

Bond House v Customs & Excise

The Triumph of Innocence?

By Peter Mantle
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Advocate General Maduro delivered his opinion in Bond House (and joined references Optigen and Fulcrum) in the ECJ on 16 February. The opinion examines the Commissioners of Customs and Excise's legal approach to 'carousel' frauds. All of Customs' arguments, accepted by the VAT & Duties Tribunal, were rejected by the AG. Although in a small but significant number of cases the ECJ answers the questions referred differently from the AG, and Customs cannot be expected to move their position until the Court has given its judgment, it is widely anticipated that the Court will follow the AG in this case and reject Customs' approach.

The case concerns the treatment of traders unwittingly 'involved' in carousel frauds. Customs maintained that each individual transaction involving goods that had at one stage been sold by a person perpetrating a carousel fraud could not amount to an economic activity and so was outside the VAT system. Their approach required regard to be given to the whole supply chain. Each transaction was taken outside the VAT system because it owed its existence to the perpetration of a fraud on the revenue.

'Carousel' fraud was used as a label for a variety of factual scenarios, but at the heart of each was a seller who sold goods, typically computer chips (cpus) or mobile phones, charging and receiving 'VAT' on the sale, then disappearing, without paying Customs any VAT. That seller's main aim was to receive a sum by way of VAT and make off with it. The other key feature was circularity; the goods would pass through at least one set of the same hands twice. It was this coming together of fraud and circularity that was said to exclude economic activity and VAT.

The practical effect which, beyond doubt, made this analysis attractive to Customs was that they could refuse to pay VAT credits to those UK traders who sold the cpus or phones into other member states (so-called 'brokers'). If a VAT credit had already been paid Customs sought to recover it from the broker by assessment. Among the advantages for Customs were that brokers, unlike the fraudsters, had to make a claim to Customs, which Customs could refuse. Refusing the claim meant that no loss from the fraud fell on the revenue. Brokers were, relatively speaking, easily identifiable and might have the funds to pay an assessment. Significantly, Customs completely avoided having to consider whether brokers were aware of the fraud, let alone establish that they were aware of fraud, or even that they ought to have been, as the legal analysis was exactly the same whether the broker was innocent or not.

Those familiar with alleged carousel frauds will think in terms of carousels involving perhaps upwards of 6 traders, several accepted

as innocent. However, the AG, following the tribunal in Bond House, used a simple three trader example; A in another member state, who is probably fraudulent, sells to B, the fraudster, who sells to C, who is innocent, who sells abroad back to A. This is the worst possible scenario for the innocent trader. He buys from and sells to those aiming to attack the proper operation of the VAT system. More normally, as in the cases themselves, the broker will himself purchase from a party who is also innocent.

In what must be reckoned a strongly reasoned opinion, the AG first rejected the notion that the carousel must be regarded as a whole. He rejected the idea that the character of an individual transaction in a chain of supply must be determined by having regard to the whole of the chain. The AG stated that the rule for VAT purposes is that *"each transaction must be considered individually and per se without regard to its purpose and results"*. Presumably 'per se' means by reference to its own essential characteristics. If upheld, this will clearly be an important reaffirmation of the prohibition on looking beyond the features of the particular transaction in issue when determining its VAT status.

The ECJ has found the concept of "chain of transactions" a useful one when considering the right to deduct input tax (following the introduction of the concept by Monckton's Nicholas Paines QC making the UK's speech in the BLP case). However, the use of the chain concept in BLP and most subsequent input tax deduction cases was in the very different context of whether a particular business input was a cost component of and sufficiently linked to taxable supplies to permit deduction. The AG seems to have seen the call to view a series of separate transactions as a single event as invoking the concept of "chains of supply". Perhaps unsurprisingly, he saw it as a wholly inappropriate conceptual tool to ascertain whether economic activity has taken place. Certainly he saw it as no basis on which to attempt to link innocent traders to the fraudulent intent of others. It may, on occasion, in input tax deduction, be necessary to link a particular supply to a trader with a particular supply by him. However, that seems to give no basis for concluding that whether a transaction amounts to an economic activity can depend on another transaction. Indeed, it is very hard to see, once a link is made between transactions by use of the "chain of supply" concept, how it could ever lead to Customs' desired conclusion of no economic activity. "Chains of supply" are identified with the normal operation of markets and of the VAT system. They could hardly play a role if either the whole carousel fraud phenomenon, or particular transactions within it, were so alien to the VAT system that they did not even amount to economic activity. Logically the conclusion that individual transactions were not supplies could never be reached by invoking "chains of supply".

