# TC01799

**Appeal number: MAN/2007/1135**

*VAT - MTIC fraud – contra trading – fraud established both in dirty chain leading up to contra trader and also by contra trader – insufficient evidence to show that Appellant knew of either fraud, but held that it should have known – appeal dismissed*

**FIRST-TIER TRIBUNAL**

**TAX**

**SPEARMINT BLUE LIMITED** **Appellant**

**-and-**

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

**TRIBUNAL**: **KEVIN POOLE (TRIBUNAL JUDGE)**
**ALBAN HOLDEN**

**Sitting in public in Manchester on 21 February to 2 March 2011 with subsequent written submissions**

**Alexander Martyn Chester, Director for the Appellant**

**Vinesh Mandalia of counsel instructed by Howes Percival for the Respondents**

DECISION

## Introduction

1. This is an MTIC appeal. It arises from the refusal of the Respondents ("HMRC", which will be used in this decision to refer also to Her Majesty's Customs & Excise, the predecessor body to the Respondents) to repay the sum of £1,012,011.18 claimed by the Appellant ("SB") as input VAT incurred by it in four purchases of iPods and four purchases of Satellite Navigation units from a UK supplier during its three month VAT accounting period ended on 31 July 2006. The goods in question were sold on by SB to a purchaser in Portugal in a sale which was zero rated for VAT purposes.

2. HMRC claim to be entitled to refuse the repayment because they say SB's purchases giving rise to the relevant input VAT were connected to the fraudulent evasion of VAT and SB either knew or should have known of that fact.

3. In relation to each purchase, the connection is alleged to be either with or through what HMRC describe as a "contra trader".

## The Evidence

4. We were supplied with a large amount of documentary evidence, mostly in the form of witness statements and exhibits from various HMRC witnesses. We also heard oral testimony from Alexander Martyn Chester ("Mr Chester"), the sole current director of SB, and the following HMRC officers:

(1) Michael McBrine (in relation to the alleged defaulting trader DTM Provisions Limited)

(2) Sandeep Pabari (in relation to the alleged defaulting trader Wood Works (Sheffield) Limited)

(3) Graham Taylor (in relation to the alleged contra-trader 4A Developments Limited)

(4) Nigel Humphries (in relation to the alleged "cell" of contra-traders involving 4A Developments Limited)

(5) Lesley Camm (in relation to the First Curaçao International Bank ("FCIB") evidence)

(6) Lynne Casey (formerly Lynne Cullen) (HMRC control officer for SB in late 2003)

(7) Christina Quinn (control officer for SB from January 2004 to January 2005)

(8) Jane Carr (officer in charge of the extended verification of SB's VAT return for the VAT accounting period ended 31 July 2006)

(9) Roderick Stone (in relation to MTIC generally).

5. Much of the documentary material included in our bundles was poorly organised and identified. A significant part of the evidence contained in it had to be abandoned by the Respondents when they were unable to make its meaning clear to the Tribunal at the hearing. Much of it was simply not referred to at the hearing, the Tribunal was left to read it and ascertain its significance after the event. Any questions arising from that process have necessarily been left unanswered. Arrangements for the transcription of the proceedings were cancelled late in the day. As a result, it has taken the Tribunal much longer than it would have wished to produce its decision.

**The Law**

*General law on loss of the right to deduction of input tax*

6. The leading authority in this area of law is the decision of the ECJ in the joined cases of *Axel Kittel v Belgium* and *Belgium v Recolta Recycling* C-439/04 and C-440/04 [2006] ECR 1 – 6161. The ECJ ruled (at [59]) that the right to deduct input tax may be refused if:

> "it is ascertained, having regard to objective factors, that the taxable person knew or should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of VAT"

7. In the Court of Appeal judgment in the joined cases of *Mobilx v HMRC; HMRC v Blue Sphere Global Limited;* and *Calltell Telecom Limited v HMRC* [2010] EWCA 517 at [49] it was made clear that this refusal of the right to deduct does not depend on any specific UK legislation:

> "It is the obligation of domestic courts to interpret the VATA 1994 in the light of the wording and purpose of the Sixth Directive as understood by the ECJ (*Marleasing SA* 1990 ECR 1-4135 [1992] 1 CMLR 305) (see, for a full discussion of this obligation, the judgment of Arden LJ in *Revenue and Customs Commissioners v IDT Card Services Ireland Limited* [2006] EWCA Civ 29 [2006] STC 1252, §§ 69-83). Arden LJ acknowledges, as the ECJ has itself recognised, that the application of the Marleasing principle may result in the imposition of a civil liability where such a liability would not otherwise have been imposed under domestic law (see *IDT* § 111). The denial of the right to deduct in this case stems from principles which apply throughout the Community in respect of what is said to be reliance on Community law for fraudulent ends. It can be no objection to that approach to Community law that in purely domestic circumstances a trader might not be regarded as an accessory to fraud. In a sense, the dichotomy between domestic and Community law, in the circumstances of these

> appeals, is false. In relation to the right to deduct input tax, Community and domestic law are one and the same."

8. The substance of the *Axel Kittel* test is generally broken down into its constituent parts in order to apply it, and we find it helpful to do so. For the denial of a right to deduction of input VAT to be justified, each of the following elements must be present (having regard to "objective factors"):

> (1) A fraudulent evasion of VAT must be shown to have taken place ("the fraud element"),
>
> (2) A connection between that fraudulent evasion and the trader's purchase must be established ("the connection element"), and
>
> (3) It must be shown that the trader knew or should have known that by its purchase it was participating in a transaction which was connected with fraudulent evasion of VAT ("the knowledge element").

The correct formulation of the knowledge element has attracted much discussion and argument in earlier cases, but in the leading case of *Mobilx* at [56] the Court of Appeal has effectively approved the above formulation of it. It is clear that the knowledge element must be assessed by reference to the trader's state of knowledge at the time of its purchase.

9. In seeking to establish that SB had (or should have had) actual knowledge of the fraud, HMRC do not have to establish that it knew (or should have known) the precise details of the particular fraud. As Briggs J said in *Megtian Limited v HMRC* [2010] EWHC 18 (Ch):

> "[37] In my judgment, there are likely to be many cases in which a participant in a sophisticated fraud is shown to have actual or blind-eye knowledge that the transaction in which he is participating is connected with that fraud, without knowing, for example, whether his chain is a clean or dirty chain, whether contra-trading is necessarily involved at all, or whether the fraud has at its heart merely a dishonest intention to abscond without paying tax, or that intention plus one or more multifarious means of achieving a cover-up while the absconding takes place.
>
> [38] Similarly, I consider that there are likely to be many cases in which facts about the transaction known to the broker are sufficient to enable it to be said that the broker ought to have known that his transaction was connected with a tax fraud, without it having to be, or even being possible for it to be, demonstrated precisely which aspects of a sophisticated multifaceted fraud he would have discovered, had he made reasonable inquiries. In my judgment, sophisticated frauds in the real world are not invariably susceptible, as a matter of law, to being carved up into self-contained boxes even though, on the facts of particular cases, including *Livewire*, that may be an appropriate basis for analysis."

10. Or, as Moses LJ said at [59] in *Mobilx*:

> "If a trader should have known that the only reasonable explanation for the transaction in which he was involved was that it was connected with fraud and if it turns out that the transaction was connected with fraudulent evasion of VAT then he should have known of that fact."

11. For HMRC to establish the knowledge element without proving actual knowledge of the fraud on SB's part, it is not sufficient for them to show that SB should have appreciated there was a risk, or even a likelihood, that its purchases were connected with VAT fraud; they must establish that it should have known that the only reasonable explanation for those purchases was that they were connected with VAT fraud:

> "The true principle to be derived from *Kittel* does not extend to circumstances in which a taxable person should have known that by his purchase it was more likely than not that his transaction was connected with fraudulent evasion. But a trader may be regarded as a participant where he should have known that the only reasonable explanation for the circumstances in which his purchase took place was that it was a transaction connected with such fraudulent evasion." *[per Moses LJ in Mobilx at [60]]*

12. HMRC accepted that the burden of proof in relation to all three elements falls on them, and it is clear that the relevant standard of proof is the normal civil standard – the balance of probabilities.

13. The application of the *Axel Kittel* test in straightforward MTIC cases has been considered a number of times and the authorities give a fair amount of guidance on it. However where contra-trading is involved (as is allegedly the case in this appeal) its application is less straightforward and the guidance in the authorities is less clear.

*What is contra trading?*

14. The essence of the concept of contra trading (which is HMRC's own coinage) is that it comprises an extra step inserted into what might be called a "classic VAT fraud" in order to conceal that fraud and in order to make it harder for HMRC to recover the lost VAT if and when they do detect it.

15. A classic VAT fraud for these purposes arises when a UK trader acquires goods from another EU country, effectively free of VAT. He then supplies them to another UK trader, charging VAT. He then disappears with that VAT without paying it over to HMRC. That is where the actual fraud is perpetrated. The goods are then supplied to another overseas customer without having to charge VAT (but reclaiming the VAT paid to the missing trader as input tax under the normal rules), either directly by the first purchaser from the missing trader or (more usually, in the interests of concealment) after a chain of supplies through other UK traders (all of whom will charge output VAT and suffer input VAT under the normal rules, usually each generating a very small profit and corresponding net output VAT liability). Each of the UK traders will ensure that he receives the VAT on his onward sale in order to pay the VAT due to his own supplier. At some point, however, the goods must be

sold overseas in order to generate the VAT repayment claim from HMRC which repays to the last UK trader in the chain the VAT which he has paid to his supplier. In practice that last trader in the chain is the party mainly at risk in the whole structure, as HMRC can withhold his VAT repayment until they are satisfied that it is untainted by fraud.

16. As HMRC became more careful about investigating chains of transactions before releasing VAT repayments, the fraudsters developed the concept of contra trading as a counter measure. A trader with a potentially large (and therefore suspect and vulnerable) repayment claim ("Trader 1") would enter into a separate transaction or series of transactions designed to substantially reduce or eliminate that repayment claim. The means of doing so would be to acquire goods from overseas (to an appropriate value) in a VAT free purchase and then generate an output VAT liability by selling them on to a UK trader ("Trader 2") who would then sell the goods overseas again in a zero rated sale. The repayment claim of Trader 1 (which could be traced back directly to fraudulent VAT defaults by traders who had supplied goods to him, directly or through other UK traders) would be cancelled out by his output tax liability to Trader 2, so HMRC would be less likely to investigate Trader 1's dealings in detail and would not have the leverage of an outstanding VAT repayment claim while doing so; and if they investigated Trader 2's large VAT repayment claim, they would find no fraudulent VAT default in the chain of UK purchases and sales of the goods leading up to Trader 2.

17. The chain of transactions leading from Trader 1 to Trader 2 (there may be other UK traders between them, all accounting properly for input and output VAT) is known by HMRC as the "clean chain". In contrast, the chain of transactions leading from the original fraudulent trader to Trader 1 (usually involving other UK traders, called "buffers" by HMRC, all accounting properly for input and output VAT) is known as the "dirty chain". The shifting of the VAT repayment claim by Trader 1 from the dirty chain to the clean chain means that effectively a "cut-out" has been inserted between the original fraud and the trader (Trader 2) which is ultimately claiming the repayment that actually crystallises the loss flowing from that fraud. Trader 2 will of course claim that it neither had nor could have had knowledge of any fraud. This gives HMRC another hurdle to overcome if they try to recover their loss by refusing to satisfy the repayment claim of Trader 2, the ultimate dispatcher/exporter.

18. From HMRC's perspective, Trader 1 has simply transferred the repayment claim to Trader 2, another participant in the overall fraud. Given the sheer volume and complexity of MTIC fraud with which HMRC have to deal, this is perhaps an understandable perspective. However, it is not necessarily correct. It is inherent in the whole system of VAT that large amounts of input VAT and output VAT will cancel each other out and this can happen perfectly innocently. HMRC are not entitled to assume that all such situations are necessarily tainted by fraud. The challenge is to distinguish between innocent transactions and those which have been purposely generated as part of a larger attempt to defraud HMRC. It is only transactions in the latter circumstances that can truly be regarded as contra trading.

*How should the Kittel test be applied to a case of alleged contra-trading?*

19. As was made clear by Moses LJ at [58] in *Mobilx*, "the test in *Kittell* is simple and should not be over-refined." There is no separate formulation of that test that applies in contra-trading cases.

20. It must be acknowledged however that there are some obvious complications in applying the test in contra-trading cases, especially where it is found that an appellant did not have actual knowledge of VAT fraud connected with his purchase.

21. The first potential complication is how to interpret the "connection" requirement in a case of contra-trading. It now appears to be settled however that such a connection exists (for the purposes of the *Kittell* test) between Trader 2 and both Trader 1 and the original defaulter in the chain leading up to Trader 1 (see the comments of Sir Andrew Morritt at [44] to [45] in *Blue Sphere Global v HMRC* [2009] EWHC 1150 (Ch), which were not disagreed with on appeal by the Court of Appeal).

22. The second complication is caused by the fact that there can be some uncertainty as to precisely what fraud or frauds are involved in a case of contra-trading.

23. Lewison J in *HMRC v Livewire Telecom Limited; HMRC v Olympia Technology Limited* [2009] EWHC 15 (Ch) made it clear that he considered there were two potential frauds involved. He repeated this view in *HMRC v Brayfal Limited* [2011] STC 1338 where he said (at [19]):

> "The essence of contra-trading is that transactions in the clean chain are used to mask transactions in the dirty chain. There is no fraud in the clean chain. The dirty chain is where the fraud takes place. Accordingly in order for a trader in the clean chain to know or have the means of knowledge that his transactions are connected with fraud, he must either know or have the means of knowledge that the contra-trader is a fraudster; or he must know or have the means of knowledge of the fraud in the dirty chain".

24. Where in a particular case it is established that the contra-trader has acted fraudulently in "masking" the transactions in the dirty chain, then it is clear that a connection to that fraud will suffice to deny Trader 2 his input tax, if he is shown to have the requisite degree of knowledge of that connection.

25. But it is equally clear that a trader sitting in the position of contra-trader may be doing so without himself acting fraudulently – as was found to be the case in *Livewire* and *Blue Sphere*. In such a case, there is no fraud of the contra-trader with which a connection can exist. It follows that, to deny Trader 2 his input tax in such cases, HMRC must establish that Trader 2 knew or should have known that his purchase was connected to the original fraud by the defaulting trader in the supply chain leading up to Trader 1.

26. In such a situation, further complications are likely to arise as a result of the precise order of events. It is quite possible (indeed likely) that the fraudulent default of the original trader may take place after Trader 2 has purchased from Trader 1. In that case, unless it could be shown that Trader 2 was party to an overall conspiracy which gave him actual knowledge of the impending default, how could it be said that Trader 2 should have known at the time of his purchase of the connection to the original trader's fraudulent default (which had not by then even taken place)?

27. These issues have arisen in the submissions made on behalf of SB, and we address those submissions below, after setting out our findings of fact.

*Language difficulties – the amendment or re-interpretation of the Kittel test?*

28. The written closing submissions made on behalf of SB contain a section headed "An interesting coda". As a heading, this does not suggest that what follows contains anything of major substance. In the present case, however, we do not consider it would be safe to take the heading at its word. In substance, the commentary which follows that heading raises an entirely new argument which was not put at all at the hearing.

29. The key submission contained in it is to the effect that the UK courts have developed their jurisprudence in this area on the basis of a misunderstanding of the original ECJ decision in *Kittel* (or alternatively that the ECJ has slightly amended what could be called the "*Kittel* rule" in a subsequent case).

30. The essence of the submission is that, properly interpreted, the decisions of the ECJ in *Kittel* and the subsequent case of *Criminal Proceedings against R* [2010] (Case C-285/09) ECJ mean that denial of input VAT may only be permitted in cases where the particular transaction giving rise to the VAT in question is "aimed at evading VAT". This is clearly a narrower test than the traditional view of the *Kittel* rule, where the phrase "connected with fraudulent evasion of VAT" is used. SB submits that it

> "would simply be perverse to find that, by *any* of its purchases April to July 2006, was Spearmint Blue participating in a transaction aimed at evading VAT. And, of course, no VAT was avoided by any of those purchases."

31. The reasoning underpinning this submission can be summarised as follows.

32. The language of the *Kittel* case before the ECJ was French. In the original judgment, the key phrase was "il participait à une operation impliquée dans une fraude à la TVA", and this was rendered in the English version of the judgment as "he was taking part in a transaction connected with fraudulent evasion of VAT".

33. SB seeks to persuade us that the phrase "impliquée dans" connotes a much more proximate involvement in the fraud than the English translation of that phrase, "connected with". It submits that a more accurate translation of the phrase "impliquée dans" would be "aimed at". It prays in aid the case of *R*, in which the French version

of the ECJ's judgment uses the phrase "impliquée dans" but the English version uses the phrase "aimed at". It says this is clear evidence that the ECJ has "had second thoughts about the accuracy of the way in which it rendered in English the phrase *'il participait à une operation impliquée dans une fraude à la TVA'* in *Kittel*" and the meaning "aimed at" should be preferred to the meaning "connected with".

