services with no third parties involved. In cases of that kind there is no space between the issue of supply for VAT purposes and the nature of the private law contractual obligation. But that is a circumstance, not a rule. There may be cases, generally (perhaps always) where three or more parties are concerned, in which the contract's definition (however exhaustive) of the parties' private law obligations nevertheless neither caters for nor concludes the statutory question, what supplies are made by whom to whom. Nor should this be a matter for surprise: in principle, the incidence of VAT is obviously not by definition regulated by private agreement. Whether and to what extent the tax falls to be exacted depends, as with every tax, on the application of the taxing statute to the particular facts. Within those facts, the terms of contracts entered into by the taxpayer may or may not determine the right tax result. They do not necessarily do so. They will not do so where the contract, though it tells all the parties everything that they must or must not do, does not categorise any individual party's obligations in a way which inevitably leads to the conclusion that he makes certain defined supplies to another. In principle, the nature of a VAT supply is to be ascertained from the whole facts of the case. It may be a consequence, but it is not a function, of the contracts entered into by the relevant parties."

41. It is clear from the above that, although relevant to the analysis of the supply, the issue of characterisation of a supply cannot be conclusively determined wholly by reference to the contractual documents or contractual obligation; it is one factor to be taken into account in assessing the overall view to be taken.

42. The guidance given by Laws J in *Reed* was cited with approval by the Court of Appeal in *WHA Ltd and another v Customs and Excise Commissioners* [2007] STC 1695. In the Supreme Court judgment [2013] UKSC 24 the Court considered the characterisation of a supply where a car insurer contractually arranged a garage to repair the damaged car of a customer and the garage was paid by a Gibraltar entity (WHA). The Court made the following observations at [26], [57] – [59]:

> "As this court has recently observed (*Revenue and Customs Comrs v Aimia Coalition Loyalty UK Ltd* [2013] UKSC 15 at [68], [2013] 2 All ER 719 at [68], decisions about the application of the VAT system are highly dependent upon the factual situations

involved. A small modification of the facts can render the legal solution in one case inapplicable to another. It is therefore necessary to begin by considering carefully the facts of the present case. As was also noted in the *Aimia* case at [38], the case law of the Court of Justice indicates that, when determining the relevant supply in which a taxable person engages, regard must be had to all the circumstances in which the transaction in question takes place. Furthermore, as Lord Walker explained in the *Aimia* case at [114]–[115], in cases where a scheme operates through a construct of contractual relationships, as in the present case, it is necessary to look at the matter as a whole in order to determine its economic reality. Accordingly, although the transaction of particular importance is that between the garage and WHA, it has to be understood in the wider context of the arrangements between the insured, NIG, Crystal, Viscount, WHA and the garage.

…

The interposition of reinsurers does not alter that position. Neither, on the facts found by the tribunal, does the interposition of WHA. In economic reality, when WHA pays for the repairs it is merely discharging on behalf of the insurer (via the chain of contracts connecting it to NIG, through Viscount and Crystal) the latter's obligation to the insured to pay for the repair. WHA's role, in relation to the aspect of its business concerned with the payment of the garages, is to act as the paymaster of costs falling within the cover provided by the policies. The interposition of WHA does not, by some alchemy, transmute the discharge of the insurer's obligation to the insured into the consideration for a service provided to the reinsurer's agent.

That conclusion is supported by a number of considerations. First, as was noted in *Revenue and Customs Comrs v Aimia Coalition Loyalty UK Ltd* [2013] a All ER 719 at [73], the Court of Justice has consistently stressed that the deduction of input tax is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities. In the present appeal, however, WHA does not bear the burden of the VAT paid to the garage: it pays the garage out of the float provided by Viscount, and its profit or loss is unaffected by the VAT. Secondly, it was also noted in the *Aimia* case at [75] that the consequence of the deduction of input VAT is that the tax is charged, at each stage in the production and distribution process, only on the added value, and is ultimately borne only by the final consumer (or by a person who stands in the shoes of the final consumer). In the present appeal, however, WHA adds no value in respect of its supply of 'footing of the bill', as the Court of Appeal put it: its inputs and its outputs in relation to that aspect of its business are identical. The final consumer of the services supplied by the garage is the insured; and the effect of dismissing this appeal is that VAT is borne on that supply.

That conclusion is also consistent with the guidance given in *Customs and Excise Comrs v Redrow Group plc* [1999] 2 All ER 1, [1999] 1 WLR 408. When Lord Hope of Craighead posed the question ([1999] 2 All ER 1 at 6, [1999] 1 WLR 408 at 412): 'Was something being done for him for which, in the course or furtherance of a business carried on by him, he has had to pay a consideration …?', and Lord Millett asked ([1999] 2 All ER 1 at 11, [1999] 1 WLR 408 at 418): '… did he obtain anything—anything at all—used or to be used for the purposes of his business in return for that payment?', those questions are to be understood as being concerned with a realistic appreciation of the transactions in question (see the *Aimia* case at [66]). So understood, it is plain that WHA did not obtain anything in return for the payment to the garage which was used for the purposes of its business. On the contrary, as the tribunal found and the Court of Appeal confirmed, and as I have explained at [42] and [53], above WHA's business *was* the making of the payment."

43. In applying the guidance set out in the authorities I consider the principles to apply are:

(1) To consider the overall circumstances, including all parties involved;

(2) Not to view individual elements of the arrangements in isolation;

(3) To consider the contracts as relevant factors to take into account but which are not conclusively determinative of the issue;

(4) To consider all relevant factors such as whether commercial value is added by a party to the supply.

Issue (2): Abuse of law

44. The principal guidance on the abuse principle in the context of VAT is the well-known decision of the ECJ in *Halifax plc and others v Customs and Excise Commissioners* (Case C-255/02) [2006] STC 919 which concerned a scheme entered into by Halifax to avoid irrecoverable input tax on the construction costs of a number of call centres in the UK.

45. In its judgment the ECJ referred to settled law that Community law cannot be relied upon for abusive or fraudulent ends, holding that this applied equally to VAT at [69] to [70]:

> "69. The application of Community legislation cannot be extended to cover abusive practices by economic operators, that is to say transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided for by Community law (see, to that effect, *Firma Peter Cremer v Bundesanstalt für Landwirtschaftliche Marktordnung*…; *General Milk Products GmbH v Hauptzollamt Hamburg-Jonas*…and *Emsland-Stärke*…
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> 70. That principle of prohibiting abusive practices also applies to the sphere of VAT."

46. The CJEU continued at [73], [74], [75], [80] and [81]:

> "Moreover, it is clear from the case law that a trader's choice between exempt transactions and taxable transactions may be based on a range of factors, including tax considerations relating to the VAT system (see, in particular, *BLP Group* [1995] STC 424, [1996] 1 WLR 174, para 26, and *Customs and Excise Comrs v Cantor Fitzgerald International* (Case C-108/99) [2001] STC 1453, [2002] QB 546, para 33). Where the taxable person chooses one of two transactions, the Sixth Directive does not require him to choose the one which involves paying the highest amount of VAT. On the contrary, as the Advocate General observed in para 85 of his opinion, taxpayers may choose to structure their business so as to limit their tax liability."
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> In view of the foregoing considerations, it would appear that, in the sphere of VAT, an abusive practice can be found to exist only if, first, the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions.
>
> Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. As the Advocate General observed in para 89 of his opinion, the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages.

…

To allow taxable persons to deduct all input VAT even though, in the context of their normal commercial operations, no transactions conforming with the deduction rules of the Sixth Directive or of the national legislation transposing it would have enabled them to deduct such VAT, or would have allowed them to deduct only a part, would be contrary to the principle of fiscal neutrality and, therefore, contrary to the purpose of those rules.

As regards the second element, whereby the transactions concerned must essentially seek to obtain a tax advantage, it must be borne in mind that it is the responsibility of the national court to determine the real substance and significance of the transactions concerned. In so doing, it may take account of the purely artificial nature of those transactions and the links of a legal, economic and/or personal nature between the operators involved in the scheme for reduction of the tax burden (see, to that effect, *Emsland Stärke* [2000] ECR I-11569, para 58)."

47. In *HMRC v Newey T/A Ocean Finance* [2013] STC 2432 the CJEU highlighted the fundamental importance of considering economic and commercial realities. The Court stated at [43] – [52]:

"Given that the contractual position normally reflects the economic and commercial reality of the transactions and in order to satisfy the requirements of legal certainty, the relevant contractual terms constitute a factor to be taken into consideration when the supplier and the recipient in a 'supply of services' transaction within the meaning of arts 2(1) and 6(1) of the Sixth Directive have to be identified.

It may, however, become apparent that, sometimes, certain contractual terms do not wholly reflect the economic and commercial reality of the transactions.

That is the case in particular if it becomes apparent that those contractual terms constitute a purely artificial arrangement which does not correspond with the economic and commercial reality of the transactions.

The court has held on various occasions that preventing possible tax evasion, avoidance and abuse is an objective recognised and encouraged by the Sixth Directive (see *Halifax*, para 71 and the case law cited) and that the effect of the principle that the abuse of rights is prohibited is to bar wholly artificial arrangements which do not reflect economic reality and are set up with the sole aim of obtaining a tax advantage (see *Ampliscientifica Srl v Ministero dell'Economia e delle Finanze* (Case C-162/07) [2011] STC 566, [2008] ECR I-4019, para 28; *Tanoarch sro v Tax Directorate of the Slovak Republic* (Case C-504/10) [2012] STC 410, para 51; and *JJ Komen en Zonen Beheer Heerhugowaard BV v Staatssecretaris van Financiën* (Case C-326/11) [2012] STC 2415, para 35).

In the main proceedings, it is not disputed that, formally, in accordance with the contractual terms, Alabaster provided the lenders with the supplies of loan broking services and that it was the recipient of the supplies of advertising services provided by Wallace Barnaby.

However, taking into account the economic reality of the business relationships between, on the one hand, Mr Newey, Alabaster and the lenders and, on the other hand, Mr Newey, Alabaster and Wallace Barnaby, as apparent from the order for reference and, in particular, the matters of fact mentioned by the Upper Tribunal (Tax and Chancery Chamber) in the third question, it is conceivable that the effective use

and enjoyment of the services at issue in the main proceedings took place in the United Kingdom and that Mr Newey profited therefrom.

It is for the referring court, by means of an analysis of all the circumstances of the dispute in the main proceedings, to ascertain whether the contractual terms do not genuinely reflect economic reality and whether it is Mr Newey, and not Alabaster, who was actually the supplier of the loan broking services at issue and the recipient of the supplies of advertising services provided by Wallace Barnaby.

If that were the case, those contractual terms would have to be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice (see, to that effect, *Halifax*, para 98).

In the present case, the re-establishment of the situation that would have prevailed in the absence of the transactions at issue, if the referring court were to consider them to constitute an abusive practice, would, in particular, mean that the services agreement and the advertising arrangements concluded between Alabaster and Wallace Barnaby could not be relied upon against the Commissioners, who could legitimately regard Mr Newey as actually being the supplier of the loan broking services and the recipient of the supplies of advertising services at issue in the main proceedings.

In the light of the foregoing considerations, the answer to the first to fourth questions is that contractual terms, even though they constitute a factor to be taken into consideration, are not decisive for the purposes of identifying the supplier and the recipient of a 'supply of services' within the meaning of arts 2(1) and 6(1) of the Sixth Directive. They may in particular be disregarded if it becomes apparent that they do not reflect economic and commercial reality, but constitute a wholly artificial arrangement which does not reflect economic reality and was set up with the sole aim of obtaining a tax advantage, which it is for the national court to determine."

48. The fact that a contract has some effect and is not, for example, a sham, is not sufficient to show it reflects economic and commercial reality; as per the Court of Appeal in *Newey* at [101], [104] to [108]:

"…a careful reading of the CJEU judgment suggests that total artificiality is not an invariable requirement, but rather a paradigm example of where the contractual terms do not reflect economic and commercial reality. But, as I have already noted (see [79] above), the Upper Tribunal clearly had this point in mind at [49] of the UT Decision, and it is also apparent from many of the leading cases that contractual arrangements can be found to be abusive even if they are genuine and play a part in arrangements which have an overall commercial purpose.

…

I consider that there may arguably be scope for operation of the principles that any input tax on supplies which are attributable to the exempt supplies should be duly paid, and that steps taken to avoid incurring such input tax could (depending on the facts) be abusive. The relevant supplies for present purposes are those of advertising services, made by Wallace Barnaby to Alabaster (I shall henceforth not refer separately to Lichfield and Abacus, but the same principles apply to them). As such, the supplies of advertising fall outside the immediate scope of VAT in the UK, because both companies belong in Jersey and (importantly) the UK has not taken advantage of the derogation in Article 9(3) of the Sixth Directive to treat the place of supply of those services as the UK, that being the country where their effective use and enjoyment takes place. That being so, I do not see how, if the arrangements in Jersey are viewed in isolation, it could sensibly be said that it was contrary to the purposes of the Sixth Directive for Alabaster to choose to obtain its advertising

services from Wallace Barnaby. Alabaster was simply taking advantage of the freedom which any trader has to structure its business in a tax-effective manner. This freedom has been repeatedly recognised in the jurisprudence on abuse of law, not least by the CJEU in Halifax and by the Supreme Court in Pendragon. I have quoted some of the relevant passages earlier in this judgment: see [43] and [49] above.

Can it then make any difference to this analysis that Alabaster was incorporated on the instructions of Mr Newey, as part of a tax avoidance scheme which was designed and implemented with the sole object of relieving him from the burden of irrecoverable VAT previously borne by him as a sole trader in the United Kingdom? In my judgment this is the critical question. As Advocate General Maduro said in paragraph 85 of his opinion in Halifax, quoted at [45] above, "[t]he normative goal of the principle of prohibition of abuse within the VAT system is precisely that of defining the realm of choices that the common VAT rules have left open to taxable persons." Thus it is necessary to ask whether the common system of VAT has left it open to Mr Newey to choose to restructure his business in the way that he did.

On behalf of Mr Newey, Mr Ghosh submits that this question must be answered in the affirmative. He submits that it is essentially a threshold issue, which must be kept separate from analysis of the chosen business structure once it has been established. It is no part of the common system of VAT, he submits, to dictate to a trader whether he should carry on his business as a sole trader, or in partnership, or through a corporate vehicle; or whether the business should be carried on inside or outside the EU. Furthermore, it is irrelevant whether these choices are motivated mainly, or even solely, by fiscal considerations. Once the choice has been made, and a structure for carrying on the business has been established, the VAT rules will then apply to it in the usual way, unless it can be seen, on examination, that the arrangements are artificial and do not reflect economic and commercial reality. In that case, there may well be scope for the doctrine of abuse of law to operate; but the doctrine cannot legitimately be used to undermine Mr Newey's threshold decision to incorporate his business in Jersey. The effect of that choice, if it was properly implemented, was that the business would now be carried on by a different legal person, namely Alabaster, in a different location, namely Jersey; and that the necessary advertising services would likewise be provided in Jersey, pursuant to the contract made between Alabaster and Wallace Barnaby.

I accept this submission, and agree that it was in principle open to Mr Newey to decide that the business of Ocean Finance should henceforth be carried on by Alabaster in Jersey, with the benefit of advertising services provided by Wallace Barnaby. Mr Newey's decision to restructure the business of Ocean Finance in this way was purely tax driven, but that in itself does not make it artificial or abusive. On the contrary, there was nothing unreal or artificial about the underlying business of Ocean Finance, and the decision to incorporate it in Jersey was a rational piece of tax planning which sought to take advantage of the territorial scope of VAT and the freedom of any trader to incorporate his own business so that it is carried on in future by a different legal entity in a different location. It is none of the business of the common system of VAT, or of national revenue authorities, to interfere with business choices of that nature, provided that they are properly implemented and the form of the new arrangements corresponds with their economic and commercial substance.

It is in this context, as it seems to me, that the evaluation mandated by the CJEU in the present case must be performed. The CJEU cannot have meant that the threshold choice of structure should be disregarded merely because it was purely tax driven, because in that case the outcome would have been obvious, and it would not have been merely “conceivable” that Mr Newey was still to be regarded as the supplier of the loan-broking services and the recipient of the advertising services. The CJEU must

therefore have meant that the question of artificiality has to be assessed by reference to the business relationships actually entered into between Mr Newey, Alabaster, the lenders and Wallace Barnaby, with a view to testing whether they reflected underlying commercial reality. A central focus of this enquiry would naturally fall on the continued role of Mr Newey himself, and his relationship with Alabaster. Was the board of directors of Alabaster truly independent from him, or was he a shadow director with whose instructions or wishes they invariably complied? Were the loan processing functions which he and his staff continued to carry on in Staffordshire now genuinely provided to Alabaster pursuant to the Services Agreement, or was the commercial reality that Mr Newey was still carrying out the work on his own behalf? Were the advertising services provided by Wallace Barnaby to Alabaster genuinely the product of an independent commercial relationship between those two companies, or was this just elaborate machinery set up to enable Mr Newey's decisions on advertising in the UK to be implemented via his meetings with Ekay Advertising, the recommendations made by Ekay Advertising to Wallace Barnaby, and the power which heretained to approve the content of advertisements? And what is the true significance, in this context, of the fact that late advertising space offered to Alabaster was on occasion not taken up because an Alabaster director was unavailable to approve it?"