In any event if, as the AG says, we must always look at individual transactions, rather than the chain of supply as a whole, that is fatal to Customs' analysis in all cases where brokers dealt with innocent sellers and buyers. It was only by looking to earlier transactions that the fraud of those who sought to cheat Customs of VAT could taint those who sought to deduct VAT credits.

In seeking to give wider significance to the fraud of some in the carousel, by the argument that the fraud deprived the whole carousel of economic activity, Customs placed great weight on circularity. It is noteworthy that, in rejecting the view that regard had to be paid to the carousel as a whole, the AG considered the fact that the "chain of supply" was circular was wholly unimportant. He went on to say that *"The character of a transaction in a chain is not affected by the fact that goods subsequently pass through the hands of the same trader."* Moreover, circularity did not cause supplies within the carousel to fall completely outside the lawful economic sector. The AG remarked that circularity was recognised as a normal market phenomenon in certain commodity markets and stated that the VAT system was designed to cope with it, transactions remaining subject to VAT.

If the Court were to depart from the AG it would almost certainly have to find some special significance in circularity. That could perhaps be found, if all the persons in the carousel were conniving fraudsters, with each individual transaction a sham, deliberately acted out to enable the fraud. However, where goods pass into the hands of innocent traders, or lawful economic channels as the AG puts it, it is difficult to see why circularity should transform the VAT analysis. For Customs it appears to have been key that circularity was engineered by the fraudsters better to execute the fraud. The tribunal in Bond House found that circularity had been engineered, although exactly what it found as fact and its significance remain unclear from its decision. If it were crucial to

show “engineered” circularity, that does not look like an objectively ascertainable fact once it is recognised, as the AG did, that circularity can occur normally. On the AG’s approach regard to “engineering” would be excluded not only on the grounds that it involved subjective examination of intention (see below), but also for looking beyond the relevant individual transaction to the intention of a third party elsewhere in the chain of supply.

Dismissive as he is, the AG says relatively little on circularity. Customs doubtless would have looked for a more direct answer to their point that circularity meant that there was no final consumer and hence no consumption that could be subject to the tax. However, it is hard to see that references in Article 2 of the First Directive to a general tax on consumption are more than background to Article 2 of the Sixth Directive which provides for each supply of goods for a consideration to be subject to VAT if effected by a taxable person acting as such. That focuses on examination of individual transactions. It seems unlikely that the ECJ will depart from the AG on the basis that brokers were not acting as taxable persons because their actions were being “engineered” by fraudsters. This is particularly so as the fraudsters seem to “engineer” in some imprecisely identified way, perhaps doing little more than acting in the market, selling cheap and offering to buy dearer.

In his second major conclusion, the AG rejected Customs’ submission that it was necessary to look at the underlying purpose of the transactions in the carousel. Customs contended that fraud could be objectively deduced from observing the carousel as a whole and that but for the fraud no transactions prior or subsequent to the fraudulent sale(s) would have taken place. He did so, first, by reaffirming that ascertaining whether or not there was economic activity should be confined to the characteristics of each individual transaction. Those characteristics were not altered by the fraudulent aim of other persons.

However, the AG went further. It will be recalled that in the simple A-B-C example the broker buys from the fraudster. Thus one party to the transaction bearing the input tax claimed for deduction is aiming to defraud Customs. The broker might have been in difficulties even if regard is limited to that individual transaction. However, the AG certainly appears to conclude that even where a supply of goods which is otherwise subject to VAT is made by a person who aims to commit a fraud by deliberately not paying to Customs the VAT it has charged and disappearing, that individual transaction remains an economic activity. Thus the transaction remains subject to VAT even though it might fairly be said to be aimed at abusing the very VAT system itself.

For those puzzled by Customs’ suggestion that theirs was an objective approach which did not require notice to be taken of any individual’s intention, the AG’s words will be welcome. He stated (expressly in the context of underlying fraudulent purpose) that Custom’s approach “*would disregard the objective character of the concept of ‘economic activity’ and would produce the incongruous result of an entire supply chain falling outside the scope of the Sixth Directive merely because one trader in the chain has failed to account for VAT to the tax authorities. Such an outcome is particularly puzzling since it would mean that, as a result of that trader’s failure to account for VAT, he would in fact be under no obligation to pay VAT in the first place.*” Readers may reflect that in the absence of circularity, or once circularity is considered unimportant, the contrary is unarguable.