34. The language of the *R* case was German. It was dealing with a situation in which the party to the case had clearly acted fraudulently in selling cars to Portugal without charging VAT, fraudulently arranging the invoicing so that the acquisition VAT that should have been charged in Portugal was lost. The question was whether the German authorities had the right to recover German VAT from him (on the basis that the normal VAT exemption should not apply where the sales themselves were carried out on a fraudulent basis to evade Portuguese VAT).

35. It is true that the French translation of the question put to the ECJ by the German courts contained the phrase *"il participait à une operation impliquée dans une fraude à la TVA"* and it is also true that the English translation of that question given in the English version of the ECJ judgment was "he was participating in a transaction aimed at evading VAT". However, we do not consider that this amounts, as SB claims, to an express endorsement by the ECJ of the "*aimed at*" formulation. It is merely a reflection of the fact that the *R* case involved a situation in which the taxpayer in question was indeed entering into a transaction by which he clearly "aimed" at the fraudulent evasion of VAT.

36. It is also to be noted that the ECJ, in answering the question that had been put to it, completely rephrased it, so that there was no reference to "connected with" or "aimed at" in its ruling.

37. We therefore find nothing in SB's submission on this point and reject it. If we had considered it worthy of more detailed exploration, we would certainly have requested submissions on it from HMRC before reaching a decision as it was a completely new point raised by SB in its closing submissions for the first time.

**The Facts – History of SB and 4A**

*Preliminary points*

38. The key individual in this appeal is Mr Chester. He represented SB at the hearing of the appeal and was the sole witness on its behalf. He became a director of SB on 25 June 2003, but he was instrumental in its incorporation on 21 November 2002 and clearly that incorporation was only one step in plans which Mr Chester had previously formulated.

39. Mr Chester's account of the background and history leading up to his involvement in SB was in some respects corroborated by the documentary evidence (in particular the correspondence and contemporaneous notes of meetings taken by HMRC officers); in certain areas that documentary evidence either filled out blank spots or (on occasion) contradicted Mr Chester's evidence or put it in a different light. Where there was such contradiction, we prefer the documentary evidence.

40. We found Mr Chester to be a very intelligent man of some charm. He did however have a tendency to avoid or skate over awkward questions or questions of detail and on one occasion he changed his evidence on the order in which things had happened only when it became apparent from the documentary evidence that his first version of events must be incorrect. In short, we do not consider his account of the history to be entirely reliable. We therefore approach his evidence with some caution and are more ready than we would otherwise have been to draw adverse inferences from some of the unexplained gaps in his evidence or from conflicts with the documentary evidence.

41. Although the transactions the subject of this appeal did not take place until the summer of 2006, we consider their true character can only be discerned by setting them in the context of SB's full history. Much of this history was glossed over quite quickly at the hearing, which has necessitated a detailed consideration of the documentary evidence in order to obtain the fullest possible picture.

*Mr Chester's activities leading up to SB's incorporation*

MDS Telecommunications Limited

42. Mr Chester had been involved in the telecommunications industry for some time. He was, during 2002, employed by a company called MDS Telecommunications Limited ("MDS") as national sales manager. His precise role and status are not totally clear, but crucially during that time he became involved in mobile phone trading being carried on by MDS alongside its main activities of telecommunications sales agents.

43. Mr Chester said MDS's mobile phone trading activity was started through an introduction from Darren Thomas ("Mr Thomas"), the finance director of MDS. MDS was, he said, owned by Michael Ward ("Mr Ward"), a man of extensive experience in the telecommunications industry (having previously been national sales manager for a large telecommunications company for seven years). It is not important to our decision how that trading started. What is important, however, is the nature of Mr Chester's involvement in it.

Blue Telecommunications Limited

44. MDS had an associated company, Blue Telecommunications Limited ("Blue"). Blue was a small reseller of telecommunications services. Rather than just introducing customers to telecoms providers (as MDS did), Blue actually acquired the necessary airtime (and later bandwidth) from those providers and sold them on to its own customers. This meant it kept control of the customers. MDS had bought Blue in March 2000 for £50,000, but on the basis that it would only be paid once Blue had generated profits of £100,000.

45. Mr Chester said he did not know much of the detail about MDS's mobile phone trading (which he said had been started by Mr Thomas and Mr Ward without his involvement), but he became aware that problems had been experienced because they had bought goods from a missing trader. He said he became involved with the

discussions with HMRC and through that involvement he became aware of the risks and existence of MTIC fraud. He also saw a copy of HMRC's VAT Notice 726 (concerning joint and several liability in MTIC situations) at that time.

46. HMRC records show a slightly different picture, which we accept as accurate. In particular, they show that Mr Chester called them on behalf of MDS on 30 May 2002. That call followed an earlier telephone conversation on 28 May 2002 when HMRC had contacted him as a result of discovering from a freight forwarder that MDS had bought mobile phones from a suspected VAT defaulter, with Mr Chester's name being given by the freight forwarder as their contact at MDS. He was clearly closely involved with the mobile phone deal, indeed during that conversation he gave HMRC information about what payments MDS had made in relation to the deal – which included a "third party payment" of the bulk of the purchase price to an entity other than the supplier of the phones.

47. Very shortly after this telephone conversation, on 8 June 2002, Mr Chester became a director of Blue.

48. The next event recorded in the documentary evidence before us was a note of a visit to Blue on 29 October 2002 by HMRC Officer D'Rozario. The visit was initiated by HMRC because they had realised that Blue had common directors with MDS, which had dealt with two missing traders (HMRC's term for the situation where a trader disappears without properly accounting to them for VAT which it has charged to customers) and a hijack trader (HMRC's term for the situation when a fraudulent trader illicitly uses the VAT registration details of a legitimate trader for the purposes of VAT fraud).

49. At the 29 October 2002 meeting Mr Chester, along with Mr Thomas and Mr Ward, met Officer D'Rozario. Mr Chester was identified as the managing director of Blue. The business of Blue was described as summarised above and Officer D'Rozario was left basically satisfied that Blue did not pose a current MTIC threat. No mention was made at that meeting of any intention to extend Blue's business to include mobile phone trading.

50. Clearly matters moved on rapidly after that meeting. Within a month, SB had been incorporated and had applied for VAT registration.

*SB's incorporation and VAT registration application*

51. On 21 November 2002, SB was incorporated. At this point, two new characters enter the picture. The first, Joseph Ian Henry ("Mr Henry") was to play only a small part and drops out of the picture after approximately five months. The second, Mr Robert James Morton ("Mr Morton") is central to the whole story.

52. Mr Chester described Mr Henry as a previous work colleague in two large telecommunications businesses, Thus plc and Energis. They had enjoyed working together, and according to Mr Chester, Mr Henry had "a list of 50 people he wanted to buy mobile phones from". Mr Chester got him interested in going into business together and it was agreed he would invest £5,000 for a 5% share in SB from the

outset. His role was to be largely administrative – record keeping, paperwork and so on. His involvement turned out to be short-lived.

53. The other new character was Mr Morton. Mr Chester explained that he had met Mr Morton through the Church of Jesus Christ of Latter-day Saints in 1997; Mr Morton was engaged to a childhood friend of Mr Chester's. He said that Mr Morton had approached him, interested in what he was doing (though he did not make clear how Mr Morton had found out about his plans). He trusted Mr Morton, who told him he had been a police officer in the West Midlands police (including, Mr Chester thought, the special branch) for some twelve years, and who taught at Sunday School and had many ties to their local community. In fact, it transpires that Mr Morton has a criminal record – including a caution for shoplifting in January 2002 and a conviction in May 2002 for theft from his employer.

54. Mr Morton became a director and company secretary of SB immediately following its incorporation by formation agents on 21 November 2002. He was described to the Registrar of Companies as "Business Development Manager". Mr Henry was appointed as the other director.

55. Mr Chester, although he was one of the driving forces (if not the main driving force) behind SB, did not become a director at that stage.

56. SB applied to register for VAT very quickly. Mr Henry signed the application on 21 November 2002, the day SB was incorporated. In that form (which was actually submitted to HMRC by SB's accountants, Murphy Salisbury of Stratford upon Avon, with a letter dated 25 November 2002), the principal place of business of SB was given as the address of Murphy Salisbury and the intended business activities were described as "General Trading". The words "Buys excess stock i.e. computers" were later added in reply to this question on the form, though we accept this was done by HMRC by way of amendment to the form after discussions with SB to clarify its intended business, and after being told on 13 December 2002 that SB had bought £150,000 worth of computers in early December 2002.

57. In the form, SB indicated that it did not expect to receive regular repayments of VAT, it gave an estimated value of £150,000 for its taxable supplies over the following 12 months and it stated that it was not likely to buy from or sell to other EC member states over the next 12 months. It also said that it had made its first taxable supplies on 21 November 2002 (though nothing further was heard of those supplies).

58. When asked about the apparent inconsistency between these replies and the intended business of SB as he outlined it, Mr Chester believed Mr Henry must have misunderstood the form, and made mistakes in filling it out. We do not accept this. We consider that the form was very carefully filled out in a way which was intended, so far as possible, to avoid ringing any alarm bells at HMRC, whilst being vague enough to deflect any later allegations that it was intended deliberately to mislead them. We find that Mr Henry wanted to press on with the mobile phone trading and he was trying his best to obtain the necessary VAT registration for that purpose.

59. In the VAT registration application, Mr Henry mentioned his existing personal VAT registration under the trading name "Hicomms". Officer Quinn's statement included reference to this. She said that Mr Henry had been registered in his own right for VAT from 16 September 2002 until 1 April 2005, when he was compulsorily deregistered as a missing trader. He only ever submitted one VAT return, for his first accounting period. In the absence of any returns, HMRC issued central estimated assessments but their attempts to trace Mr Henry were unsuccessful and when they eventually cancelled his VAT registration they wrote off the small outstanding amount of those assessments.

*Events following SB's VAT registration application*

60. Following the submission of SB's VAT registration application, Officer Helen Harris of HMRC called at Murphy Salisbury (the supposed principal place of business) on 21 January 2003 for a pre-registration check visit. She made the point that it would not be acceptable to HMRC for SB's accountants' office to be regarded as SB's principal place of business. She was told SB was currently looking for business premises in the Manchester area but that in the meantime "Michael Ward the major shareholder may be willing to become company secretary and the application could be made from his home address" in Stratford upon Avon. Thus it is clear that SB's accountants thought Mr Ward was well aware of SB by January 2003, and expected to be involved in it. Mr Ward, we must remember, was the owner of MDS (Mr Chester's then employer).

61. Officer Harris returned to her office and after further consideration rang Murphy Salisbury to inform them that Mr Ward's private address would not be acceptable as a principal place of business for SB. Murphy Salisbury had already checked with SB and said that "things had changed and that Alexander Martyn Chester had agreed to become the company secretary and the application would be put forward with his address". They wrote to HMRC that same day, confirming that Mr Chester had been appointed as company secretary of SB (which he had not) and giving details of his home address, which was to be used as the business address.

62. This was followed up by Mr Chester himself, who called his local VAT office in Chester that same day. He introduced himself as a director of SB (which he was not) and gave his mobile phone number so that someone from HMRC could contact him about a pre-registration meeting.

63. Included in the documents before us was a copy of a report by Officer Colin Wardle of his pre-registration visit to Mr Chester at his home just over a week later, on 29 January 2003. Mr Chester apparently identified himself as the company secretary of SB – which was not correct (it was apparently intended that he should take up that post, but never actually did so). As noted by Officer Wardle, Mr Chester identified SB's "main business activity" as:

> "General trading company – buying & selling any goods on which a profit can be made, intending to be wholesale only at this stage.

> Trader has stated that he intends to enter the mobile phone market (wholesaling) immediately"

64. At that meeting, Mr Chester's involvement in MDS and Blue and also Mr Henry's business Hicomms were noted. It was recorded that MDS's last VAT return (for the period ended 30 November 2002) was outstanding, and HMRC had issued it with a central assessment of its estimated liability.

65. Mr Chester also apparently stated at the 29 January 2003 meeting that approximately £45,000 of share capital had been raised by way of "start up capital", the company secretary (presumably referring to himself) and the directors (presumably referring to Mr Morton and Mr Henry) all being shareholders. He also said SB was using the offices of Blue, described as its "associated company". He said he was about to become a director of Blue (though he had in fact been one since June 2002). Officer Wardle's notes go on:

> "Trader is trying to set up as a phone buffer – but needs the VAT number before he can obtain any goods.
>
> Trader has already been in contact with Sabbatier, France, as his main supplier of Nokia mobile phones
>
> - Sabbatier are willing to supply trader but need to exchange details (including VAT certificates) before they are willing to trade.
>
> Trader was introduced to Sabbatier by Advantage Telecommunications, who will invoice Sabbatier for a commission on the deals. Advantage will not be invoicing or supplying Spearmint Blue in any way.
>
> ...
>
> Trader states sales will be mainly UK based at the start of the business, but intends to source other customers both in the EC and outside the EC ie Africa"

66. Mr Chester largely accepted what was written in this note, but initially maintained that SB was not intending to deal in mobile phones, though he "may have talked of the possibility of acquiring phones from France". He maintains that he did not say SB was going to be a "buffer" (HMRC jargon for a UK to UK supplier of domestically purchased mobile phones).

67. After further consideration of the evidence, Mr Chester said he must have "mixed up" his dates about the timing of SB's decision not to deal in mobile phones. He had now reached the conclusion that the intention to deal in mobile phones on its own account must have been part of SB's "range of possibilities" when it was first incorporated. That intention, he said, only changed when outside investors came in, who raised it as an issue. That was later in 2003 (see below). In response to their concerns he said, SB decided it would not deal in mobile phones.

68. We see no reason why the note of the meeting on 29 January 2003 should be incorrect and find that it is an accurate reflection of what was said at that meeting, subject to the comment that Officer Wardle's use of the word "buffer" was probably his own shorthand for what was discussed rather than a term that was actually used at the meeting.

69. We find that Mr Chester was clearly holding himself out by 29 January 2003 as authorised to speak on behalf of SB, and in attempting to persuade HMRC to issue a VAT registration to SB he did tell them it was proposing to acquire mobile phones from a supplier in France with a view to the wholesale trading of those phones to UK customers. We also find that he made no mention at the meeting of the "export finance" business model (which loomed so large in his evidence at the hearing). See [107] for an explanation of the "export finance" business model. Mr Chester's explanation of this omission is that until SB had sufficient funding, it would not be in a position to carry out its intended business. Nonetheless, we would have expected him to have explained its intended business (as described at the hearing) to HMRC and he did not.

70. SB was eventually registered for VAT with effect from 20 March 2003, though we were not provided with details as to exactly when the registration was completed.

*Further events at Blue*

71. After the pre-registration visit by Officer Wardle to Mr Chester at SB on 29 January 2003 (and entirely independently of that visit), officer D'Rozario followed up his earlier visit of October 2002 (see [49]) to Mr Chester wearing his "Blue" hat. This activity was prompted as a result of the known connection between Blue and MDS, and the fact that MDS (both Mr Thomas the finance director and its accountants) were becoming difficult to contact having done a large number of mobile phone deals in its VAT accounting period ended 31 August 2002. Those deals included the receipt of goods from missing traders and hijacked VAT registrations and the making of third party payments (ie payments to parties other than its actual suppliers). Finally, another known mobile phone trader had applied to HMRC for confirmation of Blue's VAT registration, presumably as a preliminary step before dealing in mobile phones with it.

72. Officer D'Rozario called at Blue's premises in Chester on 13 February 2003. He was informed by a secretary there that Mr Chester was still running the business. He left a letter following up outstanding points from the meeting in October 2002. In reply, Mr Chester telephoned him later that day. He was "very very confused" because he thought all the outstanding points from the October meeting had been resolved by Blue's accountant. He said he would follow this up with Mr Thomas and the accountant.

73. During the conversation, Officer D'Rozario asked about the plans for the business and Mr Chester said Blue were now considering trading in mobile phones. Primarily this was because MDS had not traded since August 2002 and Blue wanted

to try it as they thought they could make "decent money" from it. He referred to contacts with Sabatier ("a large distributor of mobile phones based in Paris"), through which Blue hoped to enter the market. Blue had already given Sabatier a "forecast" of an order for 5,500 Nokia 7250 phones to a value of £1.3 million, hoping to make a profit of £55,000 to £110,000 from selling on the phones. The purchase price was to be funded by "prepayments from customers". He hoped to sell about 500 of the phones to small independent phone retailers in the UK, with the remaining 5,000 being sold to about 7 larger UK customers (which he had already cleared and verified).