49. The Appellant cited *Adecco UK Ltd & Ors v Revenue and Customs Commissioners* [2018] EWCA Civ 1794 ("Adecco") in which the Court of Appeal focussed on the contractual arrangements in place and did not extensively consider the economic commercial reality. Mr Gibbon submitted that this test was not a key plank of the VAT analysis but rather a sense-check, confirming the Court's view informed by the contracts (at [49]):

> "There is no suggestion that any of the contractual provisions was artificial, a sham, liable to rectification or vitiated for any other reason…"

50. The Supreme Court in *HMRC v Pendragon* [2015] UKSC 37 subsequently clarified the meaning of artificial at [5], [10], [11] & [33]:

> "Artificiality, if it is to be deployed as a workable legal concept, has to be tested against some standard of transactional normality, and the search for such a standard is far from straightforward. Taxpayers faced with a choice between alternative ways of achieving some commercial objective are in principle entitled to select the one with the more tax-efficient statutory outcome.
>
> …
>
> Two main difficulties arise where the principle of abuse of law is applied to tax avoidance schemes.
>
> The first arises from the assumption made by the Court of Justice in *Halifax* that the principle will not apply to what it called "normal commercial operations" (para 69). Subsequent case-law has established that this means those that are normal in the context of the relevant line of business, not necessarily normal for the particular taxpayer: *Revenue and Customs Commissioners v Weald Leasing Ltd* (Case C-103/09) [2011] STC 596. I do not think that the court can have intended to set up a third distinct test, in addition to the two which are set out in paras 74-75 and repeated in its order. The "normality" of a transaction is relevant to the question posed in the court's first test, about the "purpose" of the relevant provision of the VAT Directives. "Normal commercial operations" will not as a general rule be regarded as contrary to the purpose of the Directives, since these must be assumed to have been designed to accommodate them. Thus in *Weald Leasing* the taxpayer's decision to take equipment on lease from an intermediate company rather than buy it outright was an ordinary commercial transaction. It was not abusive even though it was unusual for the

taxpayer in question and was designed to obtain a tax advantage by spreading the liability to tax over a longer period. The choice between leasing and outright purchase was a choice accommodated by the scheme of the VAT legislation. The tax treatment of lease payments being a facility available under the legislation itself, resort to it could not be regarded as contrary to its purpose. For the same reason, a transaction is not abusive merely because it falls within an exception or derogation from ordinary principles of EU law governing the incidence of VAT, such as the right enshrined in the Sixth Directive to deduct input tax generated by transactions in another member state. It follows that the sourcing of goods or services from a country in which the VAT regime is more favourable is not in itself abusive, even though the object and effect is to allow the deduction of input tax without the payment of output tax (*Revenue and Customs Commissioners v RBS Deutschland Holding GmbH* (Case C-277/09) [2011] STC 345). The reason, as the court explained in that case at paras 51-52, is that this is a choice inherent in a scheme of taxation that is designed to be fiscally neutral as between different member states while allowing for some differences between their implementing laws. Likewise, the conduct of a genuine business activity through a subsidiary incorporated in another member state is not abusive, although the sole reason for the choice is that it has a lower rate of corporation tax: *Cadbury-Schweppes Plc v Inland Revenue Commissioners* (Case C-196/04) [2006] STC 1908. Precisely the same considerations must apply to a decision to source goods or services from outside the European Union, an option which is inherent in the territorial limits of the EU VAT regime and the assignment of economic relations with third countries to other policies of the Union."

The selection as the funding bank of an offshore institution which was not a taxable person cannot in itself be regarded as objectionable. It is no part of the policy of the legislation that a party should be restricted in its freedom to select as its commercial partners firms whose place of residence gives dealings with them a tax advantage, even if that is the only reason for their selection. But it is not just the non-resident status of SGJ which enabled the tax advantage to be obtained. The particular method by which SGJ was brought into the chain of contracts, involving successive transactions by which Pendragon navigated its way from one VAT exemption to another, was an unnecessary and artificial way of involving them. Taking the scheme as a whole, its economic substance was that it was a sale and lease-back, which is a perfectly ordinary commercial financing arrangement. But it had two special features. One was that instead of Pendragon plc or a dealership company transferring the cars to the funding bank SGJ and taking them back on lease, a Captive Leasing Company was interposed at Step 2 as the lessor, which then leased the cars to the dealership companies and assigned the leases and title to the cars to SGJ at Step 3. The other special feature was that instead of the leases being brought to an end by the exercise of an option to purchase or by some other mode of termination, another captive company (Captive Co 5) was interposed at Step 4 to take a transfer of SGJ's leasing business (or a discrete part of it) comprising the leases, title to the cars and the associated 'goodwill'. Each of these two features was essential to the tax efficacy of the KPMG scheme. The second was essential in order to bring Captive Co 5's acquisition of possession within the gateway for assets acquired as part of a business transferred as a going concern. The first was essential because under art 8(2)(d) of the Cars Order the use of that gateway was available only if the transferor of the business had himself taken possession of the cars under one of the other gateways at paras (a), (b) or (c). The relevant one was (c), which included the assignment of rights under a hire purchase or conditional sale agreement. However, neither of these two special features of the scheme had any commercial rationale other than the achievement of a tax advantage. They were manifestly included not for the purpose of facilitating the obtaining of credit from SGJ but for the sole purpose of legally recharacterising a transfer of cars without incurring net liability on the price."

EVIDENCE AND FINDINGS

51. The evidence in this appeal comprised a substantial amount of documentary evidence. All of the documents were considered; the following sets out my findings on the salient documents.

52. A letter from Arthur Andersen to Mediability dated 3 March 1997 and headed "VAT FREE ADVERTISING" stated:

> "I refer to the matter of arranging events so that Mediability Ltd will be able to supply advertising services to a company which is incorporated in Guernsey on a VAT free basis.
>
> I have been progressing the issue with Rupert Webb at Wilmslow Financial Services Ltd and we are considerably closer to implementing the necessary arrangements which are required to effect the desired end result…
>
> As matters progress with regard to the incorporation of a Guernsey company, I will keep you fully informed…"

53. Thereafter Karakus was created on 19 March 1997. The First Agreement between Karakus and the Appellant is dated 1 May 1997 and describes the parties as follows:

> "The Company [Karakus] carries on the business of providing financial intermediary.
>
> The Credit Broker [the Appellant] carries on the business of credit broking and has the necessary expertise, credit licenses, staff and facilities for the processing of applications for loans and for the giving of financial advice."

54. Under the terms of the First Agreement the Appellant agreed to provide the following "Credit Broking and Data Processing" services to Karakus (at Clause 2 of the First Agreement):

> "(a) to deal with all initial enquiries from Applicants For Loans in response to Advertisements placed by the Company offering loans;
>
> (b) to give financial Advice to Applicants for Loans;
>
> (c) to make enquiries of the Applicants for Loans to ascertain if they have sufficient equity in their property;
>
> (d) in prima facie satisfactory cases to forward to the Applicants for Loans the appropriate loan application forms;
>
> (e) to receive completed loan application forms from the Applicants for Loans;
>
> (f) to vet the completed loan application forms for completeness and accuracy;
>
> (g) to undertake credit references;
>
> (h) to value the assets in respect of secured loans;
>
> (i) where any Applicant for a Loan has passed all the credit check controls, to forward copies of the completed and successfully vetted loan application forms to the Company with recommendations as to possible Lenders and ancillary terms;
>
> (j) items (a) to (i) inclusive being sometimes hereinafter referred to as the "Specified Services".

55. At Clause 3 of the First Agreement Karakus "agrees to pass all the successfully completed application forms received from the Credit Broker to the Lenders in consideration of a commission in respect of all successful Loan Applications."

56. The Appellant invoiced for its services at the rate of £60 per successfully processed secured loan application. At Clause 5 the First Agreement stated:

> "The Company shall procure Advertising Services at its sole discretion and promote the availability of Loans from the Lenders in such newspapers, magazines, radio, television, directories, pamphlets and other media as it considers appropriate to attract Applicants for Loans"

and at clause 8 Karakus: "hereby covenants not to undertake any form of Credit Broking which activity shall be solely the responsibility of the Credit Broker" and agreed not to give any financial advice "to any Applicants or prospective Applicants for Loans which activity shall be solely the responsibility of the Credit Broker and further to refer any requests for such advice to the Credit Broker".

57. Clause 15 deals with the duration and termination of the First Agreement. Termination was conditional on the following:

- "If the other party has committed any breach of any of its obligations under this Agreement and (in the case of a breach which is capable of remedy) has failed to remedy the same within 30 days after receipt of written notice specifying the nature of the breach and requiring it to be remedied; or
- If the other party is the subject of insolvency proceedings (save for the purpose of amalgamation or reconstruction);
- If an encumbrance takes possession, or a receiver is appointed, of any property or assets of the other party;
- If the other party ceases to carry on business."

58. The letter from Arthur Andersen explicitly states the purpose of the arrangements was to enable the Appellant to receive VAT free advertising from Mediability. The letter indicates that it is driven by Arthur Andersen and the Appellant for the sole purpose of receiving VAT free advertising from Mediability via the use of an offshore company.

59. It is clear from the First Agreement that the Appellant held the necessary expertise to carry out the processing of loans. HMRC noted there is no provision for payment by Karakus for goodwill. On the material before me there was no evidence to conclude that there was a transfer for which goodwill would be expected nor what the value of any goodwill would have been at the relevant time. However, it is clear that Karakus received the benefit of the Appellant's experience, resources and contacts, on the face of it, for no payment. However, more notably, Karakus appears to have no control or veto in respect of the applications; the Appellant is the business with the necessary knowledge, experience and infrastructure but given that Karakus is the purported principal, there are no explicit provisions by which it has the power to make the ultimate decision or even to be involved in the business of loan broking; on the face of it, it's role is limited to forwarding applications that have already been checked and approved by the Appellant to the lenders. I agreed with the submissions on behalf of HMRC that this feature implies that the use of Karakus was artificial and which is the reason, therefore, for the limited value added by it in the business of loan broking.

60. In support of its case the Appellant relied on *Ocean Finance* [2010] UKFTT 183 (TC) at 28, 50 and 52 in which the FTT held:

> "We further find that, whilst Alabaster did not itself have the infrastructure in Jersey to conduct a loan broking business, it equipped itself to conduct such a business by outsourcing the processing operation to the Appellant. Given this, we do not consider that the fact that there were only limited resources in Jersey itself has any impact on the carrying on by Alabaster of the loan broking business. Whilst we accept that

certain information known to the Appellant in respect of Alabaster's business, such as its profitability, and income and costs, might not be known to an arm's length sub-contractor, it would be known to a 100% shareholder, and there is nothing in this fact that suggests that the contractual relationship between the Appellant and Alabaster was anything other than contractor and sub-contractor.

He said that the operations we have described of signing off forms such as OAFs were not normal commercial practice. We accept that, if compared with an arrangement that might have been entered into between independent parties operating at arm's length, the arrangements lack certain commercial features. It is true, and the Appellant accepted, that the loan broking business could have been carried out in the UK, and the loan broking business could have been pursued with an integrated, rather than sub-contracted, processing service. Nevertheless, we find that Alabaster carried on a commercial business. It was itself a commercial enterprise, carrying on economic activities of loan broking for which it equipped itself to a limited extent with its own staff and directors, and to a large extent through engaging the services of the Appellant under the Services Agreement. This was no brass plate company. Nor do we consider that it is in any way material to the question of commerciality that advice on the decision-making processes in Alabaster had been given by Moore Stephens.

It is common ground that the Appellant's operation in the UK was a substantial one. We were referred to the salaries of senior staff and underwriters in the UK, which were substantial when contrasted with those of the Alabaster directors and Lucy Woodworth. However, this merely emphasises the extent of the processing operation that Alabaster had contracted to equip itself to conduct its loan broking business. We do not infer from this that it must have been the Appellant that was carrying on the loan broking business. We are satisfied that the loan broking business was carried on by Alabaster, with the services of the Appellant provided through the Services Agreement.

We consider that on the facts of this case it was Alabaster that had a business relationship with the lenders. Just as if it had done so through its own staff in Jersey, Alabaster carried on that business relationship, having equipped itself to do so through the Services Agreement with the Appellant. The mere fact that functions are performed through an outsourcing arrangement does not mean that the principal who has sub-contracted those functions out to another party should be regarded as not having the business relationship with its own contractual counterparties."

61. I am not bound by the Decision of the FTT and I consider that the Decision must also be read in the context of its subsequent appeals and the observations set out by the UT, CJEU and Court of Appeal. Whilst I accepted the Appellant's submission that Karakus held the contracts with the lenders, this feature in isolation does not, in my view, equate to Karakus adding value. The FTT's decision in *Ocean Finance* did not consider this feature in isolation and its Decision relied heavily on its finding that the activities of the parties reflected the terms of the Services Agreement. As will become apparent, I found that the factual situation in this case was different.

62. In my view, there was no reason why the Appellant could not have held those contracts. Taken together with the limited value added by Karakus, I found that these features supported HMRC's case that the use of Karakus was an artificial insertion for the purpose of achieving the "desired end result" referred to in the letter from Arthur Andersen above, namely enabling the Appellant to receive VAT free advertising through the use of an offshore entity.

63. It was clearly open to Karakus to equip itself to conduct the business by outsourcing the processing to Appellant (see Clause 8) but in my view, this does not, of itself, indicate, as the

Appellant submitted, control by Karakus over the applications without further consideration of the evidence as a whole. It must be noted that under Clause 8 the processing of the loans is specifically reserved to the Appellant which meant that Karakus could not, without breaching the agreement, carry out any such role. Furthermore, under the terms of the Agreement Karakus could not carry out any loan broking on its own account. However, the Appellant was under no such contractual obligation which left open the possibility of it acting in competition with Karakus. The absence of any contractual terms preventing it competing or dividing the way loans would be processed between the companies indicated that this was not an arm's length agreement between parties seeking to protect their own interests.

64. The Appellant accepted that the First Agreement contained no key performance indicators. I did not accept the Appellant's argument that it should be an implied term that the services the Appellant agreed to perform at Clause 2 (a) – (j) would be carried out to a competent standard and within a reasonable time frame. In my view, the absence of key performance indicators or terms relating the performance of the services was an uncommercial feature of the agreement which reflected the fact that it was not an arm's length contract between independent companies.

65. Although under Clause 5 Karakus had responsibility for procuring advertising, this was not the reality of the situation as it was in fact the Appellant who procured advertising, which was not disputed on behalf of the Appellant and which I found as fact. The First Agreement also indicates that Karakus would negotiate in relation to advertising however it was again accepted that this was not the case. In my view, these features, taken together with the fact that the Appellant received no payment for these services which it performed without being contractually bound to do so indicates that the First Agreement did not reflect the commercial reality between the parties and was driven by the Appellant to achieve the aim of the scheme.

66. I noted the Appellant's submission that the First Agreement was professionally drawn up, however it remains unknown upon whose instructions and I did not find that this assisted in relation to the issues to be determined.

67. I rejected the Appellant's submission that the Appellant must have been satisfied with the payment terms set out at Clause 4.2; there was no evidence to support such speculation and I did not consider that any such inference could reasonably be drawn when considering the overall picture as to do so ignores the HMRC's argument that if the arrangements were put into place for the sole purpose of mitigating tax for the benefit of the Appellant, the agreement in respect of payment terms was motivated by that purpose and achieving the end result intended by the arrangements.

68. My conclusion in relation to the First Agreement is that it lacked commercial terms which would be expected in a contract between independent companies and contained uncommercial features. Moreover, in evaluating all of the circumstances it was clear that the terms of the First Agreement did not reflect the commercial reality of the situation for example in relation to the procuring and negotiating of advertising.

69. As the authorities make clear, contractual terms are not decisive of the issues to be determined and I therefore went on to consider the documentary evidence available. In a letter dated 1 May 1997 from Mediability to Mr and Mrs Webb T/A Fairdene Financial Services a request was made that the fees paid by Karakus to Mediability be cross-guaranteed:

> "Before we can commence the necessary work we would be obliged if you could return the duplicate of this letter, signed by you, to indicate your agreement to act as guarantor of Karakus Ltd in respect of the payments due under the Contract.

> In consideration of us providing the services referred to above and, in the event that Karakus Ltd…fails to make payments due under the Contract in accordance with the Contract, Fairdene Financial Services hereby irrevocably and unconditionally guarantees to pay to Mediability Ltd any amounts up to a maximum aggregate sum of £150,000 which are payable by Karakus Ltd to Mediability Ltd.
>
> An amount equal to any amount unpaid, subject to the above limitation, shall be paid by Fairdene Financial Services to Mediability Ltd (without set-off or other deduction) upon receipt by Fairdene Financial Services of a letter which details any amounts outstanding from Karakus Ltd and which is accompanied by copies of invoices issued by Mediability Ltd to Karakus Ltd. The amount detailed as payable shall be conclusive unless manifestly incorrect.
>
> In addition Fairdene Financial Services is principal obligor and as a separate and independent obligation irrevocably and unconditionally agrees to indemnify Mediability Ltd in full on demand against all losses, costs and expenses suffered or incurred by Mediability Ltd arising from or in connection with the failure by Karakus Ltd fully and promptly to make the payments in accordance with the Contract.
>
> The parties acknowledge that a separate guarantee has been entered into between Mediability Ltd and Wilmslow Financial Services Ltd ("the first guarantee"). For the avoidance of doubt it is hereby acknowledged that Mediability may only recover once in respect of consequential loss suffered by it; such claim being made either against Fairdene Financial Services pursuant to this guarantee or against Wilmslow Financial Services Ltd pursuant to the first guarantee…"

70. The "first guarantee" was set out in largely similar terms in a letter of the same date to Wilmslow Financial Services Ltd.

