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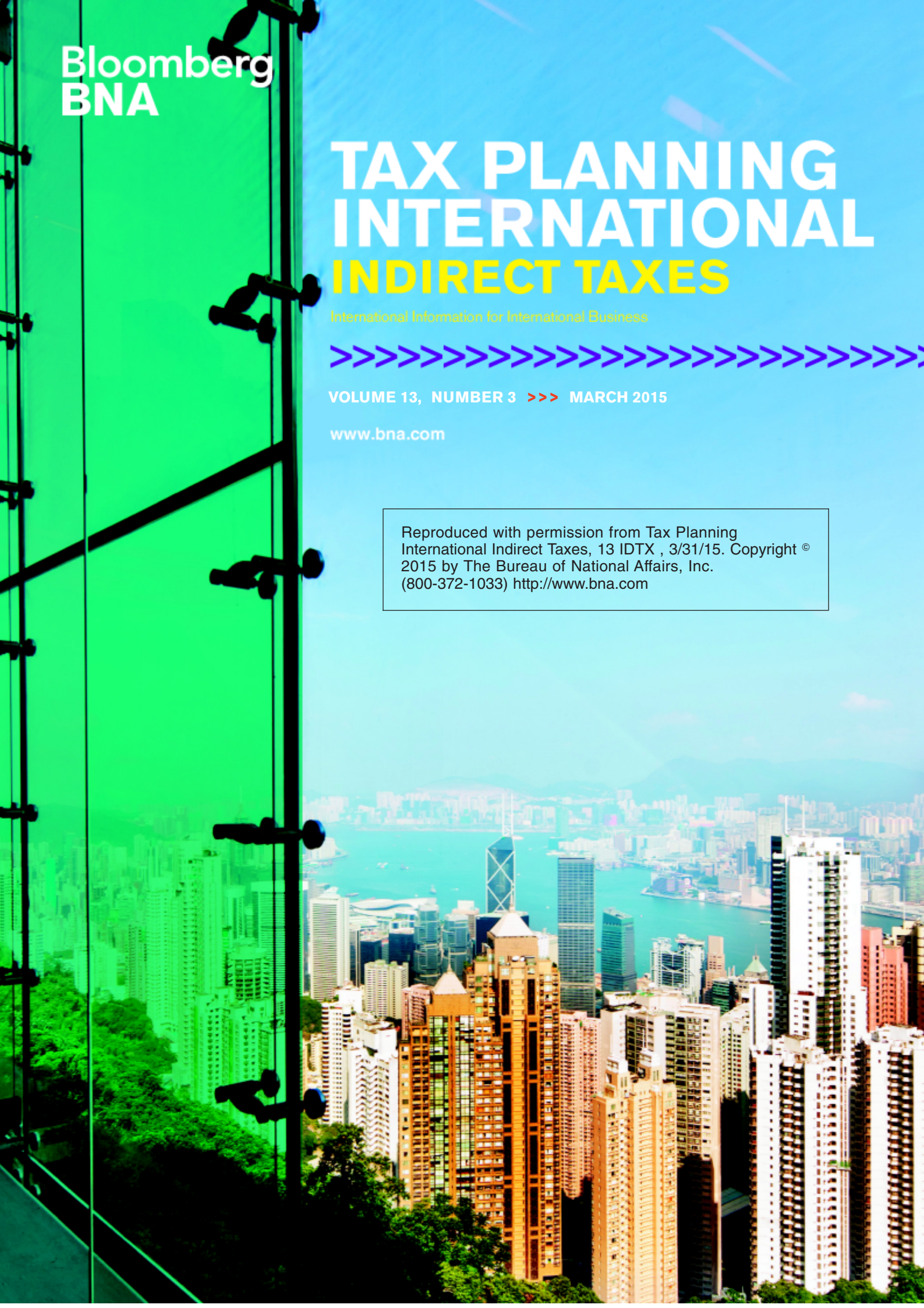
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Viewpoint: Caveat Emptor!

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This article examines the extent to which a purchaser of goods and services is required to investigate the bona fides of its supplier and its supplier's suppliers.