74. Following this conversation, Officer D'Rozario arranged for Blue to be added to the national log of known "Buffers and Brokers" (HMRC shorthand for traders in mobile phones) for future monitoring.

75. During the conversation, Officer D'Rozario observed that Mr Chester was still not showing as a director of Blue on the Companies House website. Mr Chester said he had only recently completed and submitted the relevant papers to Companies House. This was nearly seven months after his appointment.

76. We find that Mr Chester has played down the true extent of his role at MDS and Blue in the mobile phone trading activities of those companies and this affects his credibility as a witness in our eyes. He did not mention in his evidence that he had been a director of Blue (still less its managing director). Public records confirm that he was a director of Blue from 8 June 2002 until 11 June 2003.

*Overlap between activities of SB and Blue*

77. It is notable that Mr Chester, in his supposed capacity as company secretary of SB, was telling HMRC on 29 January 2003 of its intention to purchase phones from Sabatier, and some two weeks later was telling a different officer of HMRC the same thing, this time in his capacity as managing director of Blue.

78. This is clearly odd. Mr Chester did not address the issue at the hearing, as he was not specifically asked about it. All we can infer is that he had simply not yet decided at the time which company he would put the trading through. At that stage, if Mr Ward and Mr Thomas were (as we find was the case) both aware of SB and expecting to be involved in it, one can understand why the distinction between the two companies might be a little blurred. Put simply, it did not matter greatly to Mr Chester which company he used to trade with Sabatier, as his employers were involved in both companies with him. If a VAT registration could be obtained for SB, then it would probably be preferable to operate through that company as it would not become mixed up with Blue's other business; but if it could not, then it would be better to trade through Blue than not at all.

79. Another odd feature of the overlap between Blue and SB is that Mr Chester was a director of Blue but had made a conscious decision <u>not</u> to become a director of SB. When asked why this was, he said there had been a "time of awkwardness" between him and Mr Ward about him leaving MDS and Blue. He was seeking to give

us the impression that by refraining from becoming a director in SB, he was trying to conceal his involvement in it from Mr Ward and Mr Thomas (whom he referred to as "my partners", which indicates something a little more than a mere employment relationship). But it is apparent from the documents that Mr Ward and Mr Thomas were heavily involved in SB from its very early stages.

80. Mr Ward was described by SB's accountants as its "main shareholder" in January 2003 (see [60] above).

81. Also included in the evidence before us were two letters from Mr Thomas to HMRC. The first was dated 17 April 2003 and in it Mr Thomas (describing himself as "Company Director" on a letter purporting to be sent on behalf of SB, though he never held that office) requested, without giving any reasons, "that the quarterly returns for the above registration number be changed to monthly returns". We find that the only realistic reason for wanting this change is because Mr Thomas was expecting SB to be a "repayment trader". In the second, dated 11 June 2003, Mr Thomas confirmed to HMRC (this time writing in a personal capacity) that he was not a director of SB, but explained the background:

> "Having had discussions with the principle shareholder it was suggested and agreed that I join the board of directors in an operational role. Since then the decision has been made by me not to accept the position..."

82. From these letters, it appears that Mr Thomas was expecting to take an active part in SB's business right up until June 2003 (indeed, he applied in April 2003 for its VAT accounting to be changed to monthly). Therefore, whatever the reason for Mr Chester not being a director of SB until June 2003, it was clearly not because he was trying to conceal his involvement in SB from Mr Thomas and Mr Ward.

83. It is notable that the date of Mr Thomas's later letter to HMRC (11 June 2003) was the same as the date of Mr Chester's resignation as a director of Blue. We infer that Mr Chester was originally working to set up SB in conjunction with MDS and Blue (but at some apparent distance from them) but on 11 June 2003 some final breach with MDS/Blue took place and Mr Chester was thereafter definitively running the business in partnership with Mr Morton alone, having been up to then at least proposing (if not actually intending) to run it also in conjunction with his colleagues from MDS and Blue.

84. We can only infer that Mr Chester initially avoided any obvious connection with SB on incorporation in the hope that its VAT registration application would be processed without his connection with it becoming apparent to HMRC. It was only when it became clear this was not going to happen that he felt nothing would be lost by making his involvement as the guiding force behind SB known to HMRC.

*Mr Chester's explanation of the background to setting up SB*

85. Mr Chester, in his witness statement, set out his version of the background to his setting up SB:

"2. In 2002-2003 Alexander Chester one of the appellants directors worked for a telecommunications company MDS Telecommunications Ltd. His job for MDS was to manage and direct the objectives of a national sales force responsible for the sale of voice and data services through fixed line network technology. Having worked in the industry for some years Alexander selected and employed a team to secure revenue for MDS in his full time capacity of National Sales Manager. During his time with MDS the company started without the involvement of Mr Chester to trade in mobile phones buying and selling within the United Kingdom. The company enjoyed through these activities a significant increase of revenue enabling the support of its sister company Blue Telecommunications. Blue Telecommunications was a switchless resellers of voice and data services with approx 250 customers struggling to operate in a competitive market place. At this time Alexander when questioned brought to the attention of HMCE officers that the company, Blue Telecommunications intended to start buying and selling mobile telephones and that it hoped to give the company the revenue it required to assist in its objectives. Mr Chester explained that this activity was handled by his partners Darren Thomas and Michael Ward while he focused his efforts on building the voice and data service side of the business. Through visits and communication with HMCE Mr Chester learned that the company purchased goods from a missing trader and became aware of the risks and existence of MTIC fraud.

3. At this time Mr Chester understood that the industry was facing a national shut down as HMCE clamped down on fraudulent activity. Exporters would not export as they were left in a vulnerable position claiming back VAT from export sales that may have been involved in MTIC fraud without their knowledge. While this caused a shut down on trade it also provided opportunity.

4. Mr Chester saw that there was an obvious need for a strong, well funded, process driven exporter to take advantage of the good business that existed among the occasion fraudulent activity. If an exporter could position itself through due diligence and close communication with HMCE staying away from troubled areas highlighted by HMCE and being selective with its trading partners there was a great need and business opportunity. Mr Chester approached the owners of MDS and Blue Telecommunications suggesting this business idea and its benefits. While at first Michael Ward showed interest in the venture he decided that he wished to continue only with Blue Telecommunications and MDS. The owners of MDS and Blue did not want to look towards that model and Mr Chester decided to go alone. A long time friend Robert Morton through an association in the Church of Jesus Christ of Latter-day Saints (LDS Church) approached Mr Chester interested in what he was doing and finally joined with Mr Chester working and owning together Spearmint Blue Limited. Mr Morton was a Police Office for West Midlands Police and had a particular eye for detail while possessing experience in law enforcement."

86. There are clearly inconsistencies between this account and that which emerges from the documentary evidence. We find that Mr Chester was closely involved in the mobile phone trading of MDS on at least one occasion in May 2002 (see [46]); and his new venture was initially focused on mobile phone trading, only changing over to the "export finance" structure referred to at the start of his paragraph 4 when the mobile phone trading opportunities were severely restricted by the April 2003 Budget changes. By being vague about the chronology and blurring or glossing over some of the facts, Mr Chester has conveyed a general impression of events which is significantly different from what we find actually happened, and we found this to be a characteristic of much of his oral testimony at the hearing as well.

*Limited business of SB in early stages following its VAT registration*

87. SB was finally registered for VAT with effect from 20 March 2003. As mentioned above, Mr Thomas quickly applied on its behalf to be placed on monthly VAT returns (clearly in anticipation of SB making VAT repayment claims). However, in cross examination Mr Chester agreed that SB's VAT returns to the end of April, May and June 2003 were all nil returns. It was not clear what had happened to the £150,000 of computers that HMRC were told in December 2003 had been bought by SB. Nor did the proposed purchase of mobile phones from Sabatier in France materialise; we were not informed what had become of that relationship. We can only infer that Sabatier lost interest because of SB's lack of a VAT registration until late March 2003.

88. Thus it is clear that SB did not actually complete any sales or purchases during April, May or June 2003. It seems likely that this period was largely taken up with reconfiguring SB's intended business following the April 2003 "Joint and Several Liability" Budget changes and in attempting to arrange finance for SB.

*Funding of SB*

89. There were various mentions made about SB's funding, both in the documents and in oral testimony. The picture that emerges is not clear. This is illustrated by the following summary of the evidence before us in relation to various sources of funding.

<u>Funding from directors and secretary</u>

90. As mentioned above at [65], Mr Chester had told Officer Wardle at the meeting on 29 January 2003 that approximately £45,000 of finance had been raised from the company secretary (ie himself) and the other directors (ie Mr Morton and Mr Henry). He gave oral testimony at the hearing that Mr Henry had contributed £5,000 for a 5% stake in the business. He did not clarify what had happened in relation to the other £40,000 of investment that he had mentioned to Officer Wardle.

<u>Funding from Roger Payne</u>

91. In his oral evidence before us, Mr Chester said that an initial investment of £44,000 all came from one Roger Payne ("Mr Payne"), a Birmingham businessman

who was a friend of Mr Morton. The original intention was that Mr Payne would own about 15% of SB.

92. Companies House records show that Mr Payne was appointed a director of SB only on 27 June 2003 (two days after Mr Chester became a director). He resigned as a director on 12 February 2004 when he apparently changed his mind about his involvement. At a meeting with Officer Quinn in March 2004, it was noted that SB's bank account showed the receipt of £43,980 from a Mr Roger Payne in June 2003 (at about the same time as Mr Payne became a director). This was clearly four or five months after the meeting in which Mr Chester had told Officer Wardle that the initial funding had come from the company secretary and directors. It clearly cannot therefore be correct that Mr Payne's investment was the "initial" investment as claimed by Mr Chester.

Funding from Property Gains Management Limited ("PGM")

93. It is clear that most of SB's financing has come from this source. It was first mentioned by Mr Chester in a meeting with Officer Quinn on 11 March 2004. At that stage he said, according to her note of the meeting:

> "Re shareholders trader advised me he had replied to an advert in an "in flight mag" for someone looking for investors. He maintains he had approached the company but couldn't remember it's name they put him in touch with potential investors. These people came to talk to him at "Blue Telecom" around Mar '03. Same people called at his prev address in Malpas in June/Jul '03 and offered to invest to £350k, he could not show me contracts or any meaningful paperwork.
>
> Business bank a/c shows substantial deposits.
>
> Jul '03 £55.5K from PGM Ltd (thought to be Property Gains Management Ltd director Paul Waghorn – name given to me, individual lives in Spain Arroyo de la Miel, Benalmedena Malaga.
>
> June '03 £43,980 depost made by Roger Lawford Payne – Director
>
> 27/8/03 depost £90K from PGM Ltd
>
> 8/10/03 depost £100K PGM Ltd
>
> Further investments (min £40K) made by a Mr Deep Singh, *[Milton Keynes address]*"
>
> (Mr Singh was identified to us by Mr Chester as the UK representative or agent of PGM.)

94. Mr Chester confirmed at the hearing that the bulk of SB's funding came through a relationship with a Mr Paul Waghorn ("Mr Waghorn") of PGM. In doing so, he provided a little more substance to the picture which had emerged from the documentary evidence before us.

95. Mr Chester said he had initially approached an individual called Michael Smallwood, an expatriate living in southern Spain. He had contacted him because he had seen an advertisement placed by him or his company in an in-flight magazine, seeking investors looking for advice on investing their money. Mr Chester must have reasoned that if Mr Smallwood was advising potential investors, he may have access to finance for investment in SB. Mr Smallwood invited Mr Chester to visit him in southern Spain but when he got there he told him that he had recently lost his money through some involvement with a horse racing trader from north eastern England, so he had no cash to invest. He suggested Mr Chester get in touch with Mr Waghorn, who lived in Torremolinos in southern Spain. Mr Waghorn, it appeared, came from Southend, had originally worked in Chase Manhattan Bank in New York and now had his own business providing investment advice to wealthy individuals.

96. Mr Waghorn came to meet Mr Chester at his office in Cheshire. He explained that most of PGM's investments were in property. However he made an initial investment of £20,000 "at the start of 2003", and PGM's investment built from there (though this first £20,000 does not appear to have been mentioned by Mr Chester in his meeting with Officer Quinn on 11 March 2004, which is in itself suspicious). Mr Chester said that there was a contract between SB and PGM governing the loan of the cash; it provided for an interest rate of 36% per annum, and repayment on 90 days' notice. No copy of that contract was produced in evidence. Mr Chester offered at the hearing to produce a copy (in the face of objections from Mr Mandalia as to the lateness of this offer), but no copy was actually proffered and there was no formal application for permission to admit it as late evidence.

97. By "the end of the first quarter of 2003", Mr Chester said PGM had invested £150,000 in SB (from the bank statement entries given above, the figure of £145,500 seems to have been reached on 27 August 2003), and during the first year of the relationship with PGM, it had invested a total of about £300,000 to £350,000 in SB. Mr Chester said that each time a further investment was made, the original contract was amended.

98. It was apparently a term of the investment that the money invested would not be used to trade in "specified goods" as identified in the April 2003 budget changes (i.e. telephones, computers and associated parts, accessories and software).

99. By late 2006, the amount lent by PGM and investors through it totalled some £3.5 million, he said.

100. PGM appeared on a list of unauthorised firms published by the Financial Services Authority in February 2007. Potential investors in it were warned to exercise caution, as they would "not benefit from the UK compensation and complaint schemes if anything goes wrong." PGM still appears on such a list published by the FSA, though it was dissolved on 11 July 2006.

Summary of position on funding of SB

101. The initial source of finance for SB therefore remains unclear. It is unfortunate that this is the case, as it leaves a general air of uncertainty lingering around the financial foundations of SB and its business.

102. It is clear that the bulk of SB's funding throughout its lifetime has come from PGM, either directly or indirectly by the introduction of other investors. The first known funding came from PGM in July 2003, though there were unsubstantiated assertions of earlier funding from it in smaller amounts.

103. Mr Chester clearly considered SB's activities were going to be immensely profitable, if he was prepared to agree to pay an interest rate of 36% per year on loans. He obviously also considered that those profits were going to be generated quickly and without long term commitment of funds, bearing in mind he agreed to a 90 day repayment period.

*SB's position in the spring and summer of 2003*

104. A number of significant events seem to have happened to SB in June and July 2003. Up to that time, it had not traded at all, in spite of the contacts with Sabatier and Mr Henry's list of traders that he wished to buy telephones from. It had been much slower to obtain a VAT registration than it might have hoped. Its contacts with Sabatier had come to nothing. It had finally managed to obtain a VAT registration in late March 2003 and Mr Thomas had written to HMRC on its behalf to obtain monthly (rather than quarterly) VAT accounting periods. That application appears to have been successful, as SB was placed on monthly returns from April 2003.

105. Then the Budget announcement was made in early April 2003 about the introduction of joint and several liability for traders in mobile phones and computer parts. This was HMRC's attempt to reduce the volumes of MTIC fraud it was seeing. We have no doubt it caused what Mr Chester described as "a national shut down" in the mobile phone trading sector, at least for a while. It clearly did nothing to advance SB's plans to trade in mobile phones, and we have no doubt it caused Mr Chester to reconsider the strategy for developing SB's business. Whilst wheels had certainly been put in motion by then to obtain significant funding through PGM, the scope for its intended activities was severely curtailed. At the end of April 2003, Mr Henry resigned as a director and his investment was paid out at around the same time. We infer that he regarded the Budget announcement as the "writing on the wall" for his list of 50 potential mobile phone suppliers.

106. SB made no supplies at all during April, May and June 2003 (it submitted nil VAT returns, as Mr Chester confirmed in cross examination). But then in June 2003 things clearly changed. The link with Mr Thomas and Mr Ward was severed, Mr Thomas writing his letter to HMRC on 11 June 2003 to inform them that he had decided not to get involved with SB, and Mr Chester resigning as a director of Blue on the same date. Mr Chester finally became a director of SB on 25 June 2003. Mr Payne became a director of SB on 27 June 2003 and invested his £44,000 during the

month. On 16 June 2003, Mr Chester also became a director of another company called Yes Business Solutions plc (referred to at [109] below).

107. We infer that it was during this period that Mr Chester, in conjunction with PGM, decided to change SB's original business plan. Instead of dealing in mobile phones (which had become much more risky since the Budget changes), he settled on the "export finance" business model, in which SB would act as exporter/despatcher of any goods other than those falling within the new "joint and several liability" provisions, on behalf of traders who were unable themselves to finance the VAT cost of exporting/despatching domestically bought goods. Mr Henry had already fallen by the wayside and now Mr Chester parted company with his former colleagues at Blue and MDS, who did not wish to get involved with the new proposal. Mr Morton's friend Mr Payne was brought in as an investor and director.

108. Whatever funding SB had in the spring and early summer of 2003, it was proving impossible to use it profitably. Mr Chester said he explained the challenge to PGM in mid-2003, saying to them that he either needed to repay the money or work "in different ways" with it while developing SB's intended business. From that discussion, he said, it was agreed that SB would use some of the PGM investment to trade in used cars while Mr Chester worked to develop the export finance business.