71. I agreed with the submissions of HMRC who questioned why such a guarantee was entered into which would include a potential liability to VAT in the event of a challenge by HMRC to the arrangements. In my view the guarantee is evidence of the fact that Karakus was not an independent entity as it has a clear financial link to the Appellant. There is no obvious commercial advantage to the Appellant in guaranteeing the fees and I consider it a reasonable inference to draw that its reason for accepting the potential liability is the advantage of the overall arrangements to the Appellant and indicates that its role was more than that of a processor to which work was outsourced. I did not accept the Appellant's submission that the guarantee gives no indication about the relationship between the Appellant and Karakus; to the contrary, it seems to me that it clearly shows the link between the companies and that the arrangements were driven by the Appellant for the Appellant's ultimate benefit.

72. An internal memorandum from the lender The First National Bank (from Mr Howell to CJ Weeks) dated 15 May 1997 with the subject "Karakus Ltd" set out:

> "With effect from 1st June 1997 a new operating company based in Gibraltar under the name of Karakus Ltd will be formed. This company will replace Wilmslow Financial Services Ltd. who will simply provide marketing, data processing and support services to Karakus Ltd and Fairdene Financial Services (a partnership), will cease to trade with effect from 31st May 1997…
>
> You will be aware that we have a marketing loan agreement in place in the name of Wilmslow Financial Services Ltd. and Fairdene Financial Services, which will need to be amended with effect from 1st June 1997. This may be complicated by the fact that there are nominee directors appointed to Karakus Ltd. who will need to sign the agreement which will also need to include Wilmslow Financial Services Ltd. and the guarantees of Mr. & Mrs. Webb…."

73. I noted the Appellant's observation that this document pre-dated HMRC's challenge to the scheme and that the position with regard to Karakus' directors changed over the years. However, it is relevant in my view as part of the background to the arrangements as they were put into place and the document shows that the FNB was notified as to the arrangements being set up and the potential "complications". HMRC submitted that the inference to be drawn was that FNB was aware that the directors were not independent nor were they making commercial decisions. The Appellant submitted that the complications referred to may have referred to the logistics of having the nominees sign the agreement. I found that, irrespective of what the complications referred to, the letter demonstrates the link, from FNB's perspective, between Karakus and the Appellant in terms of guaranteeing the loan agreement.

74. On 27 May 1997 Mr Webb was appointed sole signatory to Karakus' bank account and an internal email from a lender dated 30 May 1997 with the subject "FW: KARAKUS" requests that all members of the team are advised that Mr Webb:

> "would like all commission cheques for Wilmslow and Low Cost Loans to be paid to Karakus Limited as from Monday 2nd June 1997."

75. The document shows clear evidence of Mr Webb's personal link to and financial control of Karakus. The email shows that Mr Webb had the authority to direct the money flow required to achieve the purpose of the arrangements. The Appellant sought to argue that the email simply reflects the fact that with effect from 2 June 1997 the FBB contract was with Karakus and not the Appellant. I disagree; the email shows a clear relationship from the lender's perspective between the Appellant and Karakus such that the lender accepted Mr Webb's authority to direct the payment of commission cheques for the Appellant to Karakus.

76. On 30 June 1997 Karakus and Mediability entered into contractual terms under which Karakus was obliged to indemnify Mediability (at Schedule 5):

> "…in the event that HM Customs and Excise seeks retrospective payment of VAT from Mediability in relation to the Services…"

77. "Services" was defined under Clause 2 as "the provision of advertising services as may be agreed by the parties from time to time". Clause 4.1 provides that "Mediability will as and when requested by Karakus procure the Services for Karakus" and at Schedule 1 "Mediability will use its best endeavours to procure the Services requested by Karakus at the most competitive market rates available, subject to any discounts as may be agreed from time to time with Karakus".

78. In the absence of evidence providing an explanation, I found that Karakus' agreement to indemnify Mediability, with specific reference to a possible challenge by HMRC was a highly unusual feature. Furthermore, I consider the earlier cross-guarantee by the Appellant as evidence of further links between the parties.

79. On 18 July 1997 the First National Bank, Karakus ("the Company") and the Appellant/Webbs (the "Joint Borrowers") entered into a deed of agreement which set out that:

> "By a deed of agreement dated 1st December 1996 made between FNB and the Joint Borrowers…as varied by a further deed of agreement dated 21st May 1997…FNB granted the Joint Borrowers renewal of an advance commission loan facility of £100,000 which was thereafter paid to or to the use of the Joint Borrowers to be repaid by deduction from commissions earned by the Joint Borrowers and which would otherwise have been payable to them.
>
> …
>
> The Company wishes to enter into arrangements with FNB (and so far as is necessary the Joint Borrowers) for:-

(i) Approval as an introducer of instalment credit business to FNB,

(ii) An advance commission loan facility of £100,000,

(iii) Provision of Running – Rate Commission

NOW IT IS AGREED AS FOLLOWS: -

FNB hereby approves the Company as an introducer of instalment credit business and extends to the Company an advance commission loan facility ("the Facility") for the purpose of refinancing the Joint Borrowers' current indebtedness to FNB under the 1996 Agreement and the Variation Agreement on the following terms and conditions.

…

9. In consideration of the foregoing the Joint Borrowers hereby waive any claim they might have for further commission from FNB and the Company acknowledges that the first £100,000 of override commission on paid out business is being paid in advance under the terms of this agreement and accordingly the Company and the Joint Borrowers hereby indemnify FNB absolutely against any claim of whatever nature and however arising in respect of commissions paid or repaid under this agreement or any other agreement between any of FNB, the Company and/or the Joint Borrowers and it is expressly agreed that this clause shall survive in full force and effect notwithstanding repayment of the facility and/or expiry of termination of this agreement.

10. FNB shall be entitled, but shall not be obliged, to demand immediate full repayment of the balance of the Facility in any of the following events: -

(a) If the Company ceases to carry on the business of a licensed credit broker and/or fails to offer FNB first refusal of all instalment credit business under Clause 4 of this Agreement, such cessation or failure to be determined by FNB in its absolute discretion.

(b) If the Company fails to comply with or in the opinion of FNB appears to be in breach of any of its obligations or warranties under this Agreement.

(c) If the Company and/or the Joint Borrowers (or any of them) cease to hold appropriate license(s) under the Consumer Credit Act 1974 to enable them to introduce to FNB and/or process instalment credit business or to comply with any other statutory or regulatory operating requirements."

80. Under the agreement the balance would be automatically and immediately repayable or set off in the event of Karakus or the Webbs committing certain specified defaults. The agreement records that both Karakus and the Joint Borrowers entered into the agreement with the benefit of independent professional advice and that the financial liabilities of both to FNB under the agreement were joint and several.

81. Under the agreement the Appellant received £100,000 and at clause 6 Karakus was added to the agreement. HMRC submitted that the inference to be drawn is that it was the Appellant who introduced Karakus to the lender FNB. The purpose of Karakus' advance commission from FNB is stated as being:

> "for the purpose of refinancing the Joint Borrowers' current indebtedness to FNB under the 1996 Agreement and the Variation Agreement"

and in consideration, the Appellant and Mr and Mrs Webb "waive any claim they might have for further commission from FNB". Whilst I accepted the Appellant's submission that arrangements would have had to be made by the Appellant in respect of its advance commission, in my view this is a further indication that the agreement is not arm's length as there is no reason why, if the two companies were independent, the lender would swap one for the other. That

FNB were entitled to immediate repayment in circumstances which can be triggered by either Karakus or the Appellant committing certain defaults which indicates that, from FNB's perspective, they are dealing with effectively one company.

82. On 5 October 1999 a meeting took place between HMRC and the Appellant. Present at the meeting were two HMRC officers, an accountant from Ford Campell, the Appellant's in-house accountant Mr Mark Chadwick and Mr Webb. The record of the meeting noted the following:

> "To assist [HMRC] with her understanding of the business, they had photocopied a flow chart which was part of their sale information, detailing how the business operated. For the period that [HMRC] was looking at up to 31 March 1998, the company Karakus had been active for 11 months of the year. Basically, the company now are data processors and a marketing company. They receives [sic] calls from an advert which may be on the TV, Yellow Pages, national newspaper advertising, etc. Karakus would place an advert, and then initial contact from a prospective customer was received. Loan application details were taken and if it was an unsecured loan, it would passed [sic] to a personal loan company and an independent principal. If it was a mortgage, then the lead would be passed to Direct Mortgages Ltd…The mortgage business was being dealt with in a completely separate company because the Mortgage Code and the Consumer Credit Act could not mix together."

83. There was an issue between the parties as to who "the company" referred to; HMRC submitted that it appeared to refer to Karakus and showed confusion on the Appellant's part as if it referred to the Appellant, HMRC noted there was no power in the contract for the Appellant to be a "marketing company" as the advertising was the role of Karakus; if it referred to Karakus, whilst "marketing" could possibly cover its role, it had never acted as a data processor. The Appellant contended that the only interpretation was that the reference referred to the Appellant and showed no confusion on the Appellant's part. I accepted that the note was unclear, however on my reading the reference appears to refer to the Appellant and I agreed with HMRC's submissions that it showed confusion that would not be expected of the Appellant as to its role and activities under the arrangement.

84. The record of the meeting also noted:

> "[HMRC] asked who is given responsibility in the company to place an advert. Mr Webb explained that Karakus had given him the power to place adverts as he felt necessary. [HMRC] asked who in Karakus had given him this power. Mr Webb initially seemed unsure but then said it was John Swann who was the director of Karakus Ltd who he had initially dealt with. He confirmed he had never met him but had spoken to him on the telephone. Mr Webb, upon [HMRC's] questioning, confirmed that he had recently not spoken to John Swann, but previously when the company was first set up he may have spoken to him say 20 or 30 times.
>
> The position before Karakus was used, was the same, Mr Webb would decide on the advertising policy.
>
> Mr Webb said that the power to place the adverts was in the original agreement.
>
> [HMRC] then asked who negotiated the costs with whom. Rupert Webb initially said it was him but then explained that it wasn't really possible to negotiate the cost of an advert, only whether or not you placed the advert. Rupert Webb explained that he dealt with Darren Grundy in the company of Mediability.
>
> Mediability would send them order spaces and bill Karakus directly, but send a schedule of adverts placed to Wilmslow Financial Services Ltd. This way, Mr Webb knows how much to write a cheque out for to Mediability.
>
> …

Mr Webb explained that a copy of the application form was sent to Karakus and the original copy was sent direct to the bank, who would then authorise the loan directly. Mr Webb said that Karakus was a completely separate entity and nothing really to do with him. [HMRC] asked who was in Karakus and operating the company as Karakus, Mr Webb seemed unclear.

…

[HMRC] asked how Karakus received their monies. Now Karakus received the majority of its income by telegraphic transfer. Previously, cheques were received by Karakus. The cheques were sent to Wilmslow Financial Services Ltd and banked by Wilmslow Financial Services Ltd on behalf of Karakus Ltd…Mr Webb has drawing rights currently on the bank account however he is most concerned that the director Mr John Swann resigned yesterday and the accountant, BDO, do not want Mr Webb to have drawing right on the bank account. Under Gibraltar law, BDO say they must now take responsibility for the company which would mean that Rupert Webb would not have drawing rights on the bank account. Mr Webb said that if he didn't have drawing rights on the bank account, he wouldn't have entertained the use of the company Karakus Ltd. Now that they were about to take this off him, he was having to reconsider the position very carefully.

…

[HMRC] said that she understood that the trade was said to have ceased in May 1997 and a new trade was said to have started. [HMRC] asked how different it is now than before. Mr Webb explained that if you took Karakus out of the picture, the company's trade was exactly the same as before. The only change is the way is that they deal through Karakus…

[HMRC] asked how the difference in the trade was portrayed to Joe Public, how would she have known that the trade had ceased and a completely different trade re-started. Mr Webb explained that the customer would realise that the credit agreement said that the broker was no [sic] Karakus Ltd not Wilmslow Financial Services.

Mr Webb explained that Karakus Ltd was set up to save VAT on advertising costs. [HMRC] asked whose idea it was, Mr Webb explained he had heard about it by a competitor who had been doing it for many years and he approached Arthur Anderson to put the deal into practice for him.

[HMRC] said that she understood that Mr Webb was concerned that if he was to agree something with [HMRC] it may well be that binding agreement for VAT purposes as well. Mr Webb said he wasn't worries about the VAT position, he was very confident that the scheme that he had been sold by Arthur Anderson was watertight and there were no problems arising as a result of it.

[HMRC then asked what had happened to the £89,000 that was outstanding per the balance sheet when Karakus had took over. If, Wilmslow Financial Services were no longer dealing with any of the money lenders surely, they would have had to have paid the advance back for they were not going to earn any more commission. And since Karakus had absolutely nothing to do with the company, it wouldn't have simply been transferred over to them.

Neither [the accountant from Ford Campbell] nor Webb knew what had happened."

85. I found that the extract above shows a further degree of uncertainty from Mr Webb as to how the Appellant's arrangements with Karakus worked. Mr Webb was unsure as to who had given the Appellant power to place adverts. The limited contact with Mr Swann or any named contact at Karakus suggests that the Appellant carried out its activities without a clear understanding of the terms agreed in the First Agreement, in particular the incorrect belief that such a power was contained in the First Agreement. I inferred from this that the

contractual terms did not reflect the commercial reality of the situation between the parties. My finding was reinforced by Mr Webb's acceptance that:

> "the position before Karakus was used, was the same, Mr Webb would decide on the advertising policy"

and

> "if you took Karakus out of the picture, the company's trade was exactly the same as before"

Both statements, in my view, indicate the use of Karakus as a vehicle which added no commercial value in the arrangements. Mr Webb's uncertainty as to who operated Karakus and what had happened to the substantial sum of money outstanding when Karakus entered the arrangements is not what would be expected if the Appellant was acting as a sub-contractor with Karakus as its principal. The information provided by Mr Webb lacked commercial rationale, for instance he explained that the loan applications were sent directly to the bank for authorisation with only copies being sent to Karakus which provides no commercial reason for Karakus' involvement, and if, as stated by Mr Webb, Karakus was "nothing really to do with him" there is no explanation as to what Karakus actually did or why it was required in the arrangements unless viewed in the context of Mr Webb's explanation that the purpose of Karakus was solely "to save VAT on advertising" and that it was Mr Webb who approached Arthur Andersen "to put the deal into practice for him". My conclusion that this evidence clearly indicates that the arrangements were driven by Mr Webb with a view to receiving VAT free advertising is strengthened by Mr Webb's description of the arrangements as a "scheme that he had been sold". In my view the document does not support the Appellant's case that it was acting on Karakus' behalf and I reject that submission.

86. On 27 October 1999 the Second Agreement was entered into. The contract is entitled "Supplemental Agreement" and included in its terms the following:

(Reference to "the Agreement" is to the First Agreement)

> "(c) Clause 5 of the Agreement provides that the Company shall procure Advertising Services at its sole discretion and promote the availability of Loans from the Lenders in such newspapers, magazines, radio, television, directories, pamphlets and other media as it considers appropriate to attract Applications for Loans. In practice, WFS has been procuring such Advertising Services on behalf and for the benefit of the Company and WFS and the Company are desirous of amending the provisions of Clause 5 of the Agreement to reflect the arrangements between them in respect of procuring Advertising Services;
>
> (d) WFS and the Company are desirous of amending certain other terms of the Agreement…
>
> 3. Amendment of Clause 5 of the Agreement
>
> 3.1 WFS and the Company agree that Clause 5 of the Agreement be amended as follows:-
>
> 3.1.1 The Company, for the purpose and benefit of generating new business for itself as a result of successful Loan Applications, shall appoint WFS to act on its behalf to procure Advertising Services to promote the availability of Loans from the Lenders.
>
> 3.1.2 WFS in procuring such Advertising Services on behalf of the Company shall at all time act upon all instructions or recommendations made by the Company with regard to such Advertising Services and the Company shall not be obliged to meet any costs or expenses arising from any Advertising Services procured by WFS contrary to any such instructions or recommendations of the Company.

> 3.1.3 WFS and the Company shall use their respective endeavours to carry out their respective duties pursuant to sub-paragraphs 3.1.1 and 3.1.2 of this Clause for the mutual benefit of each of them.
>
> 3.1.4 For the avoidance of any doubt, the Company shall continue to meet all costs and expenses arising from any Advertising Services (save where such Advertising Services are procures by WFS contrary to any instructions or recommendations of the Company as provided in sub-paragraph 3.1.2 of this Clause) as provided by clause 5 of the Agreement."

87. The Second Agreement (at 4.1) also amended Clause 2 of the First Agreement to provide that the Appellant would:

> "on behalf of the Company…pass all original Loan Application forms to the Lenders"

88. The Second Agreement also added Clause 3A by amendment which provided that:

> "Notwithstanding the provisions of clause 3, the Company may exercise a veto in respect of any successfully completed application forms and instruct WFS not to pass any particular original Loan Application form to the Lender".