Thus Customs’ approach to economic activity seems likely to founder. If so it will in large measure founder on the fundamental EC law principles of legal certainty and of neutrality in VAT. The AG was clearly troubled by the practical difficulties Customs’ analysis created for innocent traders, whatever practical problems it solved for Customs. He noted the uncertainty that was bound to result. No trader could know his rights and obligations under the VAT system without guessing whether the goods had been sold by a disappearing fraudster, or predicting whether they would fall back into the hands of an earlier supplier. This cannot fit with legal certainty.

The AG also dismissed an attempt to draw support for Custom’s arguments from the ECJ’s case law on unlawful activities, i.e. those that fall completely outside the lawful economic sector because they are wholly prohibited. VAT fraud is obviously wholly prohibited. Nevertheless, any parallel clearly evaporates if the AG is right and one is required to look at the nature of the goods sold (cpus) rather than the wider aspects of the carousel.

As to the future, if the ECJ does follow the AG, a large number of innocent traders will recover substantial sums by way of input tax. There will be claims for interest and careful consideration will have to be given to whether there is an EC right to interest on a compound basis or at a market rate that exceeds the interest available under s. 78 VATA 94. No doubt traders will be well advised to consider carefully whether, in cases where causation of loss can be proved, Frankovich claims for damages for breach of EC rights can be made. A note of caution though: Is any breach of EC law committed by Customs sufficiently serious to permit damages? The VAT & Duties tribunal upheld the UK's approach, the Administrative Court has readily been prepared to assume that completing factual investigations into whether or not a carousel fraud existed justified Customs withholding VAT credits from innocent brokers, two Member States supported the UK in the ECJ and, it is understood, the Belgian courts had referred similar questions. All this will no doubt be relied upon by Customs as showing that the breach was not manifest and may prove something of an obstacle. However some will see the AG's Opinion as trenchant and indicative that he saw the case as reasonably clear-cut. He certainly seeks to build his opinion closely on existing case law.

The UK will also have lost its first line defence against loss from carousel fraud, both in terms of preventing loss of revenue from the treasury and indirectly disrupting the operations of fraudsters. No doubt Customs will resort, amongst other measures, to notices under s. 77A VATA 94 imposing joint and several liability on traders who it is said should have been aware of fraud in a supply chain where VAT goes unpaid. The legality of s.77A is already the subject of a reference in the Federation of Technical Industries judicial review ('FTI'). The AG's words about Article 21 and the opportunity to introduce joint and several fiscal liability give some encouragement to Customs, but raise a concern as he refers to the possibility of joint liability for VAT due from a person's "co-contractor" if he should have known of the "co-contractor's fraudulent activities". "Co-contractor" appears to suggest that a trader can only be made liable for VAT due from a fraudulent person with whom he has entered into a contract rather than anyone in the supply chain. S. 77A does purport to extend liability for VAT far beyond that limit. No doubt this will be decided in FTI, but, given the AG's views of the irrelevance of wider supply chains, it may be that the reference to "co-contractor" (assuming the translation from Portuguese is accurate) is not merely casual.

Thus supplies in a "circular chain of supplies" which originates because of an underlying intention to defraud a Member State of VAT do not fall to be ignored on the basis that it is not economic activity and thus falls outside the VAT system. As a final thought, does the AG's analysis here impact at all on whether or not a particular transaction in a sequence falls to be ignored for VAT purposes on the basis that the intention of each participant is to gain a tax advantage and that it has no independent business purpose? Carousel fraud may seem removed from issues of tax avoidance and abuse of rights, but such fraud is certainly an abuse of the VAT system and AG Maduro is also the AG in the Halifax case. It appears to be the case that Customs' analysis in Halifax can only be established by an overview of a sequence of transactions. It is also crucial that the Court consider the underlying aim. Thus an approach which requires focus on each individual transaction and that even fraudulent intention be disregarded in considering whether a transaction is an economic activity and counts for VAT purposes may be giving Customs cause for concern beyond Bond House and into Halifax. In Halifax Customs have argued that there is scope for a purposive interpretation of "economic activity" to prevent tax avoidance. Can AG Maduro possibly agree? However, despite some resemblances between the arguments, the AG's general approach here may leave a niche for an abuse of rights principle which, it has been emphasised by Customs, would not affect innocent third parties.

Members of Monckton Chambers VAT group involved before the ECJ were Paul Lasok QC and Michael Patchett-Joyce representing Bond House and Rupert Anderson QC and Ian Hutton representing Customs.

The views expressed in this case note are the views of the author alone.

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