*Acquisition of Yes Business Solutions plc*

109. Given that two trading activities were now in prospect (used car sales and export finance), Mr Chester said he agreed with Mr Waghorn that it would be appropriate to use a different company to operate the export finance business. Through an introduction from Mr Smallwood, he bought the share capital of a company called "Yes Business Solutions plc", which was not trading, but had a VAT registration. It was intended that this company would be used as the vehicle for the export finance business – Mr Chester said that being a plc, it would be easier to use it to raise investment through a private placement or, potentially, a public offer of shares or securities. The intention was that Yes would operate under the "Spearmint Blue" name or brand. Its name was changed to "Presiding Brethren plc" ("PB") in what Mr Chester considered an amusingly irreverent reference to the senior members of his church.

110. Public records show that Mr Chester and Mr Morton became directors of PB on 16 June 2003, and its name was changed on 3 July 2003. This was clearly almost exactly contemporaneous with the various other events which happened in midsummer 2003, as summarised above.

111. PB had been registered for VAT on 21 August 2002, with a business activity described as "design and print marketing and sales, publishing and business finance". Its last trading activity (in terms of amounts showing in its VAT returns) was in its VAT period ended 31 December 2002. Mr Chester did not explain (nor was he asked) why he had felt it appropriate to acquire an existing plc which was effectively dormant (apart from holding a VAT registration) rather than form his own brand new company, where he could be certain there were no historical liabilities. There was no

explanation as to the circumstances in which a financial intermediary in southern Spain was regarded as a reliable source of introduction for the purchase of a UK public limited company. Mr Chester did not refer to any other benefits or advantages in acquiring PB or how much was paid for it, and we infer that its existing VAT registration was an important (if not the only) advantage in the acquisition.

112. Following the restructuring of June/July 2003, the money started to flow in from PGM. Apart from the receipts listed at [93] above which Mr Chester told Officer Quinn about in March 2004, Mr Chester told us at the hearing that SB continued to receive more cash investment from PGM right through until October 2006, up to an eventual total of around £3,500,000. Mr Chester also said he had invested £500,000 of his own cash in SB, though no details were provided of how this was financed.

*Activities of SB and PB from July 2003*

113. We have only sparse information about SB's VAT returns for its first two and a half years of trading. In cross examination, Mr Chester agreed that SB had submitted nil returns for April, May and June 2003. Thereafter, it appears returns were not submitted as required – the next documented contact between SB and HMRC was a telephone call on 7 October 2003 from a Mrs Sheila White (or Shelagh Whyte), who described herself as the newly employed bookkeeper of SB. She asked if she could wait until the end of the month to submit all outstanding returns but she was told that the overdue returns for July, August and September 2003 should be submitted immediately. SB was still on monthly VAT returns at that time.

114. When Officer Lynne Cullen visited SB on 31 October 2003, she took away with her its VAT returns for July, August and September 2003, along with a cheque for £1,134.83.

115. At that visit (when Officer Cullen met Mr Chester and Mr Morton, the directors of SB), she was told that the business of SB had commenced in June 2003, and it was dealing in second hand cars, having rented a garage forecourt in Malpas. They had also taken a 7 year lease of some office premises. They told her that they had been attempting to raise funds to get back into wholesaling mobile phones, that they aimed to become a broker (i.e. exporter or dispatcher) and that they were trying to raise the funds needed to do so. We note that SB had already received £245,000 of funding from PGM and a further £44,000 from Mr Payne by that time, so it is unclear why they felt they needed to raise more funds before they could commence business. Officer Cullen asked them to notify her as soon as they started to deal in phones.

116. The next material contact between SB and HMRC took the form of a meeting on 6 January 2004. Officer Christine Quinn of HMRC (SB's new control officer) visited to carry out a check on SB's VAT return for November 2003, which claimed a significant VAT repayment. She met Mr Chester and Mr Morton.

117. At the meeting, she noticed only 6 cars on the forecourt, and regarded that business as "minimal". Mr Chester informed her that they had acquired PB, which

had not yet started trading as its address needed to be changed. Mr Chester said that as soon as the revised VAT certificate came through, PB intended to start wholesale trading, with SB's business limited to car sales.

118. He said that PB intended to trade in anything that fell outside the "Budget 2003" legislation (i.e. anything except mobile phones, computers and parts). Officer Quinn's perspective on this in her note of the meeting was that SB was proposing to "circumvent" that legislation, whereas Mr Chester's perspective at the hearing was that PB would simply be avoiding the known problem areas. Officer Quinn remarked that Mr Chester appeared to be "the main spokesman for the business". He was well versed in carousel fraud and the associated jargon. He told her that Hacker Young were being instructed to carry out checks on their prospective customers (though the nature of those checks appeared somewhat limited to her). He was aware of the Redhill check procedure, but said (to her surprise) that Hacker Young had told him not to use it as it would "get them a bad name" with other traders. She told him this was not correct.

119. Officer Quinn then turned to the main purpose of her visit, namely a "pre-cred" check of the November VAT repayment return.

120. She established that most or all of the repayment related to one transaction, an acquisition of some swimming pool covers from a UK trader called Norfolk & Suffolk Windows and Conservatories Limited ("N&S"), and the sale of those goods by way of export to a customer in Hong Kong (but with delivery to Dubai). The value of this deal was £466,750 plus VAT, hence the input VAT being reclaimed was £81,681.25. It was explained to her that N&S had approached SB to finance the VAT cost of the export for them. At the hearing, Mr Chester said that SB had a website which would come quite high on the list of results for any search for "export finance".

121. Officer Quinn was not satisfied by the documentation produced by SB in relation to this deal. She was also not satisfied by the answers Mr Chester gave in relation to some of her questions about the deal. He could not even tell her where he was supposed to make payment for the pool covers, nor had he physically checked them even though the freight forwarder dealing with them (Stanza Freight, whom he said he had found through the Yellow Pages) was local. No payment had been received from SB's customer for them. She arranged to come back the following week, to enable SB to produce better evidence in support of its input tax claim. She had already been informed that N&S was a "missing trader".

122. When Officer Quinn returned to SB the following week on 14 January 2004, she was still not satisfied by the evidence supplied to her. The only new information was a copy of a bill of lading from Stanza Freight which described the goods as swimming pool covers but they were in sealed containers. SB had still not received or made any payments for them. In the meantime, Mr Chester said that SB had done two further deals in December 2003 involving the UK purchase and subsequent despatch to Germany and Spain of razors and razor blades. He had submitted the December 2003 VAT return claiming repayment of the input tax. It was pointed out to him that

the invoices he held from the UK supplier were only proforma invoices, not proper VAT invoices.

123. Two weeks later on 28 January 2004 Officer Quinn reviewed a repayment return received from SB for January 2004. It was obvious that the return should have been in relation to December 2003. She telephoned Mr Chester to discuss it and agreed to visit on 5 February 2004. Mr Chester was to complete the December 2003 return correctly and also have the details ready for the proper January 2004 return. He confirmed that he had now "cancelled" the swimming pool covers deal as he had received and made no payment. He said he was in dispute with Stanza about it.

124. When Officer Quinn visited as agreed on 5 February 2004, Mr Chester could not tell her where the pool covers were and confirmed that the deal was effectively cancelled. He produced a sales invoice for the covers which appeared to be identical to the one she had been shown on 6 January 2004, except that, on closer inspection, it referred to the purchaser as a company called Hillcraft, rather than SB and it had a typing error in the VAT amount. Mr Chester did not explain (either at the time or at the hearing) why this other invoice was in his possession. At the hearing, he said was not even sure whether he had been aware at the time that he held the second invoice, or whether he just passed over to HMRC everything which he had in relation to that deal. By then, it was apparent that SB were not going to get their VAT repayment, so he said he had just provided everything he had in order to help HMRC with their enquiries. SB have not challenged HMRC's refusal to repay the relevant VAT.

125. Mr Chester accepted at the hearing that this experience had made it clear to him that the risk of becoming embroiled in fraud on exports was not limited to dealings in mobile phones or similar items.

126. According to a "FAME" online company report for SB produced in the bundles by HMRC, the accounts of SB for its first year of trading (up to November 2003) apparently showed total losses for the year of £81,522. These accounts were audited by UHY Hacker Young.

127. When HMRC subsequently received SB's VAT return for December 2003, it included no reference to the razor and razor blade deals which had been mentioned at the meeting on 14 January 2004. When HMRC contacted it about this return on 16 February 2004, SB maintained it had "pulled out" of those deals.

128. It was at about this time that the connection with Mr Payne (Mr Morton's business associate from the Birmingham area) was severed. Mr Payne resigned as a director of SB on 12 February 2004 and we presume that his investment was repaid to him or abandoned by him at around the same time.

129. SB's return for January 2004 was a smaller repayment return, and was paid without problem.

130. The February 2004 return was received on 3 March 2004 and contained a repayment claim of some £185,000. A further visit was arranged to discuss this return, which took place on 11 March 2004. Mr Chester and Mr Morton were both

present. SB was reclaiming input VAT totalling £183,225 on three despatch deals it had carried out in February, which accounted for the bulk of the repayment claim. The goods involved were Philips DVD players and Sony Mini Disk players. All were bought from Global Enterprise Trading Limited in the UK and sold to SSA Enterprise GmbH in Europe.

131. Once again, HMRC were not satisfied with the documents produced to them in support of this repayment claim. A follow up visit was arranged for 30 March 2004. Some of the problems were resolved at that visit, but HMRC remained unsatisfied as to the standard of the CMR documents, leaving a letter dated 30 March 2004 with SB to specify what they required of such documents. There does not appear to have been any further correspondence on this repayment claim and we do not know whether it was eventually paid. The relevant comment in Officer Quinn's note says:

> "I was satisfied that paperwork seen enabled me to verify the repayment. However as mentioned on previous visit I was not wholly satisfied with the quality of the CMR docs seen and I left letter dated 30/3/2004 explaining precisely what was expected by the dept."

132. During the visit on 30 March 2004, Officer Quinn spoke to an employee at SB (Mr Chester and Mr Morton were both away) and established that there was a further deal going through that day, involving a purchase and sale between SB and the same parties as the February deals. The goods involved were Sony digital cameras, and the VAT repayment claim arising would be £67,375.

133. In due course the VAT return for March 2004 was submitted, and on 29 April 2004 HMRC wrote to SB to tell it that it had suspended £67,375 of the repayment claim (allowing the remaining £2,213.20). We presume that this related to the Sony digital camera sale referred to above.

134. On 13 May 2004, Officer Quinn asked Mr Chester about the business of PB (in the context of discussions about the ongoing checks into SB's repayment claims). Mr Chester replied that until the claimed VAT repayment had been received by SB, PB would not be in a position to start its business.

135. In due course the VAT return for April 2004 was submitted, and on 8 June 2004 HMRC wrote to SB to inform it that they were suspending payment of £179,812.50 of the VAT repayment claim it included. They were making arrangements for the remaining £2,774.97 to be repaid. No details of the goods involved were included in our documents, but we infer the suspended VAT related to another export/despatch transaction arranged by SB.

136. After some correspondence between the parties, HMRC confirmed in their letter dated 7 July 2004 that the two repayment claims for March and April 2004 would be released "without prejudice to any post payment verification activity undertaken" by HMRC. That letter referred to iPAQ PDA's and Olympus digital cameras as having been involved in the April transactions.

137. Also on 7 July 2004, HMRC wrote to PB. They said it had not made any taxable supplies since 1 January 2003 according to its returns and therefore they were proposing to cancel its VAT registration unless it provided evidence that it intended to resume trading.

138. A meeting took place between Officer Quinn and Mr Chester and Mr Morton on 15 July 2004. The continuing verification of the March and April 2004 repayment claims was discussed, and it was made clear that SB may still have to pay back the VAT it had received if the outcome was not satisfactory. Mr Chester told her that PB was ready to take on SB's exporting business; SB would continue as a used car sales business only. Officer Quinn asked for evidence of trading for PB. She followed that up with a letter date 16 July 2004 to PB in which she confirmed that PB would have four weeks in which to supply evidence of its intention to resume trading, now that SB had received its VAT repayments.

139. Officer Quinn spoke to Mr Morton at PB on 23 August 2004 and he agreed that deregistration of PB was "inevitable", as no evidence of intention to trade had been provided. At his request, she then spoke to Mr Chester, who did not want deregistration to happen. He said he had been "all over Europe last week making contacts" but when pressed he admitted he had in fact been visiting SB's investor in Spain (presumably PGM). Following this call, Officer Quinn made arrangements for PB to be de-registered for VAT, which happened on 24 August 2004.

140. There is some confusion in the evidence between SB's May, June and July 2004 returns. Two of them (either May and June or June and July) were small repayment claims and Officer Quinn wrote to SB on 21 September 2004 asking for some supporting information. She followed this up with a letter dated 7 October 2004, in which she said she would visit on 21 October to resolve the outstanding issues. When she arrived at the premises on 21 October, she found neither Mr Morton nor Mr Chester was there. The car showroom premises were undergoing a "revamp", including some landscaping and she formed the impression the business was moving away from export finance to use car sales. She spoke to "Bruce", who introduced himself as the "car sales manager". We infer that this must be Bruce Harris ("Mr Harris"), about whom Mr Chester gave us some information (see [152] below).

141. Mr Harris got hold of Mr Chester by mobile phone and an arrangement was made to postpone the meeting until 28 October 2004. This was subsequently put back to 11 November 2004.

142. Both Mr Morton and Mr Chester were present at the meeting with Officer Quinn on 11 November 2004. Officer Quinn wished to establish whether SB had dropped its export finance dealings, as she was considering putting it back onto quarterly VAT returns. Mr Chester said he was still pursuing that business line. They went over the cancellation of PB's registration once again. Mr Chester said there had been deals "on the table" for PB which had been cancelled when it had been deregistered. He said he had lost some credibility in "the trade" as a result.

143. There followed a fairly general discussion about the steps that should be taken if SB wished to continue with its export finance trading – which Officer Quinn continued to describe as "MTIC trading" in her notes. She asked that she be informed if SB restarted such dealings, and Mr Chester agreed to do so.

144. It also came to light at the meeting that SB had used its blank October 2004 VAT return form to make its September 2004 return. This was seemingly corrected, but a similar error occurred when two November 2004 VAT returns were received. All the amounts of VAT involved appeared to be small, so it appears that no further export finance deals were carried out during the latter part of 2004.

145. The FAME report produced by HMRC showed further losses by SB during its year ended November 2004 of £262,173. Again, the accounts were apparently audited by UHY Hacker Young.

146. On 26 January 2005, Officer Quinn wrote to SB to inform it that she had put it back on quarterly VAT returns. The precise timing of the change was unclear, but in her letter she appeared to be suggesting that it would take effect after the monthly return for February 2005 had been dealt with.

147. In fact SB appears to have submitted monthly returns until February 2005, then a return for the two months to April 2005 before reverting properly to quarterly returns from July 2005.

148. Officer Quinn then passed over responsibility for SB and PB to a new assurance officer, Officer David Bayliss. Unfortunately Officer Bayliss has left HMRC and was not available to give evidence.

149. Officer Bayliss's notes and correspondence were in the bundles provided to us. From those papers, we are satisfied that Officer Bayliss first became involved when SB's January 2005 VAT return was received. It was a small repayment claim (just over £1,000). Officer Bayliss was asked to check it with SB and also establish their present intentions in relation to re-entering "wholesale trade".

150. Officer Bayliss met Mr Chester on 21 March 2005. Mr Harris was also there (introduced as company accountant for SB and PB, as well as secretary of another business called "Swollen Horse" which had recently been set up to buy in and sell on excess stock from companies such as Argos).

151. Mr Chester confirmed that SB was intended to continue in business largely as a used car dealer. He also sought to persuade Officer Bayliss that PB's business was to be "revitalised to deal with world wide imports and exports of initially Coca Cola, out of Holland, Egypt, Philippines for re export." Officer asked for evidence of PB's intention to trade, and Mr Chester said that without a VAT registration it could not secure deals. The question of PB's VAT registration moved no further forward following this clear "catch 22" impasse.

152. Mr Chester gave oral evidence about his dealings with Mr Harris. He said he had first met him in early 2004 when he had come into the car showroom with a

friend. He was Zimbabwean and very tall. He had asked for a job and Mr Chester agreed to take him on. He very quickly ended up running the car sales operation. He also became involved in the "Swollen Horse" business. Mr Chester saw him as a general manager in the making. He was allowed to have some shares in SB towards the end of 2004. He was appointed as a director of SB on 23 June 2005, the same day that Mr Morton resigned (see [155]).

153. SB's VAT returns up until the summer of 2005 contained repayment claims of just under £2,000 (for the month of February 2005), just under £7,500 (for the months of March and April 2005) and the return for the quarter from May to July showed a liability of just over £4,500. These were all small amounts, clearly relating largely if not exclusively to the used car business.