89. The Second Agreement reflects the reality of the situation which had been taking place since the arrangements were put in place. As shown from the evidence set out above, and which was not challenged by the Appellant, the Appellant had been procuring the advertising services and I consider the fact that the Appellant carried out these services without payment lacked commerciality and supported the case for HMRC that it was, in reality, the Appellant that was supplying the loan broking services and receiving the advertising supplies in the course of its business.

90. I considered the Appellant's submission that in the Second Agreement the Appellant contracted to procure advertising on Karakus' behalf and that any contract can be amended by the agreed conduct of the parties from which it could be inferred that the Appellant procuring advertising prior to the amendment was also carried out on Karakus' behalf. I rejected this submission for the following reasons; in my view the First Agreement was not arm's length, contained uncommercial terms and did not reflect the economic or commercial reality of the arrangements. Moreover, there was no evidence upon which I could conclude that there had been any amendment by agreement.

91. The amendment also reflects the fact that Karakus played no part in the loan broking or the commercial reality of the arrangements as the Appellant processed the loans and forwarded them directly to the lenders. I rejected the Appellant's submission that it could be inferred that Karakus would be given a reasonable time in which to exercise the veto by being sent copies in advance; in practical terms there is no evidence to demonstrate how Karakus could ever exercise the veto when applications were sent directly to the lenders. Furthermore, in the absence of evidence to indicate that Karakus had the necessary infrastructure or expertise to exercise any purported control, or any evidence to show that this ever occurred I concluded that the inclusion of a clause allowing the power to veto could have no effect in reality. There were no amendments to the terms of the First Agreement, such as termination, which were clearly uncommercial. I rejected the Appellant's submission that the reduction in payment for successfully processed loan applications from £60 to £50 reflects an agreement between the parties as to the appropriate fee for all services provided. There was no evidence upon which to find that there had been any agreement or negotiation between the parties as to payment nor any evidence to support a finding that the Appellant must have considered the amount sufficient. In my view, the Appellant's apparent willingness to take on additional contractual obligations for less payment was indicative of the lack of commerciality in the arrangements. In the absence of any evidence on the issue, I also did not agree that features

such as key performance indicators, which were noticeably absent from the First Agreement and the subsequent amendment, could be inferred into the First or Second Agreement.

92. The documents showed that Karakus had a number of employees. There were also a number of documents showing applications which were refused in late 1999. However, whilst I accept that the employment of staff shows a level of commercial operations by Karakus, there was no evidence as to what the employees actually did. Furthermore, I note that not only is there no evidence that Karakus made any decision at a commercial level to reject applications sent by the Appellant but there is also no evidence that it had the necessary resources or infrastructure to do so, particularly in circumstances where the successfully processed applications were sent directly by the Appellant to the lender. Although it was noted by the Appellant that Mr Alan Kentish a director of Karakus had experience in insurance, including underwriting I was not satisfied that I could conclude, in the absence of any evidence, that he had specific experience of loan broking or that, if he did, he had taken any part in commercial decisions under the arrangements. I considered the documents which showed that in 1997 Mr Kentish joined BDO Fidecs and set up its insurance management division which conducts outsourced management, compliance and infrastructure functions for Gibraltar based insurance companies including underwriting support and financial reporting. The difficulty for the Appellant is that there is simply no evidence to indicate exactly what Mr Kentish or his team had the necessary expertise to do or what they actually did.

93. A letter from Mr Webb to Jordans (Gibraltar) Ltd dated 6 December 1999 stated:

> "Following our recent visit to Gibraltar, I thought it would be useful for me to confirm in writing that you as nominees have full discretion to deal with the shares in Karakus Ltd.
>
> As you are aware, I have never sought to exercise any form of control or influence over the actions of the nominee in respect of the shares in Karakus Limited, nor do I have any intention to do so in the future."

94. There was no witness evidence to provide any further detail about the contents of the letter, for instance the purpose of it or reason why Mr Webb felt it necessary to put the point in writing. The letter must also be viewed in the context of the evidence as a whole; the statement from Mr Webb that he never sought to exercise any form of control or influence over the nominee contradicts the control and direction demonstrated by, for example, his being the sole signatory until November 1999 who directed the money flow and the concern expressed at the meeting on 5 October 1999 that if Mr Webb did not retain drawing rights on the Karakus' bank account he would have to "reconsider the position very carefully."

95. I considered the Appellant's submission that Mr Webb was a businessman trying to make money and who, it appears, considered the remuneration from Karakus sufficient which provided no reason why Mr Webb would seek to control Karakus. However, as set out earlier, I was not satisfied, on the material before me, that I could conclude that the remuneration was accepted by the Appellant because Mr Webb believed it to be appropriate and sufficient; there is simply no evidence as to how the payments were negotiated or reasons as to why the Appellant accepted them. It must also be noted that if, as the evidence indicates, the arrangements were put in place solely for tax purposes and directed by the Appellant for its own advantage, a level of control by the Appellant would be required in order that it achieved "the desired end result" (letter 3 March 1997).

96. On 9 March 2000 a meeting took place between HMRC, Mr Webb (Managing Director), Mr Chadwick (Finance Director) and Mr Ruffles (Tax Advisor with Arthur Andersen). At the meeting it was explained that Mr Webb negotiated directly with Mediability when placing adverts, Karakus had a veto and Mediability did have some direct

contact with Karakus. On first contact the borrower is asked where the advert was seen and the information was recorded by the Appellant and passed to Karakus who monitored the effectiveness of advertising. By way of background it was explained that:

> "K was an off the shelf company run by Jordans International Services who provided the directors (John Swann) and made a six months charge for their services. K is now said to be operated from the premises of BDO (accountants) in Gibraltar, the directors being Alan Kentish and Tim Revill who both live in Gibraltar and are both partners in BDO…we were advised that the shares are held in Gibraltar."

97. The reason for setting up Karakus was given as Mr Webb's awareness that competitors were operating arrangements which transferred advertising outside of the UK. Mr Webb had approached Ernst and Young but did not like their scheme and therefore approached Arthur Andersen. The record of the meeting noted that the initial scheme was intended to operate from the Channel Islands but as a UK credit broker's licence could not be obtained there it was decided to operate from Gibraltar. The reason for the arrangement was recorded as being a commercial decision to improve profits by the saving of VAT. Mr Webb is recorded as confirming that there was no other commercial reason for the decision other than the avoidance of VAT.

98. There was also a "rough extract of items contained in the notes taken by John Penney" (HMRC officer) which were not covered in the formal report. Those notes recorded that the Appellant invoiced Karakus on a weekly basis which was paid by telegraphic transfer. A print out was provided to Karakus which gave details of the applications but these were "not sent all the time (would allow random monitoring by K)." Copy loan applications were sent to Karakus with an expectation for Karakus to respond within a day to decline cases. "This is however rare. Examples requested trader unable to produce".

99. The reference to Karakus' discretion to veto in relation to advertising is not supported by the evidence; the veto provision contained in the Second Agreement related to loan applications and not to advertising. Furthermore, I found that there was no evidence to support the assertion that there was any direct contact between Karakus and Mediability nor the frequency or nature of any contact such that could lead me to conclude that Karakus had commercial input to any degree. There was no evidence to show that Karakus ever monitored the effectiveness of advertising, how this was done or by whom. It was incorrect to state that the shares were held in Gibraltar as it was Mr Webb who, at that point and until September 2000, held the shares. That the scheme was set up as a commercial decision with the sole purpose of improving profits by not paying VAT and the manner in which the arrangements came about under the Appellant's direction is consistent with the correspondence dated 3 March 1997. The evidence that applications were not always sent to Karakus further demonstrates that the contractual obligations did not reflect the commercial or economic reality and there was no evidence provided to support the assertion that while Karakus had the ability under the Agreement to veto applications, it ever in fact did so or had the necessary resources or expertise to do so.

100. On behalf of the Appellant it was submitted that HMRC sought to cherry pick the evidence and that if Mr Webb was honest on one point, it is more likely than not that he was honest on all points. In those circumstances the Appellant submitted that the assertions relating to Karakus monitoring the effectiveness of advertising and that Karakus would be expected to decline loan applications within a day should be accepted. In my view, the admissions are consistent with the limited contemporaneous evidence available and were made by Mr Webb on matters specific to him, namely the setting up of arrangements. The "expectation" that Karakus would vet loan applications is no more than an assertion; not only did Mr Webb also accept that not all loan applications were sent to Karakus but the "rare"

occasions on which it was said Karakus had declined applications were wholly unsupported by evidence. Similarly, there is no evidence to show that Karakus monitored advertising in any way and Mr Webb provided no further information as to how this was done or by whom.

101. On 21 March 2000 the Appellant wrote to Karakus to vary payment terms; the document was unsigned and confirms the terms agreed regarding an increase in payment to the Appellant from Karakus. The terms add the following to the Agreement:

> "4.5 The Company, upon demand by way of invoice from the Credit Broker to the Company, but not otherwise, shall pay to the Credit Broker an additional fee for the services provided by the Credit Broker to the Company in a sum to be agreed between the Credit Broker and the Company and, in the absence of such agreement, in a sum equal to 233% of the average weekly payments made or payable by the Company to the Credit Broker over the four weeks immediately prior to such demand.
>
> 4.6 The Company shall pay any invoice submitted by the Credit Broker pursuant to clause 4.5 immediately upon receipt of the Credit Broker's invoice. The time of payment shall be the essence of the contract. The Credit Broker may only exercise its rights under clause 4.5 once in any one year."

102. It was accepted on behalf of the Appellant that there is no evidence of negotiations to show how and why this was agreed. The terms which require immediate payment by Karakus support HMRC's case that the arrangements were under the control of the Appellant who had the power to introduce onerous terms.

103. A document dated 26 March 2000 signed by Mr Alan Kentish ("ARK") entitled "Review of commercial benefits of Karakus Limited ("Karakus") entering into debenture" included the following:

> "Karakus is a licensed credit broker in the UK that uses Wilmslow Financial Services Limited ("WFS") exclusively to process loan applications from leads generated from advertising.
>
> Karakus has agreements with a number of finance houses and advertising agencies.
>
> WFS will be owned by WFS Holdings Limited ("WFSH") which is being incorporated for this transaction WFSH will borrow £9 million from its new shareholder JZI Finance Limited ("JZI"). These funds will, inter alia, be fed by WFSH to WFS and be utilised by WFS to continue to expand and grow WFS's business.
>
> …
>
> In addition WFS has forwarded the idea that Karakus should also enter into a debenture with WFS to provide extra security to JZI for this loan.
>
> …
>
> **The anticipated benefits of entering this debenture**
>
> The director's of Karakus believe that by entering into this debenture, it will facilitate WFS in securing this loan. This in turn will allow WFS to expand their expertise and their advisory capacity.
>
> As Karakus is one of WFS's principal suppliers of business, this will mean that Karakus will receive a more rounded service and more comprehensive advice. The result of which will be that Karakus can expect a significant increase in business inflow by way of loan applications. It is clearly seen that the number of loan applications is a direct reflection of the advertising spent by Karakus. By utilising the increased presence and branching of WFS in the marketplace as a result of this expansion, Karakus will benefit by reduced advertising rates which in turn will bring about more loan applications and increased revenue.

The negatives of entering into the debenture and mitigation strategy

Clearly the main downside of entering into a debenture is that Karakus's assets will be subject to a registered charge in favour of WFS and WFS will probably assign the benefit of the debenture to JZI. The debenture could be enforced by JZI if WFSH failed to meet its loan obligations to JZI.

To mitigate this unlikely position, it is proposed that JZI should agree and so should WFSH (and WFS) that the debenture should only be enforced against Karakus once WFSH and its subsidiaries (including WFS) had utilised all their assets and resources in attempting to repay the loan to JZI.

Conclusion

The directors believe that there is commercial justification in entering into the debenture with WFS."

104. HMRC contend that the document is "window dressing". I agree that it raises questions as the document is not a formal document such as minutes of a meeting. My reading of the letter is that it is designed for the specific purpose of justifying that the debenture subsequently entered into served a commercial purpose after the shares were gifted by Mr Webb. Further, it is notable that there is no evidence to support the loan referred to and Karakus had no control over how the loan was used which in my view lacks commerciality. It leaves open the possibility that competitors could benefit from the debenture and Karakus would not necessarily receive the full benefit of the £9,000,000 despite using its assets to assist the Appellant. Taken together with the additional security sought by the Appellant (as the purported sub-contractor) appears highly uncommercial. I did not accept the Appellant's submission that it provided an incentive to the Appellant to provide a more rounded service and more comprehensive advice leading to reduced advertising rates and more loan applications which in turn would lead to increased revenue. The Appellant accepted that it may appear at first blush to be uncommercial, submitting that this may not be the case in the longterm. However, in my view that is speculation on the Appellant's part.

105. On 12 May 2000 a debenture was entered into by Karakus and the Appellant which included in its terms an immediately enforceable charge by the Appellant over Karakus' assets (see clause 1.1 and 1.3). At clause 2 the Appellant:

> "…may at any time by notice in writing to the Chargor convert the floating charge into a specific charge with reference to any assets specified in such notice and by way of other assurance of such specific charge the Chargor will promptly execute over such assets a fixed charge in favour of the Chargee in such form as the Chargee shall require."

106. At Clause 4 the following "further assurances" were given:

> "The Chargor shall at any time if and when required by the Chargee execute in favour of the Chargee or as the Chargee shall direct such mortgages pledges liens or charges in such form as the Chargee shall require over all the Chargor's right, title and interest in the undertaking p"roperty assets and rights of the Chargor now or at any time hereafter acquired by or belonging to the Chargor to secure all indebtedness."

107. Clause 5 provides that all indebtedness shall become immediately due and payable on demand at any time and failing immediate payment the security created by the debenture becomes immediately enforceable.

108. I accepted the Appellant's submission that a debenture is not unusual in commerce for one party's security where sums are owed to another, however the terms of the debenture provide for the charge to be immediately enforceable so that at any time the Appellant could have a charge over Karakus' assets. The wide scope and onerous nature of the power given to

the Appellant supports the finding that this was not arm's length trading and that the Appellant continued to have leverage and control over Karakus even after the shares were gifted. Furthermore, the debenture allowed for assignment which meant that it would remain in effect even if the Appellant assigned its rights thereunder to a competitor of Karakus. I rejected the Appellant's submission that the justification for the debenture is not undermined as it could only be used by 3rd parties to enforce debts owed by Karakus to the Appellant; in my view the debenture is uncommercial and is further evidence of the Appellant's control over the arrangements to its own benefit.

109. Karakus' annual report to the year ending 30 June 2000 show that the share capital of the company was held by Jordan Nominees (IOM) Limited, the directors considered that the Ark Trust is the ultimate controlling party and the average monthly number of persons employed by the company during the year was four and in 1999 it was two. The turnover in the unaudited 1999 accounts was £5,845,563 and in the 2000 accounts was £12,337,966.

110. By comparison the Appellant's profits were substantially greater. In my view this indicates that the benefit of the advertising services were accruing in the Appellant. I noted the submission on behalf of the Appellant that as it carried out the greater proportion of work it follows that its profits were higher. However, at this point there is still no evidence of any work undertaken by Karakus and no evidence of any commercial input or decisions made in relation to the loan broking business; the level of profit was consistent in my view with that of a shell company.

111. A letter from Karakus to HMRC dated 5 September 2000 stated:

> "The Company's activity is that of a licensed credit broker that generates its business through advertisements in the media…Wilmslow will process…applications in accordance with our guidelines.
>
> At the same time we receive a copy of all applications so that we may review and veto applications if so required."

112. As previously stated, there was no evidence before me to support the assertion that Karakus had either the resources or expertise to review applications or that it ever exercised its veto. The inference to be drawn from the evidence as a whole is that Karakus did not make any commercial decisions nor did it evaluate or consider the advice provided by the Appellant but rather the Appellant made the decisions which were communicated to Karakus.

