

## **Bond House Systems Limited v C & E Comrs [VAT Decision 18100, 29 April 2003]**

*Commissioners succeed in arguing that purchases and sales of computer chips entered into by the unwitting participant in a "carousel fraud" did not amount to "economic activity" and that, accordingly, the trader had not incurred any input tax which it could recover.*

**Mario Angiolini**  
**May 2003**

The VAT and Duties Tribunal dismissed the appeal by Bond House against the Commissioners' refusal to pay its claim relating to input tax allegedly incurred during May 2002 on purchases of computer chips later sold by Bond House to customers in Ireland.

Bond House Systems Limited is, or rather was, an established broker in computer chips. The majority of its trade consisted of purchases of chips within the UK, upon which VAT was charged by the supplier, and subsequent sales to customers registered in other Member States, whereby, upon fulfilment of the usual conditions by Bond House and its customers, no output tax would be charged by Bond House. Under normal circumstances, Bond House would have had a right to credit for the input tax incurred on its purchases and had, for a number of years, been a repayment trader.

On 7<sup>th</sup> June 2002 it submitted its May 2002 return and sought credit and repayment of some £16m of input tax it had incurred on its purchases. Following an initial refusal by the Commissioners, pending further enquiries, and an initial visit on 11<sup>th</sup> June 2002, Bond House ceased to trade. Consequential upon negotiations with the Commissioners and an application for judicial review to the Administrative Court, the Commissioners made payments totalling around £8m, without prejudice to their contentions that, upon a fully reasoned decision, some or all of this payments might not be properly due and therefore recoverable from the trader.

On 19<sup>th</sup> September 2002 the Commissioners issued their reasoned opinion, accepting £2.7m relating to some 130 transactions as allowable but rejecting the remainder of Bond House's claim to input tax credit, alleging that the 27 transactions to which the credit related were part of a "carousel fraud" and therefore outside the scope of VAT, so that no input tax credit arose in relation to those purchases.

The essential elements of a "carousel fraud", as set out by the Tribunal at paragraph 15 of the decision, are the following:

- A VAT-registered trader ("A") in one European Member State sells taxable goods to a VAT-registered trader in another Member State ("B"). This sale is zero rated in A's Member State and B should declare the purchase and enter the amount

- of VAT due in its return and claim the same amount as input tax credit;
- B then sells the goods to another VAT-registered trader ("C") in its own Member State, charging and receiving VAT on the sale but not accounting for it to the tax authorities. In effect, B would disappear and become a "missing trader";
- C, also referred to as the "broker" then sells the goods to a registered trader in another Member State, which, in the simplest form of carousel fraud, would be A, from whom the goods originated. C's sale to A would be zero rated and C would be entitled to reclaim input tax incurred on its purchase from B;

In most instances, the chain of transactions is actually more complex and a number of further traders, referred to as "buffers" are interposed between the essential steps set out above, normally between the missing trader and the broker. What was accepted as an essential characteristic of carousel fraud by both the Commissioners and the Tribunal was the element of circularity, whereby the relevant goods would, ultimately, find their way back to their starting point. All the transactions to which Bond House was party were significantly more complex than the simplest carousel set out above: firstly, Bond House never purchased directly from the "missing trader" but was at least one step and in several cases more than one step removed from that trader; secondly, it was accepted that Bond House had undertaken all necessary checks relating to its immediate suppliers, who were all properly registered for VAT and had properly accounted for VAT on the goods supplied to Bond House.

The Commissioners' primary contention was that each of the 27 transactions challenged were part of a series of transactions within a carousel fraud whose purpose was not the buying and selling of computer chips in the course of a business activity but the perpetration of a VAT fraud. Accordingly, they argued, the fraudulent purpose of the series had the consequence that the entire sequence, including the transactions involving Bond House, were devoid of economic substance. As illegal transactions were outside the scope of VAT, what Bond House had paid to its suppliers was not VAT and no input tax credit could arise. It was not suggested at any stage that any of the transactions to which Bond House was party had not been properly carried out, and all relevant paperwork had been obtained by Bond House in accordance with the requirements of VATA 1994.

Perhaps the most striking feature of the Commissioners' contentions and their refusal to pay Bond House's claim was that no allegation was made against the appellant that it knew of the fraudulent intent, nor that it was reckless in relation to the existence of such a fraudulent intent, on the contrary, the Commissioners appear to have expressly disavowed any such argument. In other words, Bond House was no more than an innocent trader unwittingly caught in someone else's fraudulent activity. In the Commissioners' submission, it was immaterial that Bond House was ignorant of the fraudulent purpose of the series of transactions and that what mattered was the "objectively determined character of the series".

Bond House's basic argument was that it had made taxable purchases in the course of its business and used those purchases for onward taxable supplies, that it had all the required documentary evidence to support its claim for input tax credit and that, therefore, it had a right to the full repayment. Once accepted, as the Commissioners had done, that Bond House was not party to the fraud, there were no grounds upon which the repayment could be refused and it was not open to the Commissioners to go beyond the transactions to which Bond House was party. What the Commissioners were attempting to do was to take a global view of the series of transaction, contrary to the thrust of the legislation and unsupported by the relevant caselaw. If the Commissioners considered that other traders were evading their tax liabilities their proper remedy was against those parties, not against the appellants. Bond House submitted that its purpose in entering into the transactions that were the subject matter of the appeal was the same as that of any other transaction it entered into over the previous ten years, the buying and selling of computer chips from and to unconnected third parties. As Bond House did not know which of its transactions involved fraudulent activities further up the supply chain, if the Commissioners' argument were to be accepted, traders could never know whether they were engaging in economic activities or not.