154. In mid-2005, SB was to undergo another structural change. Mr Chester told us that he planned to move to the USA in the summer of 2005 for family reasons (his wife is American and he wished their children to have the next stage of their education there). He had been struggling to get SB's export finance business off the ground, but had only been able to do a very few deals. He said there had been many potential deals but nearly all of them had not proceeded, either because he did not like the feel of the prospective customers or because they were put off by SB's extensive investigation of them. Much of the business which SB had managed to do had run into problems with HMRC withholding repayments, as summarised above.

155. This unsatisfactory state of affairs resulted, he said, in Mr Morton coming to him and saying he did not wish to continue in the business. He said this was in April 2005. Mr Morton did not wish to be left running the business in the UK with what Mr Chester described as "a relatively small share" and an absentee senior partner. This culminated in Mr Morton resigning as a director of SB on 23 June 2005. Clearly Mr Chester was looking to the future, as he appointed Mr Harris as a director of SB on that same day. Mr Morton's shareholding also went to Mr Harris, who now held 24% of the shares (Mr Chester holding the other 76%).

156. Mr Chester said he also had conversations with SB's investor PGM that summer. He said he was trying to reduce SB's level of debt to PGM. This resulted in a reorganisation of the shareholdings. £500,000 of debt was, he said, converted to shares amounting to 25% of the business. He said that a group structure was put together with PB as the parent company of SB, Swollen Horse Limited and another company called Red Bull Developments Limited (which does not appear to be relevant to this appeal). Whilst Mr Chester said this group was put together during 2005, an annual return of SB was included in the evidence before us which shows that the various transfers of SB shares to effect the restructuring were largely done in October 2006. Nothing significant hinges on this discrepancy, but it does illustrate once again that Mr Chester's recollection cannot be totally relied upon.

157. Mr Chester told us that he moved from the UK to the USA in July 2005. Thereafter, he returned for "a few weeks" about once every three months to keep an eye on things. Mr Harris was running things in the UK and Mr Chester mainly stayed in touch by means of weekly telephone conversations with him.

*Activities of Mr Morton after leaving SB*

158. Mr Morton resigned as a director of SB on 23 June 2005. On that same day, he generated some self-billing invoices in respect of the purchase of four motor vehicles from a motor vehicle auction business (a BMW M3 Convertible for £37,000, a Renault Espace for £6,940, a Vauxhall Astra for £2,150 and a Ford Focus for £4,010).

159. He then incorporated 4A Developments Limited ("4A") on 22 July 2005 and applied online for VAT registration on 27 July 2005. He described the intended business of 4A as follows:

> "Building development
>
> Ebay sales
>
> Wholesale
>
> Wholesale and retail sale of used motor vehicles
>
> Alterations and extensions of domestic buildings
>
> Other wholesale"

160. He gave a figure of £450,000 for the estimated expected turnover in the first twelve months, and stated that he expected neither to sell to nor to buy from other EC states in the following twelve months.

161. HMRC sent a letter dated 27 July 2005 requesting additional information. In his faxed reply dated 28 July, Mr Morton included the following further information:

> "The business will have three main revenue generating activities listed below in order of anticipated growth and financial return:
>
> Trade wholesale of goods via e-bay and directly to market traders
>
> Property renovation & improvements on behalf of clients
>
> Used car sales to trade and private buyers
>
> The forecast turnover in year one is 400k, anticipated to be generated mainly from market traders, wholesale and e-commerce (e-bay). Any property developments will be done on behalf of private clients or commercial maintenance agreements. Given the broad spectrum of the business activities I would describe the business as a general trade rather than one in specific."

162. On 22 August 2005, Mr Morton applied to FCIB to open a bank account on behalf of 4A. FCIB was a bank operating out of the Dutch Antilles which provided a sophisticated online banking facility which enabled large amounts of money to be transmitted electronically almost instantaneously between account holders by means

of electronic instructions given over the internet. In the application form, he described the "business sector" of 4A as "Trader – Mobile Phones". The form said he had been referred to FCIB by a "business associate", though no further details are given. His wife Gemma was named as a signatory to the account (and also signed the application form). It is fair to say that the signature of (supposedly) Mr Morton on the application form bears no resemblance to his signature on other correspondence in the papers before us, but it is quite clear that he authorised the opening of the account and subsequently used it extensively, even if he did not actually sign the form himself. It was stated on the form that the sums deposited with FCIB were "loan proceeds". Instructions could be accepted by the bank from either Mr Morton or his wife, though at a later meeting on 13 September 2006 Mr Morton said he was then the sole password holder on the FCIB account.

163. Accompanying the application form in the FCIB archives are two interesting documents. The first, dated 1 September 2005, is an incomplete copy of a reference dated 1 September 2005 addressed "to whom it may concern". It is on "Spearmint" notepaper and includes the following legible text (before the bottom of the page is cut off on the copy in our bundles):

> "I am very pleased to provide this reference on behalf of Robert James Morton who is a director of 4A Developments Limited. I have been involved with Robert mainly through business transactions during the last 36 months however, I would go so far as to say, I class him as a friend also."

164. The reference "BH/RM" appears at the top of this letter. The three year time span mentioned in the reference fits neatly with the beginning of Mr Morton's involvement with Mr Chester in late 2002 when setting up SB, and the reference "BH" presumably refers to Bruce Harris (who was, on Mr Chester's evidence, the UK head of SB by September 2005). We infer that this reference was produced by Mr Harris on instructions from Mr Chester and/or Mr Morton.

165. The other interesting document is headed "Robert Morton Curriculum Vitae". It outlines Mr Morton's work career from 1992 (when he would have been approximately 24 years old).

166. It says he was a "Contract Manager" for Securicor Limited from December 1992 to May 2000. From January 2000 to June 2003 (we note the apparent four month overlap with the previous job) it states he was "Business Development Manager" for Alliance Medical Limited, responsible for business development "throughout the southwest regions of Wales and England... main Accounts were Bupa, Nuffield and the Capio Group." It makes no mention of any period as a police officer.

167. It then goes on to mention his involvement with SB from June 2003 to August 2005 (making his date of departure a little later than was actually the case). Whilst at SB, it says he was:

> "Responsible for raising funds to enable Spearmint Blue Limited to fund large wholesale export transactions to Europe, mainly within the import/export industry, and establishing terms and conditions, due diligence checks and relevant company procedures with Customs and Excise."

168. Pausing here for a moment, this account conflicts directly with what Mr Chester told us – namely that it was he who had arranged the financing for SB from PGM. So either Mr Chester was misrepresenting the true position to the Tribunal or Mr Morton was misrepresenting it to FCIB. We have no way of knowing which is the true version of events, we merely observe that the accounts of the two main participants are diametrically different.

169. Finally, when summarising his role at 4A, the CV says:

> "Director & Shareholder of newly incorporated Limited Company formed to conduct trade on a wholesale scale with companies based both within the U.K. and Europe. Both white goods and cellular products will be traded, with a view to exporting when a strong financial position is established."

170. Mr Chester told us that Mr Morton had approached Mr Harris to ask for SB's help in financing his export/despatch deals. Mr Harris had reported the approach to Mr Chester, who met with Mr Morton on his next visit to the UK. It appears to have been this visit that resulted in a short written agreement between 4A and SB. A copy of that agreement, headed "Preferred Supplier Agreement" was included in the documentary evidence. It was signed by Mr Harris on behalf of SB and by Mr Morton on behalf of 4A. It was dated 7 September 2005 next to Mr Morton's signature. The full text of this agreement was as follows:

> "The following is a commercial agreement between the "companies" namely Spearmint Blue Limited, and 4A Developments Limited, outlining basic terms of business and codes of practise governing all business transaction between the "companies".
>
> Any alterations or additional terms or codes must be agreed, drafted and signed prior to implication in business transactions.
>
> 1. Spearmint Blue Limited will be provided with 4A Developments supplier details for due diligence checks prior to any transaction being finalised.
>
> 2. Spearmint Blue Limited will not approach, contact or transact with any of 4A Developments suppliers without 4A Developments prior consent.
>
> 3. Spearmint Blue Limited will assume all costs for any insurance transportation, inspections and any claims in respect of product warranty.

> 4. 4A Developments will not transact or propose to trade with Spearmint Blue Limited, if the commodity is mobile phone or cellular products.
>
> 5. 4A Developments will check all clients status with Customs and Excise verification offices in Southend-on-Sea prior to every transaction."

171. Mr Chester's evidence was that for SB the opportunity to act as export financier for 4A was "the perfect solution". He had struggled to get the business off the ground but this was largely due to his inability to find trading partners whom he really trusted. Now here was a marvellous opportunity. He knew Mr Morton well (or thought he did), trusted him implicitly and was confident that he would never become a missing trader – his ties to the local community were too strong, he considered. This meant that he could be confident in exporting on 4A's behalf without any fear of becoming embroiled in VAT fraud.

172. Mr Chester also said his agreement with 4A was that "Spearmint Blue charged through profit on the trade 5.5% exactly for their service to 4a. Whatever price was agreed between 4a and the non-UK customer, 4a would sell to Spearmint Blue 5.5% less."

173. In response to a "new business telephone questionnaire" from HMRC on 15 September 2005, Mr Morton told them that he was "a builder by trade" (though this did not appear on his CV to FCIB). It appears that on or shortly before that date, 4A had been registered for VAT. On the same day, he contacted HMRC to verify a Spanish VAT number, and over the following weeks he contacted them numerous times to verify other VAT numbers (mainly overseas ones). He had clearly been less than open in his dealings with HMRC.

174. On 28 September 2005, Mr Harris filled out and signed on behalf of SB an application form for an FCIB bank account. SB's "business sector" was described in the form as "Trader – Commodities". The mandate was set up so that instructions were required from both Mr Harris and Mr Chester before they would be accepted by FCIB.

175. It seems that Mr Morton was impatient to get started in his trading. Almost as soon as 4A was VAT registered, other traders were contacting HMRC's Redhill office to verify its VAT number. In line with policy at that time, the Redhill office refused to verify 4A's VAT details to other traders until 4A had received its first post-registration visit from HMRC.

*SB and 4A start to trade*

176. This did not appear to stop 4A from carrying out its first deal at the end of September 2005, however. In that deal 4A bought a batch of unspecified electronic goods from a UK trader called In2Digital (split between five invoices) and sold them on to SB. In fact (as was recorded by HMRC in a note of a visit made on 9 November 2005) 4A issued its sale invoice to SB on 28 September 2005, though the invoices to

4A from its supplier were dated 30 September, two days later. When asked about this timing point, Mr Morton could not explain it and believed the sales invoice to SB might have been issued when payment was received from it. Thus he believed that SB might have paid 4A before 4A had even received the goods from its supplier, or been invoiced for them.

177. The value of this deal was not expressly set out in the evidence before us, but we were told it was the only deal done by 4A during its first VAT accounting period (to the end of September 2005) and its VAT return for that period showed total sales of £1,222,518 and output VAT of £213,647.59. Its total purchases were shown as £1,218,671 plus input VAT of £213,262.13. The net VAT liability was therefore just £385.46. Although the VAT figures are very slightly out from the expected amounts, given the reported net input and output figures, we infer that these amounts are a reasonably precise reflection of the size of the transaction done with SB. We note that SB's VAT return for the three months ended 31 October 2005 show input tax of £319,799.21 with total output tax of just £527.83. We were not told how SB incurred the balance of approximately £106,000 of input VAT during its VAT quarter up to October 2005.

178. We accept HMRC's evidence that Mr Morton told Officers Tinker and Owens at the meeting on 9 November 2005 (see [180]) that 4A's supplier In2digital was known to both 4A and SB. There was even, he told them, a special arrangement between 4A and SB which allowed SB to deal with In2digital direct on paying a commission to 4A (a relaxation of the usual arrangement, under which SB had agreed not to deal direct with 4A's suppliers). The terms of the arrangement between SB and 4A were such that 4A had to give SB details of their supplier. Thus we find that Mr Chester was well aware 4A were buying from another UK trader; therefore he cannot have been satisfied that the transaction chain could not be tainted by VAT fraud – his trust in Mr Morton could only have extended to the situation where, as he said at the hearing, 4A was the importer and therefore there simply could not be a fraudulent VAT default in the transaction chain.

179. The FAME report produced by HMRC showed losses by SB during its year ended November 2005 of £485,390. The accounts were apparently again audited by UHY Hacker Young.

*4A's first visit from HMRC*

180. Mr Morton found out about HMRC's policy of not clearing VAT numbers until the post-registration visit had taken place when he called Redhill (several times) to find out why they were refusing to verify 4A to other traders. He therefore knew to expect a visit, which was duly made by Officers Steven Owens and Emma Tinker of HMRC on 9 November 2005.

181. At that meeting, it was confirmed that 4A had only done one deal so far, the purchase from In2digital and sale to SB in September. The main business activity was described to HMRC by Mr Morton as "Wholesale supplies of various items,

principally mobile phones, clothes/sports footwear and electronic goods and also tools and clocks." The subsidiary business activities were described as follows:

> "Building work (none conducted to date)
>
> E-bay sales of phones, TV's and antiques (no immediate intention to start this trade just yet as the traders have no storage space nor will they at Regus House, Chester)
>
> Car sales now discontinued"

182. After describing his previous involvement at SB, Mr Morton told the officers he had been a police officer before that. He also said that SB had been 4A's only customer to date. He said he had left SB "after his business partner left to live in the US". He said that £6,000 to £8,000 had been spent in the business to date, all derived from personal funds. He explained that:

> "Wholesale deals are financed by receiving payment from the customer and then using the money to pay the supplier. It was not known why suppliers would effectively extend credit to 4A except to say that this is the way things are done in the wholesale trade and the one supplier used to date (In2digital Ltd – 841 2205 68) were said to be known to both 4A and Spearmint Blue".

183. No explanation was given as to the £50,000 or so that had supposedly been spent on buying cars for 4A's business, either as to the supposed origin of those funds or as to what had happened to the cars themselves. We find on a balance of probabilities that Mr Morton had simply fabricated the self-billing invoices for most or all of the cars in order to obtain a VAT registration and he had never actually bought them.

184. Mr Morton said 4A did not have a UK bank account. They banked with FCIB, which they had found out about "online" (and not through a contact with a business associate, as he had stated in the FCIB account application – see [162]. It is interesting to note that Mr Morton's account changed over the following year: he informed Officers Sharrock and Flint of HMRC on 13 September 2006 that he had found out about FCIB when visiting a company in Leeds while he was still with SB). 4A's accountants were named as UHY Hacker Young of Chester, and the bookkeeper was identified as Sheila White (i.e. the same as SB's bookkeeper). She also compiled the VAT returns.

185. Although Mr Morton told the officers that present plans included only UK sales, he did not discount dealing with overseas customers and suppliers in the near future. The officers saw a board on the wall with details of two Portuguese traders, a number of UK traders known to them to be involved in what they regarded as MTIC trading, and details of various types of goods which they saw commonly traded in MTIC deals. Mr Morton said he had contacted the traders in question (rather than being contacted by them) and, crucially, that the contact details for them had been

obtained from SB. No deals had yet been concluded with them (apart from the one deal with In2digital) because of Redhill's refusal to clear 4A's VAT number.

*Subsequent trading of 4A, including with SB*

October to December 2005

186. 4A started to trade in increasing volumes. In its VAT return for the VAT quarter to 31 December 2005, it reported total sales of £7.3 million, generating output VAT of just over £812,000. This implies that 4A was starting to do its own export/despatch deals as the £812,000 of output VAT would have been generated by standard rated sales of approximately £4.6 million, leaving £2.7 million of exempt or zero rated sales. There is no indication that 4A may have been making exempt or zero-rated supplies within the UK and we find that the £2.7 million figure most probably represented export or despatch deals by 4A.

187. Included in 4A's December return was a set of three deals in which on 20 December 2005 it purchased various items of clothing from Andrevias SRL ("Andrevias"), a Romanian company, to a value of approximately £2.6 million without paying VAT and then sold them on at a small profit to SB, generating £455,054 of output VAT. That output VAT represented all but about £2,000 of SB's input VAT for its quarter ended 31 January 2006, all of which it reclaimed from HMRC (having generated no output tax during that quarter). This reflects the fact that SB's only material transaction during that quarter was its purchase of this clothing from 4A and, we infer, its sale overseas. We were not told to whom this clothing was sold by SB. We do know, however, that 4A made a total profit of just £13,001.55 on this £2.6 million sale – almost exactly 0.5%. SB received payment of its VAT repayment claim (of £457,004.71) for the period ended 31 January 2006 on 26 May 2006.