113. On 14 or 15 September 2000 (both dates are contained on the notes) HMRC had a meeting with Mediability the purpose of which is recorded as "to investigate activities of the sole supplier of advertising i.e. Mediability". Present at the meeting were three HMRC officers, Mr Alan Grundy (Managing Director of Mediability), Mr Martin Ruffles (VAT Advisor from Arthur Andersen) and Mr Andrew Beavis (note taker from Arthur Andersen). The notes of the meeting record that Mr Ruffles explained that in 1996/97 the Appellant was the principal customer of Mediability. In mid to late 1996 Ernst and Young approached the Appellant offering an arrangement whereby the Appellant could obtain free advertising; it involved setting up a company in the Channel Islands which would receive advertising from an Ernst and Young advertising company also in Jersey. According to Mr Ruffles, Mr Webb was uncomfortable with this arrangement as he took the view that the Jersey company would be heavily connected with Ernst and Young with the result that the account with Mediability would be lost; Mr Grundy of Mediability was aware of this. Arthur Andersen took legal advice and concluded that the scheme was weak. It was emphasised that Arthur Andersen were contracted with Mediability and not the Appellant. The Appellant agreed at an early stage to reimburse Mediability for work performed by Arthur Andersen. Arthur Andersen considered the legislation and Sixth Directive to find a way forward to meet all needs. The

Channel Islands were ruled out as they could not obtain a UK Credit Broker's licence for a company based there, Gibraltar was suggested after some consideration. The note of the meeting recorded:

> "Working with Marrache and Co (solicitors in Gib) AA were introduced to another company Jordans International Services. It was determined that to have substance the company in Gib would have to act as a financial intermediary, but it couldn't be owned, controlled or operated by WFS or M. It was also necessary for WFS to give up its work in the UK to the Gib company. The Gib company being third party would have to employ somebody in the UK to act as a vetting agency (another intermediary), i.e. subcontract services to UK company because they couldn't be performed in Gib. It was necessary for that company to continue advertising to get M business, but advertising in the name of WFS.
>
> …
>
> There was a need to convince WFS that its commissions from lenders would now be paid to K. Obtained information from Jordans for off the shelf Gib company (i.e. K) to avoid company being controlled by RW. Two shares in K; one held by John Swann (Jordans) and other by Jordans International Services (IOM) on trust. Beneficial interest held by RW in at least one share, MR to check on other beneficial shareholding at that time. Even though shares held on trust by RW there was no day to day involvement. RW was said to be concerned with regard to possible misappropriation of funds. BDO Fidec addressed these concerns and arranged for bank account for K to be only accessible by RW. (MR to check if RW was sole signatory at that time). These arrangements satisfied RW at this point.
>
> …
>
> Safeguards leave K independent. Subsequent changes mean that K, by agreement, have taken control of bank and shares not now said to be held for the beneficial interest of RW. (ST asked for confirmation that RW has totally lost control of shares and cannot get benefit – MR to provide confirmation of trust activities and relevant dates).
>
> …
>
> ST asked who was driving the arrangement.
>
> MR said it was AA who were driving it.
>
> Re advertising: -
>
> M bill K and M have direct contact with K.
>
> WFS know what is successful in the way of advertising and will advice K.
>
> MR explained change in contract – WFS contracted to negotiate with M but orders are always placed by K. …
>
> M have day to day dealings with WFS though a meeting has taken place between WFS and K, believed by MR/AG to be at a premises of M."

114. The note is consistent with the evidence that the sole purpose of setting up the arrangements was for the Appellant to achieve a tax advantage from VAT free advertising. The note indicates that the arrangements were deliberately designed to distance the Appellant but that the purported lack of control was no more than a veneer, for instance:

> "Even though shares held on trust by RW there was no day to day involvement. RW was said to be concerned with regard to possible misappropriation of funds. BDO

Fidec addressed these concerns and arranged for bank account for K to be only accessible by RW."

115. The involvement of Arthur Andersen was to assist in the arrangement and implementation of a tax driven scheme and the day to day contact between the Appellant and Mediability infers that the commercial reality was that the Appellant made the decisions in relation to advertising. Although Karakus may have placed orders and been invoiced by Mediability and there is reference to direct contact between Mediability and Karakus, there is no detail as to the level of Karakus' involvement or whether it had any commercial input of any substance beyond following advice and directions given by the Appellant. Overall the note demonstrates that the commercial relationship was between the Appellant and Mediability rather than Mediability and Karakus.

116. In September 2000 Mr Webb's shares in Karakus were transferred to the Ark Trust. The only document in support is a declaration of trust dated 18 September 2000. There is no evidence providing background to the transfer nor evidence of negotiations. On its face, it appears wholly uncommercial for Mr Webb to have transferred his shareholding without consideration or any apparent protection to the Appellant. In those circumstances and against the background of the evidence as a whole, I accepted HMRC's submission that it was a reasonable inference to draw that the Ark Trust was a trusted third party which would continue to follow the arrangements to achieve the desired result, namely the benefit of VAT free advertising for the Appellant. The Appellant accepted that the transfer may appear uncommercial but submitted that if the Appellant was satisfied that it was making sufficient profit from the arrangements then there was no reason why the shares should not be transferred, noting that the Appellant continued to make a substantial share of profit from the processing work. This, in my view, is speculation; without any evidence in support there is no basis upon which I can make a finding as to the motive of the Appellant or the level of satisfaction in respect of the profits made. The Appellant's query as to why a bona fide company would take over if its sole purpose was to make profits for the Appellant misses the point that whether or not the company was bona fide, it was put in place as part of the arrangements for the sole purpose of making the scheme effective; in those circumstances the clear inference is that the company was a trusted third party who was aware of the arrangements.

117. In a letter dated 30 November 2000 from Mr Mark Chadwick, Finance Director of the Appellant, to HMRC it was stated in response to queries raised that as there had been no system in place during the period of the claim by which to distinguish between the Appellant and Karakus cases on the accounting system, alternative techniques were adopted. In order to separate the companies' cases retrospectively a report was run on the loan processing system listing all questionnaire fees incurred and splitting them by broker. The Appellant correctly noted that the broker could be identified from the commissions entered onto the system, however it seems to me an odd feature if the two companies were truly independent that initially there was no such system in place and in my view indicates the treatment of the companies as essentially one business.

118. In a letter from Arthur Andersen to HMRC dated 12 March 2001 Mr Ruffles explained that the approach to Arthur Andersen was made by Mr Grundy of Mediability without the knowledge of Mr Webb in order to see if Arthur Anderson could assist in retaining an important client. Subsequently Mr Webb was present at meetings to discuss the proposed restructuring, however Mediability remained the client of Arthur Andersen. Following a change to the First Agreement for a reduction in the fee charged by the Appellant, it was also agreed between the parties that Karakus would undertake a quarterly review of the procedures employed by the Appellant in respect of loan applications that related to its

lenders. Initially all loan applications were sent by the Appellant to Karakus who would then forward the applications to the lenders. As that procedure delayed the receipt of processed loans and the payment of commissions, Karakus agreed with the Appellant that loan applications would be sent directly to the lenders with copies being sent to Karakus who could still exercise its veto where appropriate. Only the Appellant could monitor the effectiveness of any advertising campaign and only the Appellant and Mediability together who could determine where advertising was likely to be most effective. As Karakus realised this, the contract with the Appellant was amended to give the Appellant the authority to negotiate with Mediability for and on behalf of Karakus who then placed the order. Employees of Karakus visit Mediability on a regular basis to discuss the structure of advertising campaigns and ensure that Karakus is fully involved in determining how advertising was placed and to monitor the effectiveness of negotiations between the Appellant and Mediability.

119. The letter is from the tax advisers who devised and implemented the scheme to HMRC and in my view the assertions set out therein must be viewed in this context. It is correct that the First Agreement was amended to give the Appellant authority to negotiate with Mediability on behalf of Karakus, however for the reasons set out above I am satisfied that the contractual arrangements did not reflect the commercial reality of the transactions. This conclusion is reinforced by the acceptance that only the Appellant is able to monitor the effectiveness of advertising and in reality, any order placed by Karakus was directed by the Appellant. Nothing turns on whether it was Mr Grundy or Mr Webb who approached Arthur Andersen as it is clear from the evidence that the Appellant was heavily involved in the implementation of the arrangements and was, in reality, the main beneficiary of them. There is no evidence to support the assertion that employees of Karakus visit Mediability on a regular basis to discuss advertising structure. I have already set out my findings in relation to the amendment to the Agreement which provided that the Appellant forward loan applications directly to the lenders and the assertions set out in the letter above does not address the contemporaneous evidence that applications were not always sent to Karakus, that in reality there was no provision to allow Karakus time to exercise its veto, no evidence that it ever did and no evidence that it had the necessary resources or knowledge to do so.

120. By letter dated 30 March 2001 HMRC notified Mediability of assessments arising from the "economic substance of the arrangement" by which HMRC considered that Karakus was interposed between Mediability and the Appellant for the sole purpose of avoiding the charge to VAT which would not have been recoverable by the Appellant and that advertising services continued to be supplied to the Appellant by Mediability notwithstanding the contractual arrangements.

121. A letter from Mr Webb to Mr Grundy at Mediability dated 18 October 2001 stated:

> "I find myself in an impossible situation with regards to the guarantee that is currently in place especially as two weeks ago you had agreed to release Isabelle and I from this guarantee. The situation currently is that there is £1.5million (of my tax paid funds) in an escrow account to cover the VAT pre JZ International acquisition should the Karakus situation fall apart. There is also a guarantee from Freedom Finance to Mediability to cover the post acquisition liability. You have now demanded that Isabelle's and my guarantee remain in place should Freedom be unable to meet the obligations of their guarantee. This is not acceptable to me. I think that you have to make a commercial decision based on the following points.
>
> The advice we are all hearing is that the Karakus situation is robust and will survive therefore making these guarantees irrelevant.

If Customs and Excise do win it is unlikely that a retrospective payment would be required but only that the scheme be halted…

It is totally wrong that Isabelle and I should be bearing the risk for Freedom Finance to have the benefit of the VAT scheme."

122. While tax mitigation arrangements are not unlawful, as the authorities make clear the arrangements must be considered in light of all of the evidence in order to determine their proper characterisation. In my view, the contents of this documents are a feature to take into account in assessing the evidence as a whole. In the context of the situation at this point, Mediability had been assessed by HMRC and the letter from Mr Webb is clear in its reference to the arrangements as a scheme such as "the Karakus situation" and the Appellant receiving "the benefit of the VAT scheme" which weighs in favour of HMRC's case that it was the Appellant who carried out the loan broking activities and received the supply of advertising services.

123. In a letter from Mediability to Mr Webb dated 29 October 2001 Mr Gundy stated:

"…I agree that certain commercial decisions need to be taken that will minimise or eliminate personal liabilities for both of us. It seems to me, however, that the current proposal does not achieve that result but merely moves your potential liabilities onto me.

I have been working with Martin Ruffles at Andersen to seek a solution to our dilemma and I think we may be close to achieving a result that will allow me to release you and Isabelle from the Fairdene cross guarantee…

The proposed solution works as follows:

I will incorporate a new company (NewCo), which will become a media provider to all of the existing clients of Mediability Ltd except for Karakus. The Karakus account will remain with Mediability and allow Mediability to provide Karakus with all of its current media needs…

If the dispute with Customs and Excise becomes prolonged and eventually results in them making a demand of many millions of pounds against Mediability Ltd we can take a view as to whether or not Freedom Finance can satisfy that debt under the terms of its cross guarantee. Your cross guarantee will, of course, be void by that time and you will have no liability to Mediability Ltd beyond that which arises up to 31 March 2000…

I think it is important that I qualify point 5, in which you refer to earnings made by Mediability. Whilst it is true Mediability's net income has amounted to £400,000, I feel it necessary to compare this with the VAT savings Karakus enjoyed in the same period, £3,275,000. Whilst I have always accepted that there will be such a disparity I feel we should honour our agreement that Mediability should not be required to assume an uncontrolled financial liability and I ask for this point to be foremost in all further correspondence or discussion between us.

As stated at the start of this letter I agree with you that your guarantee should end as quickly as possible. Nonetheless, my liability for the arrangement lies with both the uninsurable advertising account (£900,000 per month) with Karakus and with the accumulating potential VAT debt…

As we are unable to insure the Karakus advertising account, to satisfy the NPA's demands I have had to introduce £650,000 of additional capital to Mediability. This capital will result in me being unable to take any benefit from the profits generated by the Karakus account and other advertising accounts for a significant period of time and does, I believe, demonstrate my commitment to our relationship.

Again, I agree that it is wrong that Isabelle and yourself should be bearing the risk for Freedom Finance to benefit from the VAT arrangements. However, I do not see how it then follows that I and Mediability should be bearing the risk on your behalf. This would be the outcome of the current proposal. Until such time as we mitigate the effects of the "worst case scenarios" I believe it would be commercially unwise for me to release your guarantee…"

124. Mr Ruffles at Arthur Andersen emailed Mr Grundy at Mediability and Mr Chadwick at the Appellant on 2 November 2001 with a view to concluding a number of matters. The email stated:

"The issues that I am about to discuss impact in certain respects solely upon Mediability or Freedom Finance and in other respects jointly upon both companies. Even where an issue could be regarded as having an impact upon just one of the companies, it is important in my view that we cease looking at these problems in isolation to the totality of the structure as a whole. Unless we address the issues that are facing us on a collective basis we are going to go round and round in ever decreasing circles until the benefits of the arrangements are either lost to all parties or are severely damaged.

The Karakus Arrangements – Purpose

The structure that has been entered into was designed to allow Mediability to continue providing media services in such a way that it did not suffer the loss of the substantial account previously held with Freedom Finance.

Freedom Finance wished to preserve its relationship with Mediability, but was being invited to use another media provider because to do so would confer a significant advantage in that VAT would be removed from its advertising expenditure….

The Karakus Arrangements – Consequential Effects

In order for Freedom Finance to achieve VAT free advertising it is necessary for Mediability to provide those services without the addition of VAT. This places Mediability at risk from attack by HM Customs and Excise, (C&E). As we are all aware, C&E have considered the arrangements and are challenging them.

This action by C&E was considered when the structure was first implemented. Certain guarantees were entered into by both Fairdene and Freedom Finance to ensure that Mediability, if it was eventually required to remit payment of VAT to C&E, would have funds made available to it to discharge ant such liability.

…

Freedom Finance

The principal beneficiary of the arrangements is Freedom Finance. The elimination of VAT from advertising expenditure has generated additional income of £3m+ to date.

There has, however, been a cost to Freedom Finance in that its fees against Karakus are depressed by the increased commissions that Karakus pays to Mediability…

Mediability

Mediability, however, is the party to the arrangement that carries the exposure to C&E. Similarly, Mediability does not gain any additional benefits from the arrangements by virtue of receiving enhanced commissions or other forms of enhanced remuneration. In other words, the arrangements that Mediability has entered into have been principally for the benefit of Freedom Finance with Mediability's benefit being restricted to the maintenance of the status quo in respect of fees earned.

Issues to resolve

…

Rupert wants the Fairdene cross guarantee removing whilst Alan needs to know that Mediability has adequate guarantees in place to preserve his company from liquidation. As the arrangements that are in place principally benefit Freedom Finance Alan believes that any expenditure incurred by Mediability that preserves the arrangements should be borne by Karakus. Freedom Finance take the view that Mediability should bear some of these costs. Alan feels that if Karakus is not prepared to carry the associated costs of maintaining the arrangements then Mediability should withdraw from the arrangements in order to limit the growing exposure to VAT. Freedom Finance feels that if Mediability will not carry some of the costs then they should suggest to Karakus that it moves its advertising account to another media provider…

A solution

…

Karakus pays Mediability's fees = restructure arrangements with Karakus to satisfy NPA = release of Fairdene guarantee with effect from 01 April 2000.

Conclusion

…

Freedom needs to consider whether or not the arrangement is worth the payment by Karakus of Mediability's fee…"

125. The letters are consistent with the fact that the sole purpose of the arrangements was for the Appellant to receive VAT free advertising from Mediability. Although there was a benefit to Mediability in keeping its account with the Appellant it is clear that the principal beneficiary of the scheme was the Appellant as a result of the saving on VAT. The discussions in the letter indicate that the Appellant controls the scheme and has the power to make decisions; in my view it is notable that Karakus, purportedly the principal in the arrangements, is not a part of the discussions which indicates that the decisions will be taken by the Appellant. My finding in this regard is reinforced by the statement suggesting that the Appellant has the power to commit Karakus to contractual obligations such as payment of Mediability's fee.

126. The Appellant submits that the emails arose due to a dispute between Mr Webb and Mediability regarding the cross-guarantee and Karakus played no part in the dispute as it had given its own undertaking in relation to the advertising contract with Mediability. I rejected this submission which fails to take into account a letter from Mr Webb to Mediability dated 18 October 2001 which makes the following explicit reference:

> "The situation currently is that there is £1.5 million (of my tax paid funds) in an escrow account to cover the VAT pre JZ International acquisition should the Karakus situation fall apart."

Which I find demonstrates the clear link between Karakus and the Appellant such that the latter has made the necessary preparations to cover any potential liability arising from Karakus and the arrangements as a whole. The Appellant also highlighted a "threat" by the Appellant that it might "suggest" to Karakus that it instruct a new media agent, submitting that if the Appellant had control over Karakus the threat would be more than a suggestion. I did not find that this assisted in determining the issue; in my view whether the Appellant suggested or instructed Karakus, this indicates a level of direction, albeit to varying degrees, over Karakus.

127. In a letter from Karakus to the Appellant dated 27 May 2002 Karakus asserted that it was checking and entering commissions which was previously done by the Appellant on its behalf. The letter states that it has become apparent to Karakus that basic loan details entered on to the system are frequently inaccurate and the Appellant is requested to look into the matter.

128. There is no evidence to support the assertion made in the letter. In any event, I agreed with the submission on behalf of HMRC that the "checking and entering" of commissions did not form part of the supply of loan broking to lenders but rather it pertains to the general administration by which the arrangements were run. The letter referred to "the volumes of business" passed by Karaks to the Appellant. However, on the basis of the material before me I found that the evidence demonstrated that it was the Appellant that generated business, not Karakus. The Appellant contended that the letter should be read in the context of a series of communications between Karakus and the Appellant between May 2002 and January 2003 which showed a genuine disagreement between the Appellant and Karakus relating to the Appellant's performance. I reject this submission. Taken in isolation the documents purport to show a disagreement however when viewed against the evidence as a whole I find that this is not credible. I was satisfied that Karakus never had involvement of any commercial substance; my finding was reinforced by the evidence referred to at [126] above which demonstrated an attempt by Arthur Andersen to resolve the concerns of the Appellant and Mediability in relation to the arrangements as a whole, which includes Karakus, but without any reference to or input from Karakus. I was satisfied on the basis of the evidence that the true concerns were on the parts of Mediability and the Appellant in relation to the potential liabilities which could be incurred.