“Let the buyer beware” is an old maxim of contract law which reflects the fact that vendors generally have more information as to the condition of the goods and services they are supplying than does the purchaser. Nowadays the buyer has even more cause to beware lest he be burdened with the VAT liability of a fraudster somewhere else in the chain of supply. Such traders, known as “innocent traders”, can have their right to input tax revoked where they knew or “should have known” that there was fraud in the chain of supply. This is a principle which is easier stated than explained since it raises the thorny question of how does one establish whether a trader should have known of something that he did not know.

I was recently led by Paul Lasok QC before the Upper Tribunal in the U.K. in a case (*S&I Electronics v HMRC*) where the issue before the Upper Tribunal was whether the appellant was to be denied input tax deduction in respect of transactions which transpired to be connected with fraud by another party in the chain of supply. Judgment has yet to be handed down. The case has a rather long history, having already been before the First-tier Tribunal (“FTT”) on two occasions and this having been its second appeal before the Upper Tribunal (“UT”).

In the first UT decision the Tribunal clarified that the relevant test is that it must be proven (by the revenue authorities) that the trader should have known that fraud was the only reasonable explanation for the transactions in which he was involved (*S&I Electronics v HMRC* [2012] STC 1620).

The case is noteworthy for its relatively unusual facts since the FTT found that the appellant did not in fact know that its transactions were connected with fraud. Accordingly, the issue before the UT was, in essence, in what circumstances can it be said that a trader who did not in fact know that its transactions were in any way connected with fraud ought to have known that fraud was the only reasonable explanation

for those transactions. The FTT pointed to certain characteristics of the trades that it said would have led a trader to believe that the transactions were connected with fraud but the taxpayer, who has some twenty years’ experience in the industry, maintains that the same characteristics are perfectly consistent with normal trading behaviour.

The purpose of this note is not to engage in a detailed analysis of this particular case (judgment in which is not expected for some time) but rather to raise the question of what level of diligence or awareness is to be expected of honest and tax compliant businesses.

In *Mahagében kft v. Nemzeti Adó- és Vámhivatal Dél-dunántúli Regionális Adó Főigazgatósága* (Case C-80/11), the Court of Justice held that when there are indications pointing to an infringement or fraud, a reasonable trader could, depending on the circumstances of the case, be obliged to make enquiries about another trader from whom he intends to purchase goods or services in order to ascertain the latter’s trustworthiness. It would appear that these obligations are limited to enquiries from the trader’s immediate supplier though this could not be said, at this point in time, to be settled law. However the court stressed that the tax authority cannot, as a general rule, require the trader to carry out enquiries which are, in principle, the authority’s responsibility.

There is a school of thought that the limitations contained in cases such as *Mahagében* merely preclude the imposition of strict liability on taxpayers for failing to have carried out these enquiries but, if that is correct, there is a largely unresolved issue of the steps which an honest and responsible trader is required to take in order to protect itself against the possibility of fraud in the chain of supply.

As Paul Lasok QC put it at the hearing, both the taxpayer and the revenue authority are innocent victims of a fraud perpetrated by a third party; the question is

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which of these two innocent parties should bear the financial cost of the fraudsters' default.

In *S&I*, there was complete disagreement between the appellant and HMRC as to what inferences the taxpayer should have drawn from the information in its possession, what, if any, additional steps it should have taken to investigate the fraud and, indeed, whether the steps proposed by the First-tier Tribunal would have actually revealed the fraud in question.

Some member states are taking legislative steps to address these issues and, for instance, in Ireland, the Finance Act 2014 put the *Kittel* doctrine on a statutory basis but, surprisingly, limits an innocent trader's liability to circumstances in which the innocent trader knew of the fraud or was "reckless as to whether or not" he was involved in fraud. The "reckless" requirement appears to be a significantly less onerous obliga-

tion on innocent traders than the European Court's formulation as to whether the innocent trader "should have known" of his involvement in fraud.

Despite the implementation of reverse charge measures to try to reduce the impact of fraud in certain high-risk industries, it is inevitable that fraud will continue and, it appears, that legitimate businesses need to carry out the necessary due diligence in order to ensure that they are not left footing the bill for someone else's fraud. Unfortunately, it is impossible to provide any guidance as to what measures such businesses should take and how much is enough, but it is hoped that the evolving case law in this area will shortly bring some much needed clarity to bear.

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