188. 4A's VAT return for the quarter to 31 December 2005 claimed a net overall VAT repayment of £210.76 on total sales of over £7.3 million. Given that 4A had clearly made a high level (some £2.7 million) of its own export/despatch sales, this close matching between input and output VAT cannot have simply been a reflection of 4A's fine profit margins. Nor do we consider it was an accident. On a balance of probabilities, we find that 4A was intentionally balancing its export/despatch sales (which, on their own, would have generated a large repayment claim) with its standard rated UK sales of imported/acquired goods with the purpose of avoiding any problems in reclaiming the VAT repayment which would otherwise have arisen. In doing so, it was using SB's services (and indeed its money). We note that the set of trades with SB which eliminated 4A's repayment claim took place on 20 December 2005, very close to the end of 4A's VAT accounting period – by which time Mr Morton would have had a clear picture of the value of export/despatch sales 4A would need to achieve in order to eliminate its VAT repayment claim.

January to March 2006

189. In 4A's VAT return for the quarter ended 31 March 2006, it reported £86.8 million of sales and £85.4 million of purchases. Its output VAT was £14,268,019 and its input VAT was £14,264,700. Its net VAT liability was therefore £3,318.88 on sales of £86.7 million. Once again, we find this situation (of near balancing of input and output VAT on such a large turnover) did not happen by accident. If all of 4A's reported outputs had been standard rated, it would have incurred an output VAT liability of £15,184,051.92. Its reported output liability was £916,032.82 less than this, implying zero rated export/despatch sales of £5,234,473. Clearly 4A entered into a similar value of acquisition purchases which were sold on in standard rated UK sales to balance out these export/despatch sales. We have very little specific information about 4A's dealing during this period beyond these amounts, and nothing to indicate that 4A traded with SB during the period. We therefore draw no significant conclusions in relation to it, except that it shows a clear continuation of the pattern of the previous three months in closely matching input and output VAT amounts on very large volumes of sales and purchases involving both UK and overseas elements.

190. By the end of March 2006, 4A had generated turnover of approximately £95 million in just over six months of trading, from a standing start. When asked how it was that 4A was able to achieve within a few short months what SB had been trying and failing to do for nearly three years, Mr Chester had no real answer. His comment was that Mr Morton must have been doing "preparation work" whilst still at SB. He emphasised that SB could have done a lot of deals itself but he had not felt good about the prospective trading partners he had met.

191. We should emphasise there is no evidence that Mr Chester knew the details of 4A's trading at the time it was taking place. His comments about it were retrospective at the hearing, given the information then available about 4A's trading.

*Dealings between SB and 4A in April 2006*

192. On 28 April 2006, 4A bought a consignment of laptops from Mighty Mobile SL ("Mighty Mobile") in Spain for £2,558,951.50 free of VAT and sold them to SB in a standard rated supply for £2,571,270 plus VAT. The input VAT generated for SB by this sale was £449,972.25, which represented all but about £2,300 of SB's total input VAT in its VAT quarter ending on 30 April 2006. SB sold these laptops to Pateo Iberico LDA in Portugal ("Pateo") free of VAT, thus generating a VAT repayment claim of £452,323.89 for that VAT quarter. This is consistent with Mr Chester's statement that SB's only export finance deal during that VAT quarter was this deal with 4A. SB received payment of its VAT repayment claim on 11 July 2006.

193. This deal fell into 4A's VAT quarter ended 30 June 2006. It is fair to say that the evidence presented to us as to the picture of 4A's overall trading in that quarter was unclear. After several attempts to clarify the picture for us, Officer Graham Taylor (the officer in charge of 4A's dealings at HMRC) was unable to do so and Mr Mandalia was forced to abandon his evidence insofar as it related to that period.

194. Some basic details however do emerge from 4A's VAT return for the period April to June 2006, which showed £256.5 million of purchases and £254.7 million of sales. Its total input tax claimed was £44.9 million and its total output tax declared was £44.6 million. The amount of output tax declared is exactly 17.5% of the sales declared, which would imply that 4A made no export/despatch sales during the period. The amount of input tax claimed matches almost exactly (to within £500) the amount of purchases reported, which would imply it made no significant import/acquisition purchases (notwithstanding its known purchase of computers to a value of £2.6 million from Spain referred to at [192]). The net result was a VAT repayment claim of £313,830.45.

195. Whilst Officer Taylor's evidence as to the details of 4A's trading during the quarter in question was unclear, it did include an attempt at a listing of 4A's deals by reference to material supplied to HMRC by 4A and (possibly) from other sources also. From that listing, it is clear that whatever the true picture, 4A had told him that it did in fact carry out large numbers of acquisition and despatch deals during April, May and June 2006 (including the acquisition of laptops that were sold to SB). The picture that emerges overall is that 4A was carrying out such a massive volume of deals during this period that it had no full and accurate record of what it had purportedly done – in effect its volume of trading completely outpaced its ability to keep control of its accounting and administration.

196. The final result of HMRC's verification of 4A's return for April to June 2006 was (in a decision issued on 15 October 2009) to deny 4A's £313,830.45 repayment claim and replace it with a £12,647,357.30 VAT liability. There were numerous adjustments to the return figures as submitted, but the existence of an overall VAT liability resulted entirely from the fact that HMRC denied £14.8 million of input tax claimed by 4A, on the grounds that the relevant supplies could be traced back to fraudulent evasion of VAT, of which they considered 4A should have been aware. The other main adjustments made to the return by HMRC (which would, on their own, have converted the £313,830.45 repayment claimed to the much higher repayment amount of £2,128,374.48) were as follows:

| **Item** | **Value (ex VAT)** | **VAT** |
|---|---|---|
| Cancelled UK sales | - £15,237,995.75 | - £2,666,649.27 |
| Undeclared UK sales | £4,725,645.75 | £826,988.01 |
| Errors in declared UK sales | £143,527.03 | £25,117.23 |
| Undeclared EU acquisitions | £82,312,279.75 | - |
| Undeclared EU supplies | £97,039,173 | - |

197. We are satisfied that the above adjustments made by HMRC are substantially correct (based as they are largely or wholly on information supplied by 4A). 4A has certainly not disputed them (though it is now insolvent). Whether or not the denial of

£14.8 million of input VAT of 4A can be justified, we are satisfied that the other inaccuracies in 4A's VAT return for the relevant period are of such a scale and character that they can only be explained by either fraud or complete incompetence (or both).

198. From the copies of SB's bank statements supplied to us, it is apparent that SB paid 4A for the computers sold on 28 April 2006 in instalments up to the end of May 2006. SB's FCIB bank statement shows five different payments made by it which all refer, in slightly different ways, to that deal. Four of those payments were made by it on 17 May 2006, immediately following (in each case) the receipt by SB of the same or slightly larger payments to its FCIB account from an unidentified payer. The payments made by it on that date totalled £2,339,700. A fifth payment (of £372,672.50) was made by SB on 26 May 2006 immediately following its receipt of that amount from an unidentified payer on the same day. Thus by 26 May 2006, SB had received and paid on to 4A a total of £2,712,372.50. It made a further payment to 4A on 31 May 2006 out of its RBS bank account for £308,595. This brought its total payments to 4A up to £3,020,967.50 (just £274.75 short of the total of £3,021,242.25 payable in respect of the laptops deal of 28 April 2006). We therefore infer that the 31 May 2006 payment was effectively the final significant payment for the 28 April 2006 deal. Mr Chester was not asked why the payments were made in instalments over such an extended period. We note however that SB would not have been in a position to make any of the payments except out of the payments received from the third party (in relation to the bulk of the payments) or out of the VAT repayment received from HMRC on 26 May 2006 (in relation to the final instalment). Thus 4A was clearly content to extend significant credit to SB, both in amount and in time.

199. After the dealings at the end of April 2006, SB had funded some £900,000 of VAT by paying that amount to 4A and claiming it back from HMRC. As mentioned above, the first half of this amount was received by SB from HMRC on 26 May 2006 and the second half was received on 11 July 2006.

**The Facts – SB's dealings in July 2006**

*Introduction*

200. We heard almost no evidence as to the events leading up to the transactions which occurred on 4 and 17 July 2006, which are the subject of this appeal. Mr Chester said these transactions were entered into as part of SB's "export financing" business, just as the previous transactions with 4A had been. He said that the receipt of a £450,000 VAT repayment from HMRC which all arose from SB's previous export financing deals with 4A seemed to him to "complete the puzzle", provide reassurance that the business model was sound and give comfort that HMRC regarded 4A as a safe partner to deal with. This must have been referring to the refund for the 01/06 quarter which was received by SB on 26 May 2006.

201. The deals in question were all purchases from 4A and sales to Pateo as follows:

| Deal number and Date | Goods | SB's purchase price (+ VAT) | SB's sale price | SB's input VAT |
|---|---|---|---|---|
| **1** - 4 July 2006 | 4850 iPod Nano 4 GB (black) | £654,750 | £690,640 | £114,581.25 |
| **2** - 4 July 2006 | 4500 iPod 30GB video (black) | £787,500 | £830,700 | £137,812.50 |
| **3** - 4 July 2006 | 4800 iPod Nano 4 GB (white) | £648,000 | £683,760 | £113,400 |
| **4** - 4 July 2006 | 2475 iPod Nano 1 GB (white) | £195,525 | £206,291.25 | £34,216.88 |
| **5** - 17 July 2006 | 2750 TomTom Go 910 SatNavs | £943,250 | £995,087.50 | £165,068.75 |
| **6** - 17 July 2006 | 3000 TomTom Go 710 SatNavs | £960,000 | £1,012,800 | £168,000 |
| **7** - 17 July 2006 | 3200 TomTom Go 510 SatNavs | £777,600 | £820,320 | £136,080 |
| **8** - 17 July 2006 | 4342 TomTom Go 300 SatNavs | £816,296 | £861,235 | £142,851.80 |
| | **Totals** | **£5,782,921** | **£6,100,833.75** | **£1,012,011.18** |

202. It is worth mentioning that some of the dates and item descriptions set out in the above table are not totally consistent in the transaction documents supplied to HMRC (which themselves contain a number of internal contradictions). What is clear and consistent, however, is that SB made a steady 5.5% mark up on every transaction, in line with the margin agreed with 4A.

203. All the goods in question were supplied to 4A by Mighty Mobile at prices which allowed 4A a mark up of almost exactly 0.5% (a total gross profit on all eight deals of well under £30,000).

204. All the deals involved a VAT-free intra-EU acquisition by 4A from Mighty Mobile (in Spain), a standard-rated intra-UK sale from 4A to SB and a zero-rated intra-EU despatch by SB to Pateo in Portugal. Both SB and 4A knew this to be the case. 4A would have had no VAT funding requirement if it had sold direct to Pateo rather than through SB. The effect of 4A's sale to SB was to generate a VAT output liability that would not otherwise have arisen. No information was available to us about how and when the goods were brought into the UK as part of the process.

205. Mr Chester told us he was living in the USA by the summer of 2006, and the various documents in both deals are all signed on behalf of SB by Mr Harris. Mr Chester said that he was nonetheless able to give all the necessary evidence in relation to those transactions, and he explained that Mr Harris was mentally incapable of giving evidence due to the effect that the whole experience had had on him. Mr Chester said he was physically in the USA while the 17 July deals were taking place. He accepted he was at SB's office in the UK at the time of the 4 July deals (when he logged onto SB's bank account using a computer with the same IP address as that used by Mr Harris). If he was indeed in the USA on 17 July, it appears that he had returned to the UK by 19 July 2006 (when payment was made for the 17 July deals) as the FCIB bank records show that he again logged onto SB's bank account on that date using a computer with the same IP address as that used by Mr Harris.

206. In line with SB's business model, he said that none of the deals had been originated by SB. All except one had been originated by 4A and the last deal had been originated by SB's customer Pateo. He said the reason for this was that Pateo had become disenchanted with 4A's level of service and so they had approached SB direct with a request for stock, which SB had been able to source through 4A. The documentary evidence does not accord with this assertion, and whilst we accept Pateo may have voiced some irritation to SB about 4A, we find that all eight deals were effectively agreed between Pateo and 4A and SB were then involved in order to deal with the dispatch of the goods to Pateo.

*Due diligence done by SB*

207. Mr Chester said that SB did not need to do extensive due diligence on its customer (Pateo) and supplier (4A). This was because:

> (1) His supplier (4A) was well known to him. He knew and trusted Mr Morton. He was aware that 4A was acquiring the goods from an overseas supplier (Mighty Mobile) and therefore he knew there would be no UK VAT default in the supply chain.
>
> (2) He would not be supplying or paying for the goods until SB had been paid for them. There was accordingly no credit risk. Therefore extensive financial checks would not provide any further assurance than he already had. There was no need to carry out such checks from the "general due diligence" point of view because of his knowledge as set out at (1) above.

208. In any event, SB checked the validity of 4A's and Pateo's VAT numbers by carrying out Redhill checks on them. Whilst SB had clearly checked 4A's VAT number before, there is no evidence that it tried to check Pateo's Portuguese VAT number until 5 July 2006, the day after the first four deals (when it sent a fax to HMRC's Redhill office, receiving a reply on 7 July 2006 which confirmed Pateo's VAT registration). It sent a further check request on 18 July 2006 (the day after the SatNav deals), receiving a reply on 24 July 2006. To the extent relevant (which Mr Chester considered small) SB relied on the commercial checks on Mighty Mobile

carried out by 4A. SB also instructed UHY Hacker Young to carry out basic Companies House checks on 4A.

209. In addition, SB received from Pateo a fax dated and timed 4 July 2006 at 13.40 which included a "Model: Letter of Introduction" dated February 2006, some translated company information and a copy of Pateo's VAT registration certificate in Portugal. Mr Harris forwarded this pack to UHY Hacker Young on the same date, with the following fax:

> "Dear Christian
>
> Please see attached copies of Patio Iberico LDA, a company based in Portugal who we will be trading with. Please complete the due diligence checks as fast as possible."

210. In response to this fax, it seems that UHY Hacker Young sent a further fax to HMRC's Redhill office asking for confirmation of Pateo's Portuguese VAT number, but there was no evidence before us that they had done anything else.

211. In short, beyond establishing at some time around the commencement of trading that its supplier and customer both existed and had VAT numbers, SB took no significant steps to establish any further detail about them. According to Mr Chester, this was on the basis that the supplier was well known to SB and the customer was not really SB's customer due to the fact that SB was simply financing the VAT cost of what it saw as 4A's sale to Pateo. Mr Chester's argument was that if the transactions had been fraudulent, SB would have made very sure that "all HMRC's boxes were ticked" and the paperwork would not have been dealt with as lackadaisically as it was.

*The process of agreeing and implementing the trades*

212. Mr Chester was somewhat vague about this, presumably because he was not closely personally involved. He asserted that the negotiations for the trading may well have been going on for some time before it actually took place. Mr Harris (who dealt with the detail) did not give any evidence.

213. The main contemporary evidence before us on this point was a fax dated 3 July 2006 from Mr Harris at SB to Pateo. The full text of that fax was as follows:

> "Re: New Stock offer
>
> Dear Jeff
>
> Please find additional stock for your consideration.
>
> 4500 x Ipod-30GB Black/Video with 2.5 Colour display @ £184.60 each
> 4850 x Ipod-4GB Black/Video @ £142.40 each
> 4800 x Ipod Nano 4GB White @ £142.45 each
> 2475 x Ipod Nano 1 GB White @ £83.35 each

> We would need an urgent response on this stock to secure it.
>
> Many thanks and look forward to your reply
>
> Best Regards
>
> Regards
>
> [Signature]
>
> Bruce Harris
>
> Director"

214. This fax has a number of oddities. First, it misspells the name of its intended recipient (who was Geoff, not Jeff Cook at Pateo). Second (and most crucially) its wording is entirely inconsistent with what Mr Chester described as SB's business model. If SB was simply providing export finance by funding the VAT cost on a sale that was already arranged between Pateo and 4A, it would be expected that this first contact would refer to the deal between Pateo and 4A in some way; it would certainly not have been headed "New Stock offer"; it would not have been offering "additional stock for your consideration" and it would not have required "an urgent response on this stock to secure it". It should be remembered that, on Mr Chester's evidence before us, SB's sole business model was export finance and therefore this could not have been some inappropriately used template stock offer from SB's separate "trading" business. We find unconvincing Mr Chester's explanation that the stock offer was simply part of a required "process" in order to document the relationship.

215. There was other conflicting evidence before us as to how the dealings between SB and Pateo came about.

216. On 2 October 2006, Officers Jane Carr and Jayne Meek visited SB. Mr Chester, Mr Harris and Mr Grant Counsell ("Mr Counsell", who had been appointed as company secretary of SB on 17 July 2006) were at the meeting, along with representatives of UHY Hacker Young. At that meeting, Mr Chester explained that SB's involvement in the transactions was simply to finance the outstanding VAT on export sales. The suppliers and customers were seen as belonging to 4A (which was why SB had signed the contractual undertaking not to deal with them without 4A's agreement). It follows from this that SB would simply have been dealing with Pateo at the direction of 4A.