129. Notes of a visit report by HMRC to the Appellant dated 31 October 2002 records Mr Chadwick of the Appellant as emphasising the independence of Karakus throughout the meeting. He also stated that Karakus were looking to expand the business in order to reduce its dependence on the Appellant and to make the company viable should a change in legislation remove the VAT advantage they had at that point. HMRC was advised that Karakus currently paid the Appellant £50 per contract which was due to change so that Karakus would pay a licence fee for the right to use the Appellant's name plus a fee for each loan completion which would be an incentive for the Appellant to convert enquiries to loans. HMRC were advised that Karakus were actively seeking to offer their services to other UK customers although none had yet been acquired. Karakus were working through a Gibraltar advertising agency, ESP who, it appeared, put most of the work through Mediability although the intention seemed to be that eventually Mediability would be bypassed.

130. As HMRC noted, if Karakus expanded its credit broking in the UK without the use of an intermediate it would be in breach of clauses 8 and 9 the First Agreement. Furthermore, the introduction of a licence fee for the use of the Appellant's name is relevant as Karakus had used the Appellant's name for a number of years without payment and the licence fee was not introduced until the 2004 Agreement which in my view, without any explanation as to why the change was introduced and why it had not been done before, is a manifestly uncommercial feature of the arrangements.

131. By deed of guarantee dated 5 November 2002 the Appellant agreed to fully indemnify Mediability against a VAT liability arising from its provision of advertising services to Karakus (clause 2.1.2). I accepted the submission on behalf of HMRC that this evidence is indicative of the Appellant as the real beneficiary of advertising services. In the absence of any evidence to the contrary, the only reasonable explanation for the Appellant to accept the potential liability was that it was the controlling mind and principal beneficiary behind the arrangements.

132. On 9 December 2002 the First National Bank wrote to Mr Webb regarding the commission structure. The letter referred to their recent meetings and confirmed a commission structure applicable to all business introduced via the Appellant with effect from 1 November 2002. FNB also advised that it would undertake regular reviews with the Appellant and its team to ensure targets were met. In my view the absence of any reference to Karakus is further indicative of the Appellant directing the negotiations relating to commissions. I considered the Appellant's submission that this does not alter the fact that Karakus held the contract with the lender and that the Appellant could not introduce business on its own behalf, only as an agent for Karakus. However, as stated earlier, the fact that Karakus held the contracts is not determinative of the issue to be determined which must be considered in light of all of the circumstances. The economic and commercial reality was that the lenders appeared to view the Appellant and Karakus as one business and it was the Appellant that directed negotiations and made the decisions. In those circumstances, it cannot, in my view, be said that Karakus added any commercial value of substance to the transactions.

133. Notes of a visit to Mediability on 2 May 2003 recorded Mr Grundy as explaining that it is a trade sector requirement for advertising companies to have accreditation with the media publishers in order to obtain credit and discount. Accreditation was usually achieved by obtaining insurance but Mediability was unable to obtain insurance for Karakus due to it being a non-UK company. Following submission of Mediability's accounting information for the year end March 2000 the National Publishing Association expressed concern about the company's continuing accreditation given its level of trade with Karakus which exceeded 50% of Mediability's business. Mediability was given three years to develop net assets/funds to £650,000 which was increased to £1.4m in November 2001 as a result of its substantially increased volume of trade with Karakus. Mediability could not hope to achieve that figure. Mr Grundy claimed at the meeting that he could not recall due to the passage of time whether there were plans in place to change the structure to reduce Mr Webb's exposure prior to the accreditation issue coming to a head. HMRC were advised that in early 2002 there had been a falling out between Mr Webb and Mr Grundy resulting in Mr Webb withdrawing his guarantees and Mr Grundy taking steps to enforce them. Arthur Andersen, acting for Mediability, stepped in as mediators and negotiations led to agreed revised guarantees being implemented in Autumn of 2002. Under the revised trading structure Karakus ceased to be a client of Mediability with effect from 1 April 2002. With effect from 1 April 2002 Karakus appointed ESP in Gibraltar to provide the services previously provided by Mediability. As ESP did not have the infrastructure to negotiate with the UK media, Karakus introduced ESP to Mediability with the result that from 1 April 2002 Mediability supplied ESP with "media planning and negotiating services" in respect of advertising for ESP's client Karakus. HMRC were advised that Mediability determine where advertising placements would be most cost effective and email their recommendations to ESP who, if the advice is accepted, book the space and confirm acceptance. Mr Grundy was unable to confirm whether ESP had ever rejected Mediability's advice and confirmed that the company has no mechanisms in place to evaluate rejected recommendations. He stated that the recommendations were based on discussions with the marketing manager at the Appellant and an analysis of data extracted by the Appellant. Responses to adverts were monitored and analysed by the Appellant. Knowledge of the media, availability and price of advertising space enables Mediability through discussion with the Appellant to have input into the decision-making process. Mr Grundy advised that the Appellant and Mediability would agree action required and notify the recommendation to ESP.

134. The involvement of ESP appears to add no commercial value; it could not deal with the UK media and the marketing strategy as to what advert to place where was still driven by the

Appellant. The manner in which the arrangements worked in 2003 had not, in reality, changed. The involvement of ESP is explained by a visit report dated 2 May 2003 at which HMRC was informed by Mediability that there were concerns as it could not obtain insurance in relation to an offshore entity. As ESP did not have the necessary infrastructure to negotiate with the UK media it was Mediability which supplied those services to ESP which were then provided to Karakus; although the contract was between Karakus and ESP, in my view it was Mediability which provided the commercial input and the fact that there was no evidence or examples given where ESP had rejected Mediability's recommendation supports that finding as does the fact that ESP had no mechanisms or resources in place to analyse the recommendations. I found the fact that there was no written contract or formal agreement between ESP and Mediability indicated that this was not an arm's length arrangement and the continued control of the Appellant in the arrangements is further supported by the fact that action was sometimes agreed "at short notice" with the Appellant which led me to conclude that the commercial reality was that by the time Karakus received the information, the decision had already been taken. I did not accept the Appellant's submission that the evidence shows that Mediability made no decisions itself. For the reasons set out above it is clear that commercial decisions were made by Mediability and the Appellant with ESP and Karakus taking no decisions of commercial substance.

135. The report explained that the Appellant and Mr and Mrs Webb had provided cross-guarantees to Mediability in relation to the potential VAT liability from the arrangements because the guarantee in place with Karakus may not have been enforceable due to an inability to pay. I agreed with the submissions on behalf of HMRC that the guarantees provided by the Appellant supported its case that the Appellant was the controlling mind of the arrangements as its guarantees protected Mediability from the potential repercussions of its involvement in the arrangements with Karakus.

136. On 30 June 2003 the Ark Trust transferred the Karakus shares to Fidecs Group SA. The business model of Fidecs was to provide off the shelf companies and the transfer, in my view, raises questions as to why Fidecs would seek to run Karakus as a business which is inconsistent with its commercial activities. Payment of £500 with subsequent payment totalling £16,500 for Karakus seems low given that the profits for previous year were in excess of £300,000 and retained profit carried forward approached £600,000.

137. There was no evidence of any consideration given to whether the transfer breached the terms of the Declaration of Trust ("The Ark Trust") dated 7 October 1994 which required dealing with trust assets to be "in furtherance of the objects of the charitable trust in clause 5". HMRC submitted, and I agreed it is arguable, that the low amount paid taken together with the absence of any protection to prevent the onward sale of the shares to a competitor of the Appellant, that the transfer breached the Declaration. However, I make no findings in this regard; there is insufficient information before me to reach a conclusion as to the Ark Trust's motivation and to do so would be speculation.

138. The annual report for the year end 31 December 2003, dated 5 April 2004, contains the first reference to PDQ Finance being used as a processor. There is no evidence as to what type of entity PDQ was; the documents use the terms processor, lender and broker. It is also unknown whether PDQ had any connection to the Appellant or whether it was a wholly independent entity from the parties to the transactions. The use of PDQ appears, as the Appellant accepted, to be in breach of clauses 8 and 9 of the First Agreement and in the absence of any evidence in support I did not accept the Appellant's submission that there may be no breach if both Karakus and the Appellant understood the clause to refer to credit broking using the Appellant's brand. The Appellant agreed that there is no information pertaining to PDQ, however I was invited to infer that it can be assumed that it was a

secondary processor otherwise PWC would not have prepared PDQ's financial statements on that basis. Without any evidence in support I do not consider that it is appropriate to draw such an inference; there is simply no information relating to the basis upon which PWC were instructed to prepare the financial statement.

139. On 30 March 2004 the parties entered into the Third Agreement. The terms included:

> "RECITALS
>
> (f) Bespoke also has considerable expertise in the field of advertising financial services and products.
>
> (g) Bespoke envisages that if it is entitled to use the Trade Marks then this will significantly benefit Bespoke.
>
> …
>
> 3.1 On and subject to the provisions of this Agreement Freedom grants to Bespoke a non-exclusive licence to use the Trade Marks in connection with the supply of the Products including on or in relation to any advertising marketing or any promotional material concerning the Products (including that prepared in connection with the Advertising Procurement) and on the Freedom Website.
>
> …
>
> 3.6 Bespoke shall use the Trade Marks in the form stipulated by Freedom and shall observe any reasonable directions given by Freedom as to colours and size of the representations of the Trade Marks and their manner and disposition on any promotional or marketing material, packaging and labels or any other tangible material relating to the Products and in respect of any geographical representation of the Trade Marks.
>
> 3.7 Unless the prior written consent of Freedom is obtained in respect of the Product in question, no Product which is supplied under or by reference to the Trade Marks shall include any advertising by or on behalf of any competitor of Freedom.
>
> 3.8 Whenever the Trade Marks are used by Bespoke they shall (in respect of registered trade marks) be accompanied by wording to show that they are registered trade marks and in the case of the Trade Marks generally that they are used by Bespoke with the permission of Freedom, the terms of such wording and its placing shall be as reasonably requested by Freedom.
>
> 3.9 Bespoke shall submit designs of all printed materials and graphic representations using the Trade Marks to Freedom for approval as to the manner and the context of the intended use of the Trade Marks and shall not make use of any such materials or graphic representations until they have been approved by Freedom which approval shall not be unreasonably withheld or delayed.
>
> …
>
> 3.15 Without prejudice to the provisions of clause 3.14 above, Bespoke acknowledges that any goodwill derived from the use by Bespoke of the Trade Marks will accrue to Freedom.
>
> …
>
> 5.1 Unless otherwise agreed in writing with Freedom, Bespoke acknowledges and agrees that save in respect of those circumstances where it is permitted under this Agreement to carry out processing services the same as or similar to the Processing Services or appoint a third party to do so being those circumstances detailed in clauses 5.13 and 5.14, all processing services or whatsoever nature including services the same as or similar to the Processing Services in respect of all of Bespoke' requirements for the same which are generated directly or indirectly as a result of

Advertisements, including all of Bespoke' requirements in respect of Customers and Calls are to be carried out by Freedom or such third party as Freedom shall appoint and accordingly Freedom shall have the exclusive right, during the term of this Agreement, to itself carry out or appoint a third party to carry out such processing services.

6.1.8 Before broadcasting or publishing or procuring the broadcast or publication of any Advertisement it shall send a copy of such Advertisement to Freedom for its approval provided always that if Freedom does not within seven (7) days of having received a copy of Advertisement concerned give notice of its approval or rejection, Freedom's approval of the Advertisement in question shall be deemed to have been given.

7. Payment and Fees

7.6 On the first Working day of each week Bespoke shall pay to Freedom the sum of…£250,000 ("the Advance")

…

7.13 Once in each Year Freedom shall be free to increase the ASP Service Fee, the Trade Mark Licence Fee and any of the other sums payable by Bespoke hereunder including for the avoidance of doubt increasing any fee payable for the Processing Services…

…

8. Confidentiality/Non-Solicitation

8.1 Subject always to any provisions of this Agreement to the contrary…both parties agree:

8.1.1 to maintain secret and confidential the Information…"

140. Clause 9 provides that the agreement shall continue for an initial period of 10 years and thereafter until terminated by six months' notice in writing, or in specified circumstances set out in clause 9.2 – 9.4. The consequences of termination are set out at clause 10 under which Karakus would cease to be able to use the Trade marks at all. Under clause 11 neither party is liable for any loss of profit, loss of goodwill, loss of data or loss of opportunity. Under the Agreement Karakus could not assign, transfer, sub-contract any right or obligation under the Agreement without the prior written consent of the Appellant. However, the Appellant was not subject to the same restriction and could assign, transfer, sub-contract any right or obligation (clause 17). In my view this was further evidence of the control held by the Appellant over Karakus.

141. The Appellant received £250,000 for the performance of specified services. However, under Clause 7.13 once per year the Appellant could increase the fees. Such a feature is, in my view, unusual if Karakus were controlling the arrangements. I agreed with the submissions on behalf of HMRC that the confidentiality provisions under Clause 8 were wholly inadequate if the Agreement was an arm's length contract between two independent companies. Termination of the Agreement is severely restricted and would leave Karakus with nothing.

142. The terms are significantly more favourable to the Appellant than to Karakus which supports the fact that the Agreement is not arm's length. The Agreement also contains a number of uncommercial features, such as the inadequate confidentiality clause and the restriction to termination rights. The recital notes that Karakus has considerable expertise in advertising financial services and products which is simply not borne out by the evidence in

relation to loan broking. Furthermore, Karakus obtains the use of the Appellant's trademarks but the licence prohibits Karakus allowing use by competitors whereas the Appellant is not subject to the same restriction and could therefore allow the use of its trademarks by competitors of Karakus which is, in my view, indicative of the Appellant's control over Karakus and the arrangements. I did not accept the Appellant's submission that prohibiting the use of the trademarks by Karakus is entirely commercial; I accepted that the trademarks belonged to the Appellant however the agreement, in my view, does not reflect the fact that it is Karakus which is said to be the principal and in my view it lacks commerciality for an independent company to agree that the sub-contractor, namely the Appellant, could use the trademarks without limit. The control given to the Appellant relating to use of its trademarks in advertising does not appear realistic if those activities were performed by Karakus. The goodwill from use of the trademark accrues in the Appellant (clause 3.15) which is consistent with the Appellant as the controlling mind, the Appellant maintains further control over all legal proceedings concerning infringement (clause 3.18). Karakus meanwhile had limited redress for breaches yet the Appellant's remedies are advantageous. I also found the limited liability of both parties was uncommercial.

143. Under clause 5.1 Karakus is prevented from using another party to perform processing services which is inconsistent with the purported use of PDQ. The Appellant, however, is not subject to any such restriction which is consistent with its control. I rejected the Appellant's submission that the correct reading was that that Karakus was only prevented from engaging a processor and allowing it to use the trademarks; on my reading clause 5.1 includes Advertisements which have used the trademark but is not limited to them. For the first time in the written agreements key performance indicators are included however there is no evidence to show that these were ever reviewed by Karakus. Although the customer data is owned by Karakus, the Appellant is not prohibited from sub-licensing the use of the data which could include a competitor of Karakus which is a wholly uncommercial feature of the Agreement.

144. A minimum amount is imposed on Karakus to spend on advertising per year. I agreed with the submissions for HMRC that there is no commercial reason why Karakus, as the purported principal, would agree to its sub-contractor being given the right to increase the amount (clause 6) and I accept that this is a further indicator of the Appellant's control. I found it made no commercial sense for Karakus to be required (clause 6.1.3) to report to the Appellant about planned advertising and to send the Appellant proposed advertisements if Karakus was in control. Furthermore, there is no evidence to support the assertion that this ever in fact happened.

145. The Appellant noted that Recital G in which Karakus envisages that if it is entitled to use the Appellant's trademarks then it will significantly benefit Karakus which will ensure that the Appellant stays "motivated". The Appellant did not agree that Clauses 3.6 and 3.8-9 gave the Appellant control over use of the trademarks in advertising as HMRC suggest, submitting that the Appellant was protecting the style of the trademark and that it is properly represented when used publicly. I agreed that it made commercial sense for the Appellant to protect the use of its trademark, however there was no evidence upon which I could make a finding as to what the Appellant's thoughts or reasons were and I noted that this was another feature over which the Appellant retained ultimate control.

146. I noted the Appellant's submission that the owners of Karakus were Fidecs Group SA and the directors were Mr Tim Revill and Mr Kentish, who were clearly credible as directors of BDO Fidecs. In my view this did not assist the issues to be determined; there is simply no evidence as to whether Mr Revill or Mr Kentish provided any commercial input of substance, what involvement the owners had or whether there were negotiations or advice taken. In

those circumstances I took the view that I could not infer as the Appellant urged, for instance, that negotiations had taken place.