Bond House further contended that, on the evidence, the existence of a carousel fraud could not be established in relation to the transactions that were the subject matter of the appeal. Finally, Bond House submitted that the difference in treatment by the Commissioners between them and other participants in the sequence of transactions was indicative of the inability on the part of the Commissioners to properly distinguish what was and what was not VAT and that the Commissioners' approach breached the appellants' human rights as well as the principles of proportionality and of legal certainty.

The Tribunal accepted Bond House's argument that the burden of proof in relation to establishing the existence of the carousel fraud rests with the Commissioners, particularly given that the Commissioners had accepted that the appellant had not knowingly been party to the fraud nor engaged in any dishonest activity.

On the evidence, the Tribunal held that the existence of a carousel fraud had been satisfactorily proved by the Commissioners in relation to 26 out of the 27 transactions and it also held that Bond House, though ignorant of the fraudulent intent of other parties to the series of transactions, "was imprudent in its dealings, and its directors failed to ask themselves obvious questions".

The Tribunal then accepted the Commissioners' submission that, in order to assess the transactions to which Bond House was party, it was permissible to examine the whole chain of supply. Although the Tribunal cited, amongst other things, DFDS (Case C-260/95, [1997] STC 384) and Emsland-Starke (Case C-110/99 [2000] ECR I-11569) in support for such a proposition, its reasoning in this respect is not entirely clear.

Having accepted that proposition, the Tribunal then continued by holding that the Sixth Directive was only concerned with transactions which led from producer to consumer and that transactions which have "some other purpose" are not within the contemplation of the VAT legislation. Transactions to which Bond House was party did not contribute to the process of production and distribution but "merely played a part in the circulation of chips round a circle which had nothing to do with their distribution to a final consumer". Accordingly, those transactions were not within the contemplation of the Sixth Directive and did not amount to "economic activities".

The Tribunal also found, applying by analogy the principles set out in Halifax (VAT Decision 17124, [2001] V&DR 73) that, once the fraudulent transactions in the circle were "collapsed or eliminated", "the logical outcome could only be that the appellant itself made an entirely circular supply, buying from and selling to itself if all the others were party to the fraud, but still within the circle even if some others were to be regarded as innocent". Once again, the reasoning for this somewhat startling conclusion is unclear.

The Tribunal rejected the further arguments put forward by the appellants in relation to the inconsistent treatment of other traders within the chain because the Commissioners had not submitted contradictory arguments in different fora and that, once the law had been clarified, it would be open to the Commissioners to re-visit the position of other traders. The Tribunal rejected also the arguments of the appellant in relation to the violation of human rights and the principle of proportionality and legal certainty. It held that the Convention was not available to protect perceived as opposed to genuine rights and that, likewise, it was not disproportionate, nor in breach of any legitimate expectation the appellant might have had, to refuse to pay money which was not, as a matter of law, properly due.

On the facts, the Tribunal therefore concluded that repayment was not due to the appellant in relation to 26 out of the 27 transactions subject matter of the appeal and accordingly dismissed the appeal insofar as it related to those transactions.

The Tribunal's decision, certainly welcomed by the Commissioners in their continued efforts to prevent the significant revenue loss caused by this kind of fraud, is a problematic one. It leaves legitimate traders in the unfortunate position of not being able to ascertain whether a particular transaction, in all other respects identical to transactions usually undertaken by that trader, is within or outside the scope of VAT without extensive investigations into the complete chain of supply. The Tribunal also appears to have ignored of Neuberger J in Halifax [2002] STC 404 and his remittal to the Tribunal in that case in order for the purpose and objective of each participant company in a series of transactions to be considered in the context of tax avoidance and, this author would suggest, a fortiori in the context of tax evasion. Further, the finding that circular transactions which do not lead to the consumer are not within the scope of VAT, upon which the Tribunal based its decision, appears an unnecessarily wide proposition and could potentially create serious problems in the context of other speculative markets, where commodities may be bought and sold several times by the same traders, as well as any other situations in which goods might pass through the same trader more than once. The distinction drawn by the Tribunal in this respect, found at paragraph 113, is not entirely satisfactory. The other consequence of the Tribunal's decision is that other traders within the chain, for example "buffer" companies, will presumably now be entitled to claim a refund of any payment previously made to the Commissioners in relation to circular supplies, though, once again, it might be very difficult for them to obtain the necessary information to decide which transactions are circular and outside the scope of VAT and which are not. In theory, subject to any terms to the contrary in its contract with its immediate suppliers, Bond House might have a cause

of action against those suppliers for overpaid amounts which it believed were due as VAT, though such claim may ultimately prove worthless if those companies have, in turn, also ceased to trade or otherwise become insolvent.

The author cannot but wonder how much the Tribunal was influenced by its own findings of fact, which included a finding that Bond House had sold, within the month of May, over 10% of the worldwide demand of chips, mostly sourced from start-up companies which had only limited capital availability and no proven record, as well as its conclusion that Bond House and its directors had been “imprudent” and failed to ask obvious questions. Such a finding appears close to one of recklessness, though, perhaps surprisingly given the surrounding facts, no such allegations were actually advanced by the Commissioners. Indeed, the Commissioners appear to have expressly distanced themselves from any such allegation. It will be interesting to see whether this decision, and the similar conclusions on the law reached by a differently constituted Tribunal in the joined appeals in Optigen Limited and Fulcrum Trading Co (UK) Limited [Decision released 1<sup>st</sup> May 2003] will be upheld on any subsequent appeals.

**Mario Angiolini, Barrister**

**Monckton Chambers**

This article was first published the De Voil Indirect Tax Intelligence