217. In SB's letter dated 16 February 2007, however, Mr Counsell said:

> "In this case we set up the export trade to Portugal, 4A Developments had no knowledge of where the goods would eventually be shipped to and we had no knowledge of where the goods had come from, or how long they had been in the UK."

218. And again, in an email from Mr Harris of SB to HMRC on 19 March 2007, he said:

> "... in fact Spearmint Blue trades on its own behalf, as clearly seen is in this case. Patio in Portugal approached us for goods which we were able to secure from 4A Developments.
>
> This was clearly a buy and sell transaction and nothing to do with financing 4A Developments."

219. Thus there are clearly a number of differing accounts emanating from SB as to how the dealings between SB and Pateo originated. Mr Chester told us they originated through 4A requesting SB's services as "export financier" for overseas trades which 4A had already lined up. The contemporaneous fax seems to suggest that SB obtained some kind of offer of the stock from 4A and then originated the sale itself by approaching Pateo as a potential customer. In SB's letter of 16 February 2007, Mr Counsell appeared to back this view up, but in Mr Harris's email of 19 March 2007, he said Pateo had approached SB for the goods.

220. In passing, we note that in both the 16 February 2007 letter and the 19 March 2007 email, Mr Counsell and Mr Harris contradict the evidence given before us by Mr Chester to the effect that SB's sole business model was what he termed "export finance" for deals which had already been lined up. We consider that the constant margins made by SB on every one of the deals with 4A indicate either that the deals were wholly artificially contrived (which could only have been for fraudulent purposes) or that they were made pursuant to the "export finance" model with 4A at the agreed margin. Either way, we do not consider they could have arisen in genuine arms' length trading.

221. Finally, we note that the SatNav units that were eventually traded on 17 July 2006 were comprised in a "New Stock offer" fax dated 11 July 2006 from Mr Harris at SB to Geoff Cook (and this time the name is spelt correctly) at Pateo. The format of this fax is identical to the fax dated 3 July 2006 relating to the iPods (subject to the obvious necessary changes concerning the goods involved). Our above comments concerning the origination of the iPod deals of 4 July 2006 therefore apply equally to the SatNav deals on 17 July 2006.

*Which parties were known to whom?*

222. As mentioned above, there is some contradiction in the evidence.

223. Mr Chester gave evidence before us that SB knew the identity of both customer (Pateo) and supplier (Mighty Mobile) of 4A for whom SB was being asked to provide the "export finance". This was necessary in order to satisfy SB that 4A was the importer and therefore there would be no VAT default in the chain of supplies leading up to SB. This tallied with what he told HMRC in the verification meeting on 2 October 2006. However, in his letter dated 16 February 2007 Mr Counsell told Officer Carr that:

> "In this case 4A Developments supplier was overseas and therefore there could be no MTIC fraud, this meant that the name of the supplier was not disclosed."

224. We prefer Mr Chester's evidence and find that SB did know that 4A were buying from Mighty Mobile in Spain.

225. We also find that 4A knew SB were selling to Pateo, indeed they were requesting them to do so.

*Deal documentation*

226. The deal packs assembled by HMRC from the papers obtained from SB and 4A document the chains of sales from Mighty Mobile to 4A to SB to Pateo. They are largely unremarkable, but contain a few unusual features.

227. The most obvious omission is that there were no terms and conditions of sale agreed with Pateo. It transpired that SB were only expecting to pay 4A for the goods once they had themselves received payment from Pateo, but this implies that Pateo would be prepared to pay for the goods well in advance of receiving them, and their payment (measured in millions of pounds) would be made to a company (SB) of no financial substance (all its accounts to that time showed significant losses). SB does not appear to have considered this strange, or asked itself why Pateo should be prepared to take such a risk.

228. In "Deal 1" (the sale of 4,850 iPod Nano 4GB on 4 July 2006), there was some confusion about the model of iPod being sold. It appears to have been partially clarified, but SB's invoice to Pateo includes an incorrect identification of the iPod model being sold. We find it strange that SB should have been so slack about such matters in the context of a transaction to a value of £690,640. It is clear that the error was noticed in earlier documents but it seems the invoice was issued the day before the deal took place with the incorrect specification in it and both parties were content to let the incorrect invoice stand as it did not have any great significance to either party from the commercial point of view. That invoice was actually dated 3 June 2006 (Mr Chester said this was clearly a typo and the correct date should have been 3 July 2006). In its instructions to the freight forwarders to inspect the goods (on 5 July 2006) and to release them for shipping to France (on 6 July 2006), SB continued to refer to the incorrect description for these goods.

229. In "Deal 2" (the sale of 4,500 iPod 30GB Video units) the purchase order to SB from Pateo and the sales invoice to SB from 4A were both dated 4 July 2006, but SB's invoice to Pateo was dated 3 June 2006 (presumably a typing error for 3 July 2006). This error was repeated in "Deal 3" (the sale of 4,800 white iPod Nano 4GB units) and in "Deal 4" (the sale of 2,475 black Ipod Nano 1GB units).

230. In Deal 3, there were again two versions of SB's purchase order to 4A, one of which had an incomplete description of the products (omitting the word "Nano") and the inspection report given to SB by the freight forwarder referred to the goods as being "iPod 4GB White Video" (rather than Nano) – which does not appear to have been questioned by SB.

231. In "Deal 4" (sale of 2,475 black Ipod Nano 1GB units), the invoice from Mighty Mobile to 4A describes them as "white". SB's purchase order to 4A describes

them as "black" (though its stock offer on Pateo on the previous day had described them as "white"). 4A then described them in its sales invoice to SB as "white", but in its stock release note as "black". Pateo's purchase order to SB specified "black", and SB invoiced them to Pateo as "black". The inspection report says they were "black". So SB initially offered the goods as "white" (which is how they were described in the invoices from Mighty Mobile to 4A and from 4A to SB) but Pateo specified that it wanted "black" and SB invoiced them as such. The confusion displays a degree of crossover of information from 4A to SB which would not normally be expected, and also an apparent lack of concern by all parties to clarify once and for all exactly what was being sold.

232. Mr Chester gave evidence that the various purchase orders, proforma invoices and invoices were not necessarily delivered in any particular order. It was simply felt necessary to have all the pieces of paper in place at some point in order to be able to tick the necessary boxes in SB's process. Because of the close relationship of trust with 4A, he was not unduly concerned about getting all the documents issued rigidly in the correct order at the right times.

*Transport, storage and insurance*

233. Mr Chester said that SB had simply used the freight forwarders who held the goods when SB bought them from 4A. He said he had made one attempt to inspect their premises, but had not been able to gain access and had left again without seeing anyone. This strikes us as surprising, considering that he relied on them to store and transport SB's goods to the value of approximately £6 million.

234. He also said he was relying on the freight forwarders to insure the goods, but made no effort to check what insurance they held (and there was no evidence of any such insurance in the documents supplied to us).

235. He explained his attitude to these issues by explaining that he saw SB's role as taking ownership of the goods for only a very short time, and effectively having no risk because it would not be paying for the goods until it had received payment (and if it did not receive payment, it would be able to cancel the transaction without difficulty). This does not fit comfortably with SB's obligations under its "Preferred Supplier" Agreement with 4A, under which it expressly assumed responsibility for costs of insurance, transport and any inspections (as well as product warranty claims).

*Payment*

236. HMRC had obtained extensive evidence as to the payments made for the various transactions, mainly from the records of FCIB itself which had been seized by the Dutch authorities. From this, it emerged that:

> (1) Apart from SB's payment to 4A of part of the VAT element of 4A's invoices (which was dealt with through SB's Royal Bank of Scotland bank account), all payments were made by direct transfer between the accounts of the various participants held at FCIB.

(2) Payment for all eight transactions started with a company called Andrevias in Romania and circulated in the order Andrevias – Pateo – SB – 4A – Mighty Mobile – Andrevias.

(3) In many of the transactions, the payment was circulated in instalments, therefore needing to circulate two or three times before the related invoices were paid off.

(4) All the payments for deals 1 to 4 (which took place on 4 July 2006) were made on 4 July.

(5) All the payments for deals 5 to 8 (which took place on 17 July 2006) were made on 19 July 2006.

(6) The money received by SB through FCIB was insufficient to pay its liability to 4A (because although SB received money including its 5.5% profit margin over what it owed to 4A, it also had to pay 4A the 17.5% VAT which it was funding). SB therefore simply paid on to 4A through FCIB all the money that it received from Pateo, leaving the balance of the VAT outstanding, to be settled separately.

(7) SB made two payments to 4A from its Royal Bank of Scotland account. The first (£267,384.11) was made on 5 July 2006. For reasons which are unclear, it was £7,010.27 less than the outstanding VAT balance of £274,394.38. The second (£385,997.49) was made on 20 July 2006. For reasons which are unclear, it was £33,705.86 less than the outstanding VAT balance of £419,703.35.

(8) On the 8 deals in question, 4A's gross profit was £29,692, yet SB apparently underpaid 4A by £40,716.13. Mr Chester was not asked why this should be, nor is it apparent from any of the documents before us.

(9) SB also paid freight forwarders' costs (mainly transport but also inspection) totalling £12,000 plus VAT. The costs of £3,000 plus VAT for the first four deals were paid on 21 July 2006 and the costs of £9,000 plus VAT for the last four deals were paid on 7 August 2006.

(10) The payments which have been evidenced by the FCIB material reflect exactly the known invoice prices between Mighty Mobile and 4A, between 4A and SB and between SB and Pateo. We see no reason to suppose that the payments from Andrevias to Pateo and from Mighty Mobile to Andrevias will not also reflect the invoice prices between them respectively.

237. Officers Lesley Camm and David Young of HMRC carried out an exercise of establishing more detail of the payments made through FCIB in a random selection of four of the eight deals in question. This exercise was based on information obtained from FCIB's "Paris server", which had recently been made available to HMRC for the purposes of civil proceedings. The deals in question were those numbered 1 (though

Officer Camm had numbered this deal as 2, probably more accurately as shown by the invoice numbers), 4, 6 and 8. We consider their findings in relation to each of these deals in turn.

Deal 1

238. In deal 1, Andrevias transferred a first instalment of £210,000 to Pateo at 16:36:06 (it is not clear what time zone the server clock was set to, but it is the comparative times, rather than the actual times, that are important). That same amount was transferred to SB at 16:48:17. At 17:03:37, Mr Chester logged onto the system and he then logged off again at 17:10:35. He presumably saw that the money had arrived and needed to be transferred on, but it is not clear why he did not do so himself. Instead, Mr Harris logged onto the system (from a computer with the same IP address as Mr Chester) at 17:10:57 (some twenty seconds after Mr Chester logged off); he transferred the money on to 4A at 17:12:19 and then logged off at 17:13:09. Mr Morton, in the meantime, had logged onto the system at a different computer at 17:04:08 (some thirty seconds after Mr Chester had first logged on) and the money had been in 4A's account for about thirty minutes before he transferred it on to Mighty Mobile at 17:45:26. A Mr Gromer of Mighty Mobile logged onto the system at 17:45:30 (four seconds after Mr Morton had sent the money to Mighty Mobile) and sent it back to Andrevias at 17:51:19 (within six minutes of receipt).

239. Within another six minutes, Andrevias (a Mr Iascov, who had logged onto the system at 17:48:41, three minutes after Mr Gromer of Mighty Mobile had done so) transferred a second payment of £481,610 to Pateo at 17:57:10. Just over six minutes later (at 18:03:14) Mr Cook of Pateo had transferred it (less his profit margin) to SB. Mr Chester logged onto his system at 18:25:21 (some 22 minutes later) and transferred the amount he had received to 4A at 18:27:08. Mr Morton logged onto his system at 19:25:36 (nearly an hour later) and less than eight minutes afterwards (at 19:33:06) he transferred the relevant balance to Mighty Mobile. Mr Gromer, who had been logged on since 18:52:46 (some forty minutes) transferred the relevant balance back to Andrevias at 19:42:04 within nine minutes of receiving it.

240. In the money flows related to deal 1, Andrevias paid out £691,610 and it received back £650,385. The difference of £41,225 represents the profits made (and retained) by the various participants in the circle of transactions. Those profits accrued as follows:

(1) SB: £35,890 (but if SB's VAT repayment were to be denied, this apparent profit would turn into a loss of more than double that amount)

(2) 4A: £3,395

(3) Pateo: £970

(4) Mighty Mobile: £970.

Deal 4

241. Deal 4 involved only one single payment moving in a circle. It was started by Mr Iascov of Andrevias at 20:54:07. Mr Cook of Pateo logged on at 21:04:39 and transmitted the full amount (less his profit margin) to SB at 21:12:02. Mr Harris had been logged on since 20:30:58. He presumably saw that the money had arrived and then logged off at 21:18:15. In less than 25 seconds (at 21:18:38) Mr Chester had logged on at the same IP address and transferred the money on to 4A within three minutes (at 21:21:02). He then logged off at 21:23:33 and less than a minute later Mr Morton logged onto 4A's account from the same IP address (at 21:24:23). He transferred the relevant amount on to Mighty Mobile less than six minutes later (at 21:30:18). Mr Gromer of Mighty Mobile logged onto its account at 21:34:29 (less than four minutes after the money had been transferred to it) and sent the final payment in the circle back to Andrevias less than 5 minutes later, at 21:39:02. Thus the money had moved around the five stages of the complete circle in well under an hour.

242. When asked how it happened that Mr Morton logged onto 4A's account from the same IP address as Mr Chester had used to log onto SB's account, Mr Chester said Mr Morton was on site at the time by coincidence – his wife stored furniture for her shop at SB's premises and they were probably sharing a glass of wine. He thought that either he or Mr Harris had told Mr Morton verbally that the money had arrived.

243. In the money flows related to deal 4, Andrevias paid out £207,157.50 and it received back £193,545. The difference of £13,612.50 represents the profits made (and retained) by the various participants in the circle of transactions. Those profits accrued as follows:

(1) SB: £10,766.25 (but if SB's VAT repayment were to be denied, this apparent profit would turn into a loss of more than double that amount)

(2) 4A: £990

(3) Pateo: £866.25

(4) Mighty Mobile: £990.

Deal 6

244. In deal 6, three separate payments moved around the same circle of participants. The second payment (of £300,000) was initiated by Andrevias before the first payment (of the same amount) had been received back by it. However, both those payments had travelled the full circle before the final payment of £414,000 was sent by Andrevias.

245. The first payment reached SB's account at 12:21:16 on 19 July 2006. At 13:25:45, Mr Chester logged into SB's account. He obviously saw that the money had arrived and, curiously, once again logged out (at 13:34:22) without doing anything further. Mr Harris logged in from the same IP address less than half a

minute after Mr Chester logged out, immediately transferred the money on to 4A's account and logged out again at 13:36:18. Mr Morton did not log into 4A's account until 16:11:13 and transferred the money on to Mighty Mobile within seven minutes (at 16:18:03).

246. Andrevias initiated the second payment of £300,000 to Pateo at 15:36:15, while the first payment was still sitting in 4A's account. This second payment reached SB's account at 15:48:14. Mr Chester did not log into SB's account until 16:43:29, but he immediately transferred the money to 4A himself this time, at 16:45:07. Mr Morton logged on at 16:54:20, saw the money was there and transferred it on to Mighty Mobile within six minutes 9at 17:00:11). Mr Gromer of Mighty Mobile had been online since 16:52:27 and transferred it back to Andrevias at 17:09:02.

247. The third payment was initiated by Andrevias at 16:48:08, when it had received the first payment back and the second payment had just reached 4A's account. That payment reached SB's account at 17:06:08. Mr Harris logged onto its account at 17:19:21 and the money was transferred to 4A at 17:21:15. Mr Morton was already logged onto 4A's account and transferred the money on to Mighty Mobile at 17:30:07. Mr Gromer of Mighty Mobile was already logged in and transferred the money on to Andrevias at 17:39:15.

248. In the money flows related to deal 6, Andrevias paid out £1,014,000 and it received back £954,000. The difference of £60,000 represents the profits made (and retained) by the various participants in the circle of transactions. Those profits accrued as follows:

(1) SB: £52,800 (but if SB's VAT repayment were to be denied, this apparent profit would turn into a loss of more than double that amount)

(2) 4A: £4,800

(3) Pateo: £1,200

(4) Mighty Mobile: £1,200.

Deal 8

249. Deal 8 involved two payments around the same circle, again on 19 July 2006. Andrevias initiated the first payment of £400,000 at 18:27:12. It reached SB's account at 18:36:09. Mr Harris logged into SB's account less than a minute later and must have seen the money was there. Rather than pay it on, he logged out at 18:40:35 and in less than half a minute Mr Chester had logged into the account from the same IP address (at 18:40:57). Mr Chester immediately transferred the money on to 4A (at 18:42:04). Mr Morton logged into 4A's account about half an hour later, at 19:17:54 and transferred the money on to Mighty Mobile about three minutes later (at 19:21:02). Mighty Mobile transferred it back to Andrevias at 19:33:38. Mr Iascov at Andrevias logged into its account at 19:39:59 and initiated the second payment of £462,321.20 at 19:48:04. This was received at SB's account at 19:57:13. Mr Harris

logged into the account at 20:06:17 and transferred the payment on to 4A's account at 20:09:10. Mr Morton had logged onto 4A's account at 20:01:07 and he transferred the amount on to Mighty Mobile at 20:15:03. It reached Andrevias at 20:42:23.