147. The notes of a visit report to the Appellant dated 13 April 2005 record Mr Chadwick as stating he was not familiar with Bespoke Finance (UK) Ltd which was not part of the Freedom Finance group structure. He stated that Bespoke Finance (Gibraltar) now undertakes many activities independently of the Appellant. A new media company, Venture Media, had been engaged to replace Mediability in respect of part of the media advertising spend. Mr Chadwick confirmed that Bespoke Finance would have some input into negotiation of commission rates with banks such as attending joint meetings with the lenders and the Appellant, however, Mr Chadwick acknowledged, the commission rates are in practice negotiated by the Appellant on behalf of Bespoke Finance. Mr Paul Coulter is the Appellant's UK based marketing director who would liaise regularly with Mr Ian Farr of Bespoke Finance in Karakus; Mr Farr was previously employed by the Appellant in the UK. On a weekly basis the Appellant forwards loan application forms and accompanying documents to Karakus; copies of the documents are forwarded to Karakus and the application package is sent to the bank. Mr Chadwick agreed that in reality Karakus received a package of documents relating to an application which had been approved as far as progressing the application was concerned and there was little Karakus could do or would wish to do to alter that decision. Karakus had 7 or 8 staff in Gibraltar and the Appellant employed 380 staff with another 40 employed by the mortgage business Freedom Funding.

148. There is nothing in the note to show that Karakus provided any commercial input of substance. The evidence indicates a personal link between the Appellant and Karakus via Mr Farr, although the level of his involvement remains unclear. Although it is asserted that Karakus had input into the negotiation of commission rates, it is accepted that that the negotiations are in practice carried out by the Appellant.

149. The admission that there was little Karakus could do to alter a loan application decision supports the view that the commercial reality was that the Appellant was carrying out the loan broking service without any control by Karakus.

150. Notes of a visit to Mediability on 29 April 2005 record Mr Grundy's recollection that Mediability was informed by Karakus that it could introduce Mediability to ESP. From 1 April 2002 the contract between Karakus and Mediability was terminated and from the same date Mediability commenced supplying services to ESP after the introduction by Karakus. There was no formal written contract between the parties; Mr Grundy said it was not unusual for Mediability to act without a formal contract in writing as each party operates on the basis of good faith. ESP would look at recommendations and instruct Mediability to negotiate on its behalf to secure advertising. Mr Grundy also confirmed that Venture Media (Gibraltar) Ltd had been introduced into the arrangements although he was not aware of how contact with Venture Media Ltd was initiated.

151. I consider it uncommercial that ESP and Mediability, if the arrangements were arm's length between two unconnected companies, would rely on "good faith" as a basis for the transactions. It is also notable, in my view, that there appears to be no provision for checks and controls to ensure that Mediability was negotiating the best possible rates or whether ESP were able to monitor and assess such factors. The introduction of ESP into the arrangements adds no obvious commercial value or expertise.

152. As at 5 April 2007 the Appellant's website contained no reference to Karakus although Karakus' address was contained at the foot of the page which, HMRC submitted, gives no suggestion that the companies are separate entities. However, I agreed with the Appellant that

this feature did not of itself support HMRC's case bearing in mind that Karakus was trading under the Appellant's name.

153. A note of a meeting with Mr Chadwick on 12 April 2007 recorded that Karakus at that point had "a similar arrangement in place with another lender, PDQ, apparently based somewhere in the North of England". As Karakus was not authorised for the sale of insurance, commission from the sale of PPI was paid by the insurers directly to the Appellant and not Karakus. The Appellant held a large debenture charge over Karakus to cover the eventuality that Karakus failed to pay. Karakus undertook "lender visits" generally once per year to discuss the Appellant's performance with the lenders, feedback is then provided to the Appellant. Commission rates with lenders are revised on an ad hoc basis in consultation with the lenders. The Appellant negotiated the rates with "its panel of lenders" and Karakus was granted those same rates; it is more practicable for the Appellant to carry out the negotiations as Mr Johnson, the Appellant's Lending Underwriter, is the relationship manager with the lenders. Karakus has real time open access to the Appellant's processing and system information for the loans it processes. Karakus does not have access to information relating to the loans processed by the Appellant for its own broking activity. The Head of Leads Generation at the Appellant would look at the Appellant's capacity available for processing activity at periodic intervals and liaise with Mr Farr at Karakus to discuss how many leads Karakus should generate to meet the capacity. Karakus would outline its marketing plans relying on the Appellant's marketing department for advice and assistance as to what media advertising to deploy. As far as Mr Chadwick was aware the Appellant did not have any extant agreements with lenders covering its broking activities for them. There are unsigned/draft agreements and service levels; each party is content to operate in this way albeit the risk it poses to the Appellant is "quite high in so far as a considerable element of its business could conceivably walk away with little penalty. However, FF has very strong relationships with the main lender, GE, and the risk is thought to be acceptable." Mr Chadwick explained Karakus' role in the processing of loans was to receive copies of the loan application forms and accompanying documents which were provided to the lenders in respect of an approved application. He stated that Karakus had the opportunity to audit the packs which are couriered to Gibraltar on a weekly basis. Karakus was not concerned with refusing or delaying applications but rather how much income it generates from the media spend. The Appellant's call centre takes enquiries and the Appellant's IT system has an automated underwriting feature.

154. HMRC submitted that the assertions made by Mr Chadwick were no more than window dressing. It is correct to note that there is no evidence that Karakus ever analysed the applications and the use of PDQ would potentially be a breach of the 2004**.**

155. There is only one minuted meeting of a visit to a lender by Karakus which took place after the meeting on 12 April 2007 and at which the attendee is not noted to have added anything to the meeting. The note indicates that it is the Appellant's marketing department which directs Karakus and the control by the Appellant is further supported by the clear strong relationships that the Appellant rather than Karakus has with the lenders. Overall the evidence does not indicate that Karakus added any commercial value or input into the business. I noted the Appellant's submission that the officer who compiled the notes did not give evidence and I took this into account in assessing the weight to be given to the evidence. However, the note is a contemporaneous record of the meeting and in the absence of any other evidence there was no basis upon which to reject it. Although the Appellant queried whether the officer had inaccurately recorded Mr Chadwick referring to PDQ as a "lender" instead of a processor, there is no evidence upon which I could reach such a finding which would be contrary to the only contemporaneous evidence available.

156. I was invited to infer that Karakus conducted lender visits once per year to discuss the Appellant's performance. However, on the material before me there was only evidence of one such attendance (set out above) at which the representative of Karakus, Ms McKenna, did not take any active role. On the basis of that evidence I concluded that it was not reasonable to infer that there were visits to other lenders or that, if there were, the visits constituted any meaningful check of the Appellant.

157. A note of a visit report to Mediability on 15 January 2008 recorded Mr Grundy as confirming that contractual relations between Mediability and Karakus ceased from 1 April 2002. Karakus introduced ESP to Mediability and with effect from 1 April 2002 Mediability supplied ESP with "media planning and negotiating services" because ESP "did not have the infrastructure necessary to negotiate with the UK media". A spreadsheet was provided by the Appellant to ESP who gave it to Mediability or, on occasions initially, it was provided directly to Mediability by the Appellant and more recently it invariably came direct from the Appellant. The spreadsheet was analysed to monitor the success of advertising campaigns. The relationship with ESP was terminated abruptly in mid-2005 when ESP advised Mediability that they were no longer acting for Karakus. Mediability was subsequently contacted by Venture Media Ltd who indicated they were keen to employ Mediability in a role similar to that which it had provided to ESP. It was confirmed that terms were agreed and that arrangements in place are identical to those with ESP.

158. That ESP did not have the infrastructure necessary to negotiate with the UK media reinforces the finding that it was artificially inserted into the arrangements without adding any value to the transactions. Moreover, the commercial input came from the Appellant despite the contractual terms between Karakus and the Appellant.

159. A record of a meeting between HMRC and GE Money Home Lending dated 17 April 2008 noted that FNB was acquired by GE in 2003. FNB has had an on-site team at the Appellant's premises in Wilmslow for over 10 years, comprising 5 people (and up to 12/13 historically) who dealt with loan applications submitted by the Appellant. It is recorded that FNB had very little, if any, direct contact with the borrower, the broker is tasked with submitting a package that meets FNB's lending criteria. Once the loan is concluded FNB deals with all customer queries directly and "the broker's involvement ends at this point". The Appellant is noted as being on of FNB's "large brokers". It is recorded that Mr Webb had dealt with FNB since the 1980s and the Appellant opened a broker account in 1995. There are monthly meetings with the Appellant held at the Appellant's premises in Wilmslow. Where significant changes are proposed, such as commission rate renegotiation, Mr Machin the managing director at the Appellant is more likely to be involved. The national account manager at G had limited knowledge of Karakus' position in the arrangements and he had no day to day contact with anyone from Karakus nor had he attended any meetings with the Appellant at which Karakus was on the agenda. His understanding was that Karakus formed part of the Appellant's group and as far as he knew was liaising on behalf of FNB with the Appellant. He understood that Karakus was not a "consumer brand" and no separate negotiation or agreement took place with Karakus when liaising with the Appellant on commission rates. The rates were negotiated by the Appellant and applied to the Karakus arrangements. For pricing purposes the Appellant and Karakus were treated as one save for separate source identifications introduced by the Appellant and Karakus at their end of the business. There was no evidence of any direct communication between FNB and Karakus save for the odd emails regarding incorrect commissions which originated from the Appellant on behalf of Karakus. Operationally, FNB deals with the Appellant and Karakus as one but settles commission to the two parties individually.

160. The Appellant questioned the relevance of notes from meetings with lenders. However, in my view the lenders' perspectives are clearly relevant in assessing the commercial and economic reality of the arrangements. The record reveals that the Appellant, who is referred to as the broker, has the real relationship albeit not the contractual relationship with the lender rather than Karakus. This is demonstrated by the fact that the lender has staff on site at the Appellant's premises and not Karakus' and that Karakus is believed to be in the same group as the Appellant. The lender confirmed that it was the Appellant which negotiated, that it dealt with the businesses as one and the lender's uncertainty as to whether anyone from Karakus ever attended meetings is consistent with the absence of direct communications between Karakus and the lender. I took into account that there was no witness to give evidence regarding the note. However, the record is a contemporaneous note and there was no evidence to cast doubt upon it nor did the Appellant pursue a positive case that any aspects of the record were incorrect.

161. Notes from a meeting with Belmain Finance Ltd on 29 May 2008 record the Appellant described as one of Blemain's "larger brokers". Blemain met once a month at the Appellant's premises in Wilmslow to discuss matters including commission rates, benefits, policy changes and packing arrangements. Blemain started work with Karakus in 2003 when the Appellant approached Blemain to explain that they were going to start packaging for Karakus and wanted to operate the same broker deal enjoyed by the Appellant. Blemain had some prior arrangement with Karakus but "details were vague". Blemain paid the volume benefits to the Appellant and it was not known how or if those benefits were transferred to Karakus. All Karakus queries are communicated to the Appellant, not Karakus with whom direct contact was minimal. A point of contact at Karakus, Lisa McKenna, attended a meeting with Blemain in September 2007 to review processes. Ms McKenna also attended a review meeting with the Appellant and Blemain at the Appellant's premises in November 2007.

162. The document supports the findings made above in that Blemain, another lender, also appeared to consider the Appellant as broker and that it was dealing with only one business. The lender had regular meeting with the Appellant at which negotiations took place which in my view is a further indication that although Karakus had contractual relationships with the lenders, the commercial reality was that the Appellant controlled and had the benefit of the arrangements with Karakus adding no commercial input, as indicated by the minimal direct contact between Blemain and Karakus.

163. The evidence included correspondence between Karakus and the Appellant in September and October 2008. A letter dated 22 September 2008 to Mr Mark Chadwick stated that Karakus had made a substantial loss in 2008 and in order to move back into profit would need to cut the Appellant's fees. A meeting was suggested to discuss the proposals. On 24 September 2008 Mr Chadwick responded, expressing surprise at the proposed reduction in processing fees and setting out the minimum required by the Appellant to cover its costs. The Appellant noted that its relationship with Karakus "is an extremely important one and a valuable source of good quality leads". Further correspondence ensued between the companies in which proposals and counter proposals were made but no agreement reached. On 24 October 2008 Karakus' legal representatives sent the Appellant a formal notice of Karakus' intention to terminate the Agreement. The Appellant responded with confirmation that it had instructed its legal representatives to draft a Termination Agreement.

164. I agreed with HMRC's submission that the correspondence was contrived; the evidence does not support the assertions such as Karakus as a valuable source to the Appellant or that it ever generated any business for the Appellant. In viewing the evidence overall, I am satisfied that the decision to terminate the agreement was directed by the Appellant.

165. The Termination Agreement is dated 20 July 2009. The terms included (at 9.1 and 9.4) that the Appellant paid £25,000 for all rights, title and interest in the customer data. For consideration of £1 Karakus assigned all rights in the Appellant's website (10.2) and the Appellant would reimburse Karakus for all sums reasonably incurred in the development of the website up to the sum of £50,000. Both parties agreed (Clause 12):

> "…to maintain secret and confidential all information obtained from the other pursuant to this agreement, to respect the other's proprietary rights in it, to use it exclusively for the purpose of this agreement and to disclose the same only to those of its employees to whom and to the extent that such disclosure is reasonable necessary for the purpose of this agreement."

166. The fact that the Appellant received the benefit of the termination and Karakus was left with nothing and there was no evidence to show it continued to trade lends further support for the finding that it was the Appellant that controlled the arrangements; the Appellant received the data for consideration which seems uncommercial, furthermore the confidentiality clauses are, in reality, impossible to comply with given that the Appellant had staff who worked on both the Karakus and Appellant businesses.

167. A letter dated 25 November 2010 from the Appellant to Karakus confirms that the debenture charge was satisfied in full on 31 October 2008.

SUBMISSIONS AND FURTHER FINDINGS OF FACT

Economic Reality

168. Mr Gibbon submitted that insofar as arrangements between the Appellant and Karakus may be said by HMRC to have been set up originally with the aim of obtaining a tax advantage, the Tribunal must nevertheless analyse all of the circumstances of the supplies to determine whether the economic and commercial reality was that Karakus was providing loan broking services or whether the Appellant was doing so despite the clear contractual arrangements. An analysis of the ownership, control and resources available to Karakus is essential to any understanding of the economic and commercial reality of the arrangements. Furthermore, the analysis must be carried out in respect of each transaction under the arrangements; in doing so the facts should be analysed for the following four time periods:

- 1 September 2000 – 18 September 2000
- 18 September 2000 – 30 June 2003
- 30 June 2003 – 20 March 2004
- 30 March 2004 – onwards.

169. Mr Gibbon submitted that if HMRC were correct in their view that outsourcing to other entities in arrangements is not strictly necessary for loan broking, then such outsourcing would be outlawed. Simply because the Appellant carried out a substantial amount of work under the arrangements does not mean it was necessary for it to do so and ignores the fact that Karakus held the contracts with lenders and a licence in the UK; two necessary features of loan broking with the remaining work outsourced to the Appellant.

170. Following the ratio in *Pendragon*, it was not abusive for the Appellant to arrange its commercial affairs so as to fall within Article 3(c) of the VAT (Specified Supplies) Order 1999 (SI 1999/3121) which specifically extends entitlement to input tax recovery to financial intermediaries who supply their services to "a person who belongs outside the member states".

171. HMRC contended that the commercial reality was that loan broking was conducted by the Appellant and that no true outsourcing by Karakus ever occurred. HMRC contended that

the purpose of the arrangements was to avoid VAT and that statements to that effect were made by Mr Webb and others. Furthermore, HMRC submitted, it is evidence that Mediability which traded heavily with the Appellant throughout the relevant period, was significant in initiating the setting up of the structure so its advertising services could be provided VAT free. The implementation of the scheme following receipt of accountancy advice further supports the fact that it was created in order to obtain a tax advantage.

172. I accepted the Appellant's submissions in so far as the authorities make clear that a tax driven motive is not, of itself, determinative of the issue. I also accepted that it was open to Karakus to outsource work to the Appellant. I did not, however, agree that the correct approach was to analyse the four periods identified by Mr Gibbon separately. To do so, in my view, would not be consistent with the principles set out by the authorities. My approach therefore was to consider the separate transactions while analysing the evidence pertaining to the arrangements overall.

173. Mr Gibbon highlighted that from 19 March 1997 Karakus was owned by Jordan (Nominees) Ltd on behalf of Mr Webb; the directors were Jordan (Nominees) Ltd and Mr Jonathan Swann. He submitted that in the period from 1 September 2000 to 18 September 2000 Mr Webb did not exercise practical control over Karakus or its bank account. Mr Gibbon submitted that as at 1 April 2000 Karakus had 4 employees and a turnover for the year to June 2000 of £12.3m. It outsourced the processing of loans while retaining the contractual right of approval and having sufficient human and technical resources to carry out its functions under the 1997 agreement (as amended by the 2000 agreement). On 12 May 2000 the Appellant and Karakus agreed that the Appellant would take a debenture over Karakus' assets; the Appellant submits that if it controlled Karakus there would have been no need for such a debenture. In addition to providing its services to Karakus, the Appellant also provides intermediary services as principal to Direct Mortgages Ltd, First Plus Ltd, other major lenders and approximately 7,000 independent financial advisors. The Appellant employed 110 employees of which 30 were dedicated to the contract with Karakus, 60 worked on the contract with Karakus as well as other contracts and 20 had no involvement with Karakus.

