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Blue Sphere – where do traders stand now?

The Court of Appeal's recent judgment in the joined appeals of Blue Global Limited (BSG), Mobilx Limited (Mobilx) and Call Telecom Limited and Another (Calltel) brings a welcome restatement of the law and helpfully sets out the correct approach to cases where traders have become unfortunately mixed up in a chain of transactions which at some point involves a fraudster.

Starting from basic principles Lord Justice Moses (supported by Lord Justice Carnwath and Sir John Chadwick) reiterates the approach of the European Court of Justice to the issue of when HMRC may deny a tax payer the right to deduct input tax.

“Kittel ... enlarged the category of participants to those who themselves had no intention of committing fraud but who, by virtue of the fact that they knew or should have known that the transaction was connected with fraud, were to be treated as participants. Once such traders were treated as participants their transactions did not meet the objective criteria determining the scope of the right to deduct. “

The extent of such knowledge is therefore key and in previous cases HMRC had sought to extend the scope of the test so that the right to deduct could be denied on the grounds that the trader:

“knew or should have known that it was more likely than not that transactions were connected to fraud”

The Court of Appeal has made clear that this is the wrong test. The Court affirmed the first instance decision in BSG that the right to deduct input tax may only be denied where the trader knows or should have known that the transaction **was** connected to fraud. Traders who only might know the transaction was tainted by fraudulent evasion of VAT therefore cannot be regarded as a participant in that fraud.

So the trader's state of mind needs to be considered carefully and the state of his or her mind is to be established, according to the Court of Appeal, by identifying that the only reasonable explanation for the transactions is the connection with fraud.

The long running issue about who must prove the state of knowledge has also been settled. The Court made plain that if the Customs wish to allege a certain state of mind in the trader they must prove that. This echoes the approach of Briggs, J. in the appeal in Megtian Limited (in administration) decided on 15 January 2010 where the Court indicated that it is for Customs to establish the state of the mind of the taxpayer's officers having identified him or her.

In the joined appeals the Court of Appeal drew attention to the assistance which the surrounding circumstances can lend in terms of establishing whether a particular officer should have known a transaction was connected with fraud. The decision of Brayfal Limited, decided by the First Tier Tribunal (Tax) on 3 March 2010, assists in this regard. Judge Demack sat with two members. The members' came to the view that Customs' allegations about the trader's state of knowledge were unfounded and summarised their views as follows:

- Lengthy experience of the mobile phone export business was a positive indicator for the trader
- The absence of trade references did not suggest knowledge of fraud
- Choice of insurer in any country of the trader's choice was not suspicious
- Compliance with verbal contracts was not a suspicious way of doing business despite the lack of any written terms
- The use of FCIB as a banker was no cause for concern as at the material time no authority had taken any steps against FCIB
- Customer driven transactions were not surprising and in fact were to be regarded as the norm
- The only equipment required for trading in mobile phones is a mobile phone and a fax machine
- The absence of credit terms is not suspicious but consistent with trade in this sector
- Low or non-existent credit ratings from credit agencies should not be taken as an indicator of suspicious activity. Any company trading mainly in cash would not expect any credit rating.
- It is inappropriate to expect traders to carry out verification checks on other traders apart from those with whom they deal directly.
- Checking the validity of VAT numbers through Europa was perfectly acceptable
- The fact that stock was immediately available in the precise number, type and models is indicative only of typical business practice in the sector where product can be sourced at short notice.

These recent decisions are refreshing for the re-connection they make both with the correct law and commercial reality.

So far the taxpayer has had a good year in the Courts which makes the prospect of settlements being done with the Customs more likely. Innocent traders will at last begin to recover most of the money they have been denied by Customs without the cost and delay associated with litigation.

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