174. On behalf of the Appellant it was submitted that the economic and commercial reality was as set out in the 1997 agreement (as amended); Karakus was a legitimate company conducting legitimate business to a large extent through the services agreement with the Appellant. In *Newey T/A Ocean Finance* the UT did not consider ownership of Alabaster by Mr Newey as a matter affecting the analysis of arrangements; similarly, Mr Webb's beneficial ownership of Karakus should not affect the analysis in this case and does not amount to a purely artificial arrangement which did not correspond with the economic and commercial reality.

175. HMRC submitted that at all material times the contractual structure entered into was not reflective of the economic and commercial reality and was artificial because it lacked important commercial features and included commercially perverse features. In support of its case, HMRC relied on the following features of the arrangements. The business relationships with lenders were at all times the Appellant's. The Appellant conducted a loan broking business with UK customers and UK lenders prior to setting up the structure in 1997 and it continued to operate in the same manner throughout the relevant period.

176. Ms McArdle responded to the Appellant's contention that the contract was "held" by Karakus by noting that there was a contract in *WHA*, however the existence of a contract does not amount to added value and on the facts of this case Karakus added no value, provided no commercial input and was not responsible for making decision. By way of example, Karakus

did not play any, or any significant role in communications with the lenders. The limited evidence, for instance minutes from a meeting in 2007 which a staff member from Karakus attended, does not demonstrate any substantive relationship between Karakus and the lenders.

177. Furthermore, it was the Appellant, not Karakus, which had the necessary business experience and infrastructure. The evidence shows that it was the Appellant's staff and resources that were used to carry out the loan broking; until 1999 Karakus had no employees whereas the Appellant had on average 110 employees in the year to April 2000. There is no evidence to show that the directors of Karakus had any experience in loan broking; the suggestion that Mr Kentish was involved in decision making is not supported by evidence and, moreover, any such action would have been in breach of contract which expressly states that the processing took place in the UK.

178. HMRC submitted that the evidence shows that Karakus took no part in the commercial operation nor added any value. Although the 1997 contract specified that the applications were to be sent to Karakus, HMRC do not accept that this occurred in reality; even if it had, Karakus still failed to add value as the applications had already been processed and there is no evidence that Karakus ever rejected any of the applications received or that it had the necessary infrastructure or knowledge to perform any meaningful vetting and therefore no basis upon which any inference to the contrary can be drawn.

179. HMRC contend that the Appellant and Karakus were never arm's length entities. The evidence shows that the Appellant acted as principal with lenders throughout the material time. It also entered into loan broking contracts in its own name; HMRC contend that it is commercially absurd that Karakus would engage a competitor as a processor for its loan broking business particularly given the absence of any terms and conditions to set out how the applications were to be apportioned. There is no evidence that the two companies operated in different markets.

180. Although the 1997 contract did not include any terms that the Appellant was to play any role in sourcing advertising space or dictating its content, the Appellant did in fact carry out this role. In my view there was no evidence upon which I could reasonably draw the inference urged on behalf of the Appellant that there must have been an oral variation agreed by the parties.

181. Although the 1999 contract provided that the Appellant would provide the procurement of advertising (clause 3.1), there was no provision for the Appellant to be paid for the activity nor any key performance indicators. HMRC contend that this lacks commercial credibility and demonstrates the reality that the Appellant procured advertising services on its own behalf and was therefore the recipient of those supplies.

182. HMRC submit that it was the Appellant which conducted the relationship with Mediability and instructed them as to the placing of adverts.

183. I preferred the submissions of HMRC. For reasons set out earlier in this decision, I was satisfied that not only was the Agreement between the parties not arm's length but I also found that the terms of the Agreement did not reflect the commercial reality. The Agreement contained many terms which were uncommercial or lacked terms that would be expected. I was satisfied that the evidence demonstrating that the background leading up to the implementation of the arrangements was tax driven was relevant, albeit not determinative. That evidence, taken together with subsequent evidence confirmed that the sole reason to restructure the business so as to include Karakus in Gibraltar was to avoid irrecoverable VAT. I found that the arrangements were driven by the Appellant and Mediability on the advice of a firm of tax advisers with the intention that Karakus would, on the face of it, carry on the business of loan broking with the arrangements providing for Karakus to appear to be

a separate entity by features such as the appointment of Gibraltar based directors and payment by way of commissions to the Appellant.

184. There was no evidence to support a finding that Karakus had the necessary resources to evaluate the applications processed by the Appellant nor was there any evidence to show that it ever evaluated or rejected any of the applications. Although new directors of Karakus were appointed and Mr Webb gifted his shares, the debenture maintained a significant level of control by the Appellant over Karakus.

185. Although Karakus formally held the contracts with lenders, I found that the commercial reality was the Appellant had the business relationships with the lenders and that the Appellant continued to conduct its business with UK customers and UK lenders in the same manner as it had prior to the insertion of Karakus into the arrangements. I did not accept that the fact that Karakus employed staff assisted the Appellant; there was no evidence as to what, if any, role the employees played in the transactions with the Appellant.

186. The evidence demonstrated that it was the Appellant which had the resources and expertise to conduct business. I rejected the Appellant's suggestion that it could be inferred that Mr Kentish was involved in decision making as there was simply no evidence to support such a finding. I was satisfied that in all respects the Appellant's business continued in reality as it had prior to putting the arrangements into place with the services being provided by the Appellant from its premises in the UK to UK lenders with UK based customers via advertisements placed in the UK.

187. I agreed that ownership of Karakus did not, of itself, indicate that the arrangements were purely artificial; this is a matter to be determined by reference to the evidence as a whole. However, it is a relevant factor to take into account on the basis that there was clear evidence of the link between the Appellant and Karakus.

188. I was satisfied that the Appellant sourced and determined the content of advertising, on the face of it without payment, and that it was the Appellant who had the business relationship with Mediability. These factors, in my view, support the finding that the Appellant procured advertising services on its own behalf and was therefore the recipient of those supplies.

189. Mr Gibbon highlighted that on 18 September 2000 Mr Webb transferred his beneficial ownership in Karakus to the Ark Trust. The directors of Karakus were partners in BDO Fidecs. The Appellant submitted that from that point on Karakus was wholly independent from the Appellant; no one connected with the Appellant exercised any control over Karakus. Karakus had 4 employees, rising to 6 by the end of 2002 and 9 by the end of 2003 with a £33.5m turnover in the 18 months to December 2002 and £31m in the year to December 2003.

190. Mr Gibbon submitted that during the period of ownership by the Ark Trust there are a number of examples of Karakus showing commercial independence from the Appellant. By way of example, from 16 August 2000 Karakus introduced quarterly audits of the Appellant's procedures at its premises and senior management from Karakus visited lenders to discuss commission rates both of which would have been unnecessary if the Appellant had exercised control over Karakus. Mr Gibbon highlighted a letter from HMRC to Karakus dated 29 January 2008 in which he stated HMRC had accepted that Karakus had attended meetings with UK lenders at which broker commission rates were negotiated. I am not bound by the view of the evidence taken by HMRC. Moreover, the letter goes on to state that: "but in practice the rates agreed by [Karakus] are those negotiated by [the Appellant]" which in my view does not indicate HMRC's acceptance that Karakus played a meaningful part in negotiations but rather it indicates that HMRC's view, which I accepted, was that the

commercial and economic reality was that the Appellant had the relationship with lenders and negotiated the commission rates.

191. Ms McArdle submitted that it is not credible that the shareholding in Karakus was gifted to a third party, with no control being retained over what would happen to the shareholding thereafter. HMRC submit that the Appellant must have retained de facto control of Karakus. The 2004 contract which purports to sever ties between Karakus and the Appellant is not arm's length and the debenture entered into shortly before the alleged gifting of the shares further demonstrates the Appellant's control over Karakus; it was extraordinarily onerous to Karakus and a source of very significant leverage by the Appellant over Karacus.

192. I agreed that although the shares were purportedly gifted, to do so without the Appellant retaining control when viewed against the evidence overall which clearly showed the Appellant as the controlling, directing and benefitting from the arrangements more than any other party, lack credibility. I consider this finding reinforced by the 2004 Agreement which was not arm's length and the debenture which provided significant leverage to the Appellant over Karakus. I found that the commercial reality was that, even after the shares were gifted, the entities remained tied, the Appellant retained substantial control over the arrangements and there was no evidence to support the contention that the Appellant added any commercial value.

193. Mr Gibbon noted that from 30 June 2003 BDO Fidecs owned Karakus. BDO Fidecs was one of the largest financial services companies in Gibraltar. It was part of the BDO International network of independent accountants and business advisors. The directors of Karakus were partners in BDO Fidecs. Karakus turned over £31m in the year to December 2003 and £37.4m in the year to December 2004. During 2003 Karakus took on another loan processing company, PDQ Finance to act as processing agent which, the Appellant submitted, is a further example of Karakus' independence by acting against the Appellant's interests. Karakus retained throughout this period its contractual right to approve all loan applications and had the human and technical resources to do so. Mr Gibbon submitted that Karakus took hands on control of the advertising campaign through its appointment of ESP. He highlighted that on 30 March 2004 the agreement was revised; the main change from the 1997 agreement (as amended) was that Karakus was now responsible for all advertising. During this period representatives of Karakus attended meetings with lenders to discuss and negotiate commission rates.

194. During this period the Appellant acted as a credit broker in its own right, placing loans and mortgages on referral from other brokers and/or lenders such as Abbey national, Alliance and Leicester, Barclays, Sainsbury's and other. Other commission income is recorded in its financial statements from 2001 and during the year to 2007 commission income from its credit broking business had become its primary source of turnover. In a letter the HMRC dated 7 November 2006 the Appellant explained that it had increased its business generated by direct referrals and had reduced its processing capacity for the contract with Karakus. On 28 March 2007 the Fidecs Group was acquired by the STM Group whose shares were floated on AIM; further evidence of the independence of the Appellant and Karakus. From mid 2008 there were discussions between the Appellant and Karakus regarding the Appellant lowering its fees; Karakus could not make a profit if fees were maintained at the same level but conversely the Appellant could not lower its fees without making a loss; the contract between the two was terminated with effect from 1 September 2008 as a result.

195. HMRC highlighted that the 2004 contract provided the Appellant with significant rights to assign and engage in similar activities, while providing Karakus with no such rights. All

meaningful commercial control lay with the Appellant which carried on loan broking on its own behalf at a commercial level. The Appellant's submission that Karakus "might not mind" is commercially absurd. The rights of redress for Karakus in the event that the Appellant breached the terms of the 2004 contract are severely limited in such a way that no true arm's length entity would agree to. There is no evidence that the Appellant and Karakus received separate legal advice prior to entering into any of the contracts.

196. HMRC contend that the Appellant was, at all material times, the recipient of the advertising services. The fact that Karacus was the contractual recipient and paid for them is irrelevant. It was the Appellant which conducted the commercial negotiation and directed its content and placing. The 1999 contract demonstrates that this occurred beforehand and continued thereafter. It was the Appellant's business which directly benefitted from the advertising and the Appellant's trade marks were used by Karacus without limitation of time.

197. I did not find the fact that BDO Fidecs owned Karakus assisted to any great degree; there was no evidence as to the circumstances in which the decision was made although I found the fact that this did not follow the business model of the company to be an unusual feature. There remained no evidence to show that Karakus had the infrastructure or resources to review loans nor any evidence that it had done so. I did not accept that the appointment of ESP showed a "hands on" approach to advertising by Karakus; the evidence indicated that the business operations did not alter with the insertion of ESP and that Mediability and the Appellant continued to matters as they had done previously. I found that the Appellant acted as a credit broker in transactions which did not involve Karakus did not assist; this appeal is concerned with the arrangements involving Karakus and the fact that the Appellant carried on its business in a wider capacity did not, in my view, inform the issue of the proper characterisation in the circumstances with which this appeal is concerned.

CONCLUSION ON (1) CHARACTERISATION OF THE SUPPLIES

198. For the reasons set out above I am satisfied that the proper characterisation of the supplies of loan broking services is that the Appellant was the supplier and that the Appellant was the recipient of advertising supplies.

ISSUE (2) ABUSE

199. In the alternative, HMRC submit that the scheme was contrary to the doctrine of abuse of law. The sole purpose was to obtain a tax advantage. Furthermore, it was contrary to the purpose of the relevant provisions in that the structure was artificial, not in accordance with commercial reality and therefore contrary to the purpose of the VAT regime. It was also contrary to the place of supply provisions which impose VAT on consumption; the advertising supplies were received in the UK and therefore VAT should be incurred in the UK on those supplies.

200. The advertising was in the UK media and not Gibraltar therefore only designed for UK customers and therefore consumed in UK. It was commissioned by Karakus but based on content which was directed and approved by the Appellant. HMRC submit it would be contrary to the purpose of legislative provisions to avoid non-taxation if this loan broking business which was substantially conducted in the UK was able to compete with other loan broking businesses in the UK but without incurring irrecoverable VAT on the related advertising costs.

201. HMRC contend that the essential aim of the structure was an artificial means by which to avoid irrecoverable VAT arising on the advertising services procured and to allow recovery of VAT on the Appellant's overheads; there is no credible evidence of any commercial purpose of rationale in splitting the business between the UK and Gibraltar and

the arrangements were conceived and implemented by the Appellant as a VAT saving mechanism.

202. Mr Gibbon submitted, relying on *Pendragon*, that the clear inference to be drawn from the Court's comments is that it is difficult to set a blanket, standard or general "normality" to measure transactions against, given that parties are free to contract as they wish and according to their own commercial aims and objectives; where the law leaves options open to a taxpayer, it is not abusive to take one of those options.

203. I accepted Mr Gibbon's submissions regarding the authorities. The Supreme Court confirmed that business arrangements are not, of themselves, abusive where a taxpayer chooses one of a number of normal commercial options, none of which run counter to the purpose of the legislation. The CJEU in *Newey T/A Ocean Finance* held that the effect of the principle of abuse of rights was to bar artificial arrangements which did not reflect economic reality and were set up with the sole aim of obtaining a tax advantage.

204. However, having considered all of the evidence available, I preferred the submissions on behalf of HMRC that the scheme was manifestly contrary to the purpose of VAT by virtue of its artificiality and abusive structure. The use of the special purpose vehicle in Gibraltar added expense to the business which was commercially unnecessary other than to obtain a tax advantage. The scheme required profits from the business to be used to cover the expenses of Karakus which performed none of the necessary elements of the loan broking business from a commercial perspective.

205. I found that the commercial reality was that all marketing, processing and provision of vetted applications for loans was performed by the Appellant. As distinct from *Newey T/A Ocean Finance*, the Appellant sent the completed applications directly to the lenders giving Karakus no opportunity to object. There was no evidence that the directors of Karakus had any experience in loan broking nor that they had any meaningful involvement in it.

206. Although there were changes to the ownership and apparent control of Karakus I found that it did not operate independently of the Appellant at any point throughout the relevant period. I agreed with HMRC's submission, applying the authorities, that it is not necessary for a finding of artificiality for it to be established that the Appellant or Mr Webb retained a connection with Karakus after the transfer of Mr Webb's shares to the Ark Trust. However, in the absence of any credible explanation for the transfer, I was satisfied that it was reasonable to draw such an inference on the basis of the evidence and my findings thereon. The gifting of the shares for no consideration was manifestly uncommercial and the debenture entered into by Karakus reinforced my finding on the basis of the substantial leverage it provided to the Appellant which I concluded evidenced the Appellant's continued control.

207. I found that the Agreements lacked key details which would be expected in genuine commercial arrangements between arm's length parties. By way of example the 1997 contract provides no terms dealing with the negotiation and provision of content for advertising yet this was carried out by the Appellant without payment.

208. I accepted HMRC's submission that the 2004 Agreement contained rights given to the Appellant which no genuine principal would agree to whilst also limiting Karakus' remedies, for instance Karakus was granted royalty free and without time limit, a licence to the Appellant to use customer data which it could in turn sub-licence "without prejudice to any other provision of this Agreement"; such data would be both valuable and sensitive and it is wholly lacking commerciality for a loan broking principal to grant its processor the right to sub-licence such data without strict controls in place.

CONCLUSION ON ISSUE (2) ABUSE

209. Having considered all of the evidence I found that the arrangements which form the subject of this appeal were highly uncommercial, did not reflect the economic or commercial reality and were contrived to result in a tax advantage. I was satisfied that the essential aim was to avoid irrecoverable VAT and that the structure of the arrangements was contrary to the purpose of VAT by its artificiality.

RE-DEFINITION

210. HMRC submit that the appropriate re-definition is to exclude Karakus from the arrangements so that supplies would be treated as being made to and by the Appellant with the consequence that the Appellant would be making exempt supplies of loan broking and the associated output tax would be irrecoverable.

211. On the basis of the conclusion set out above, it follows that the abusive advantage must be eliminated with the result that the re-definition treats the Appellant as the supplier of loan broking services and recipient of advertising services at all material times.

212. The appeal is dismissed.

RIGHT TO APPLY FOR PERMISSION TO APPEAL

213. 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.

JUDGE JENNIFER DEAN
TRIBUNAL JUDGE

RELEASE DATE: 05 JUNE 2020