250. In the money flows related to deal 8, Andrevias paid out £862,321.20 and it received back £811,085.60. The difference of £51,235.60 represents the profits made (and retained) by the various participants in the circle of transactions. Those profits accrued as follows:

(1) SB: £44,939.70 (but if SB's VAT repayment were to be denied, this apparent profit would turn into a loss of more than double that amount)

(2) 4A: £4,342

(3) Pateo: £1,085.5

(4) Mighty Mobile: £868.40.

*Passing of ownership to the goods*

251. Mr Chester was unclear about when title to the goods would have passed. He said he had "never given much thought" to the point. It was not covered in the sale documents. He said he "expected" that title would pass upon payment, as a matter of "common sense". Given that payment cascaded from Pateo to SB and on to 4A, this meant that Pateo was parting with payment to SB in the expectation that SB would pass that payment on to 4A in order to obtain title to pass on to Pateo. Mr Chester was not concerned with SB's position as he was confident he could "fix things if Pateo or 4A backed out" by cancelling its obligations to the other of them. This was not reflected in any contractual documents, but Mr Chester did not consider it gave rise to a realistic risk for SB.

*Inspection*

252. The goods in deals 1 to 4 were inspected only on 7 July 2006 (three days after they had been paid for in full). The goods in deals 5 to 8 were inspected on 19 July 2006 (the same day as payment).

*Delivery of the goods*

253. The goods in the first four transactions (which were completed on 4 July 2006) were paid for by all parties in the circle on that day, except for the balance of the VAT due from SB to 4A (which was largely, but not totally, paid on 5 July). It is accepted that the goods were not actually shipped to Pateo at a warehouse in France until 13 July 2006 (they left Dover on an 8pm departure on that day). We find this surprising, especially given that the purchase orders from Pateo stated that delivery was "URGENT". Mr Chester confirmed that SB had never been chased by Pateo for delivery.

254. The goods in the last four transactions (which were completed on 17 July 2006) were paid for by all parties in the circle on 19 July 2006, except for the balance of the VAT due from SB to 4A (which was largely, but not totally, paid on 20 July 2006). The goods appear to have been shipped to Pateo at a warehouse in France on 19 July 2006.

**The facts – the alleged connection to fraudulent evasion of VAT**

*Introduction*

255. HMRC say that the present case is a contra trading situation. They argue that they can therefore establish a connection to VAT fraud either:

> (1) By looking through the contra trader 4A to the original VAT frauds of the suppliers in the "dirty chains" leading up to 4A, or
>
> (2) directly to what they say is the VAT fraud of 4A itself in carrying out its contra trading scheme in order to conceal the original VAT fraud of the fraudulent defaulters in the "dirty chains" of supply leading up to 4A.

*The fraudulent VAT defaults in this case*

Was there VAT fraud by the traders in the supply chains leading up to 4A?

256. HMRC provided evidence of a number of fraudulent evasions of VAT by traders in chains of supplies of various goods leading up to 4A. HMRC's task was rendered difficult by the poor state of the records produced to it by 4A and others involved, but the relevant parts of the picture given by HMRC were not seriously challenged by SB. They did not address the point at all in their closing submissions (i.e. they did not indicate that it was still in dispute) and Mr Chester accepted in cross examination that there was clearly "an attempt" at tax fraud in the dirty chains leading up to 4A. We find fraudulent evasion to have been established, as follows.

257. During its accounting period July to September 2006, 4A carried out 3 deals in which it bought from a UK supplier and sold to an EU customer. These three deals would, on their own, have generated a net VAT repayment claim of £1,012,391.45. (Originally, 4A claimed to have carried out a further five such deals, generating a VAT repayment of a further £4,162,375, but it was established by HMRC that these deals had in fact not gone ahead.)

258. During the same accounting period, 4A carried out 11 deals in which it bought from an EU supplier and sold to a UK customer. Eight of those sales are those involved in this appeal. Those eight sales to SB generated £1,012,011.18 of output VAT and the other three sales (to a company called Chatterbox UK Limited) generated £251,152.66 of output VAT.

259. 4A should therefore have been paying a net VAT amount for the three months to 30 September 2006 of £250,772.37 in respect of these transactions, but its VAT return claimed a repayment of £2,497,225.45. It has not been possible to reconcile the

VAT return made by 4A with the other information supplied to HMRC by it and by other traders.

260. In the three deals in which 4A purchased from a UK supplier, the supplier in question was a company called Woodworks (Sheffield) Limited. The deals, all of which were invoiced to 4A on 4 July 2006, were as follows:

| Goods | Price ex VAT | VAT |
|---|---|---|
| 1520 x Hewlett Packard NW8240 PG818ET | £2,287,600 | £400,330 |
| 1512 x Sony Vaio TX2X P/B | £1,903,608 | £333,131.40 |
| 1267 x Sony Vaio TX297XP/VGN | £1,593,886 | £278,930.05 |
| **Totals** | £5,785,094 | £1,012,391.45 |

261. HMRC were able to trace the chain of supply for the first two of these deals back to a company called DTM Provisions Limited ("DTM"). This company was registered for VAT with effect from 1 March 2006. It had described its business as "supply of catering supplies". There were four verbal contacts between HMRC and an individual who called himself Dax Leroy James Robateau around the time of DTM's VAT registration. HMRC visited DTM's supposed principal place of business on 27 and 28 June 2006 but were unable to speak to anyone. They left a calling card or letter, in reply to which a telephone call was received from an individual who called herself Natalie Edwards. She claimed not to be an employee of DTM, but was visiting the premises to check the post on behalf of its Director, a Mr Pearce, who was supposedly away on holiday. An appointment was made to meet Mr Pearce, but an individual using that name called to cancel the appointment, saying he had nothing to do with DTM.

262. DTM never submitted any VAT returns. It was compulsorily de-registered for VAT in June 2006 and assessments were raised against it by HMRC totalling some £23.5 million, based on the information obtained about DTM's supplies from other traders. An amount of £732,398.80 was included in those assessments in respect of the two supplies purportedly made by DTM to a company called Alartec Limited ("Alartec"). Alartec had supplied the goods to Woodworks.

263. We find that DTM fraudulently evaded payment of the VAT totalling £732,398.80 due on its supplies of the goods to Alartec, which goods were ultimately supplied to 4A and then sold overseas by it in a zero rated sale which would, in the absence of any other transactions by it, have generated a net input tax repayment claim for 4A of £733,461.40.

264. HMRC were unable to trace the chain of supply of the goods in the third of the above deals back beyond Woodworks, due to the lack of any record of the deal in the information supplied by Woodworks. Woodworks did not supply any information to HMRC about deals it carried out after 29 June 2006.

265. Woodworks was incorporated on 23 May 2003. In its application for VAT registration dated 20 January 2004 its principal business was described as "flooring distributor". It was registered for VAT with effect from 1 February 2004. Its VAT returns for the three month periods ended 30 April and 30 July 2004 reflected, respectively, a £248.77 VAT repayment claim (with no taxable supplies made) and nil. It then rendered no returns until it rendered a return for the 15 month period from 1 August 2004 to 31 October 2005. That return reflected a net VAT liability of £200.17, but made up of output tax of £58,991.10 set off by input tax of £58,790.93. It transpired that Woodworks had recently changed hands and the new directors had started to carry out wholesale trading with a first deal taking place on 18 October 2005. In that deal, they had bought and sold some diabetic testing strips – both supplier and customer being UK traders. It was established at a visit in November 2005 that Woodworks knew nothing about the products, or even whether they were licensed for use in the UK.

266. The volumes of Woodworks' trading increased rapidly. In its VAT return for the three months to the end of January 2006, Woodworks reported that it had made £50.7 million of sales and £44.5 million of purchases. Large volumes of trade with EU traders were involved, the net result being a VAT repayment claim of £141,781.30. In its April 2006 return, the reported sales and purchases had grown to £96.8 million and £94.9 million respectively, though the result was a net VAT liability of just £10,309.63; EU trade was £14.8 million and £13 million (sales and purchases respectively). In its July 2006 return, the sales and purchases had grown again to roughly £100.9 million each, with EU trade more than £10 million in each direction; the end result was a net VAT repayment claim of £8,039.42.

267. Woodworks identified 111 deals done by it during its VAT period for May, June and July 2006. In eight of them ("acquisition deals"), it bought from EU suppliers and sold to UK customers. In seven of them ("broker deals"), it bought from UK customers and sold to EU suppliers. In the other 96 ("buffer deals"), it bought from and sold to UK traders.

268. Solely through information provided from other traders, HMRC were able to trace a further 42 deals by Woodworks on 30 June 2006 and during July 2006. The supplier to Woodworks is only known in 22 of those deals (not including the third deal listed in the table at [260] above). Woodworks has failed to respond to HMRC's requests for further information to clarify matters and neither it nor its director or manager can now be traced.

269. Clearly in the eight acquisition deals reported by Woodworks, HMRC did not trace the supply chains back to any UK VAT loss. In the seven broker deals, they traced all the supply chains back to a fraudulent VAT loss incurred through the use of a hijacked trader VAT registration. Of the 96 buffer deals, the majority traced back to fraudulent VAT defaults.

270. In the circumstances, we are satisfied on a balance of probabilities that the third deal referred to in the table at [260] above is connected either with a fraudulent default by a trader earlier in the chain of supply to Woodworks or with the fraudulent

contra-trading activities of Woodworks itself (which almost exactly matched its reported VAT input and output liabilities for both its 04/06 and 07/06 periods notwithstanding total reported sales of £197.6 million and purchases of £195.8 million in those two periods, including sales to the EU of £25.6 million and purchases from the EU of £24.1 million).

271. We therefore conclude that, on a balance of probabilities, all three purchases of 4A listed in the table at [260] were connected with VAT fraud committed by traders in the supply chains leading up to 4A.

272. It follows (see [21] above) that we also conclude the eight purchases by SB from 4A which are the subject of this appeal were connected with such fraud.

Was there VAT fraud by 4A?

273. The question also arises as to whether 4A itself was acting as a fraudulent contra trader. If it was, then SB's purchase would clearly be connected to 4A's fraud (see [21] above) and HMRC would be entitled to deny SB its input VAT if they can show that SB knew or should have known of 4A's fraudulent activities. This entitlement would arise irrespective of any difficulties over showing that SB knew or should have known of the original fraudulent defaults.

274. In order to assess whether 4A was acting as a fraudulent contra trader or as an innocent dupe, we have considered first the structure of the eight specific deals the subject of this appeal (and their associated circles of transactions). We have then considered the other evidence as to Mr Morton's activities.

275. First, we find on the basis of the FCIB evidence as to circularity and timing of payments (see [236] to [250] above) that the eight transactions the subject of this appeal were clearly part of eight wholly artificially contrived circular transactions.

276. We do not find it credible that the circular transactions were put together simply to allow profits to be generated in various amounts by all participants in the circle apart from Andrevias, at the expense of Andrevias (which itself initiated the circle and provided the funds for it). There must have been another purpose.

277. We can see no other purpose to the transactions apart from the creation of an output VAT liability for 4A and a corresponding VAT repayment claim for SB, coupled with small profits for 4A, Mighty Mobile and Pateo and a much larger profit for SB (subject to the risk of losing that profit in proceedings such as this appeal). The only motive for such a purpose which we can see would be the enabling of a VAT fraud and the sharing of the rewards arising from it.

278. Clearly the orchestrator of such a scheme would not accept a loss on his own part and the creation of a profit elsewhere in the scheme unless either (a) there are arrangements of some kind in place for the profit to be returned to him or (b) the orchestrator is thereby enabled to generate a separate (and presumably larger) profit of his own.

279. In a case such as the present, the only means of extracting a larger profit from the structure than that realised by SB is through using the contra trading concept to shelter 4A's profits from attack by HMRC. If by contra trading 4A were able to realise in cash a much larger profit on its other "broker deals" without HMRC being able to stop it, then by taking most of that larger profit Andrevias would be able to recoup its loss on the circular transactions and still make a handsome profit.

280. It follows that the only rational explanation of the existence of the circular structure is that it was intended to benefit one or both of SB and 4A and it was agreed between the participators that the benefit was to be shared in some way with Andrevias, to compensate it for the loss which it made on the circular transaction as well as to give it some share in the overall profit of the scheme.

281. At least one of SB and 4A would have to be involved in that agreement with Andrevias, but not necessarily both of them. It may well be that in the context of a circular scheme which realises in total a fraudulent profit of say 15% of the original investment (funded by a 17.5% VAT refund from HMRC), Andrevias would be prepared to see 5.5% go to an innocent "stooge" (SB) if that had the effect of converting Andrevias's risky 15% profit into a much safer 9.5% profit.

282. Thus the circular structure of the scheme does not on its own necessarily imply that 4A (or indeed SB) must have been a knowing participant in the overall scheme (although other factors may point to such a conclusion). It does however, in our view, mean that at least one of SB and 4A must have been such a knowing participant. Thus if SB was not a knowing participant in fraud, we consider that the nature of the structure itself implies that 4A must have been.

283. There are of course many other factors to be borne in mind when assessing the state of knowledge of 4A (and indeed of SB). As is generally the situation in such cases, there is no definitive and conclusive piece of evidence, no "smoking gun" which clearly shows one or other of them to have been a knowing participant in the overall fraud. It is a matter of drawing inferences from the evidence as a whole.

284. When considering the question of whether 4A was a knowing participant in the overall fraud, we have considered the overall picture emerging from the evidence before us. No one part of the picture is determinative but we find the overall picture wholly convincing.

285. Mr Morton had a prior conviction for dishonesty. He told some people (but not others) that he had been a special branch police officer. He did not appear before us to give evidence, or even provide a written statement. He clearly misled HMRC when applying for VAT registration for 4A and afterwards. He managed 4A's trading (at least until it seems to have become simply too large for him to manage properly) in a way which, incredibly, brought its input and output VAT into near perfect equilibrium on sales measured in tens of millions of pounds. He described himself to HMRC as having been responsible for arranging SB's financing while he was still with them. Having been attempting and largely failing for nearly three years to arrange wholesale trading/export finance whilst at SB, within a matter of weeks of

starting 4A he was dealing in massive and quickly growing amounts. 4A's VAT return for its quarter to June 2006 was wildly inaccurate (as indeed was its return for the quarter to September 2006, in which it failed to declare £5.9 million of EU sales and £10 million of EU purchases). The nature and extent of 4A's trading is simply incredible for a legitimate business from a standing start.

286. Viewing in the round all of the evidence of his activities, we find as a fact that Mr Morton (and, through him, 4A) was a knowing participant with Andrevias in the overall fraudulent scheme. It follows that we consider on a balance of probabilities that 4A was a fraudulent contra trader.

*Did SB actually know or should it have known of either fraud?*

Introduction

287. We have found that there was fraud in the chain of supplies leading to 4A (see [271] above) and that 4A itself was a participant in fraud (see [286] above). SB's purchases were connected to both frauds (see [21] above). In order to establish whether HMRC are entitled to deny SB's input tax entitlement, the crucial question to be decided is therefore whether SB knew or should have known of either fraud.

288. In considering this question, we follow the approach taken by the Tribunal in *Brayfal* (approved by Lewison J in the Upper Tribunal at [11]):

> "...[i]n determining what it was that the taxpayer knew or ought to have known the tribunal is entitled to look at the totality of the deals effected by the taxpayer (and their characteristics), and at what the taxpayer did or omitted to do, and what it could have done, together with the surrounding circumstances in respect of all of them."

And then again:

> "The object of the exercise is to paint a picture from the accumulation of detail. The overall effect can only be appreciated by standing back from the detailed picture which has been painted, by viewing it from a distance and by making an informed, considered, qualitative appreciation of the whole. It is a matter of evaluation of the overall effect of the detail, which is not necessarily the same as the sum total of the individual details. The details may also vary in importance from one situation to another. The process involves painting a picture in each individual case."

Did SB know of either fraud?

289. Having found that 4A was a knowing participant in the fraudulent scheme, and that for the scheme to operate it was only necessary for one of 4A and SB to be a knowing participant, we must reach a conclusion about SB's knowing involvement based simply on inference from the other evidence before us and from our assessment of Mr Chester as he gave evidence; the structure of the scheme itself does not give rise to any adverse inference.

290. Before doing so, however, we must address a point made in SB's closing submissions which has a bearing on this issue.

291. In written closing submissions on SB's behalf, its advisers (who had not attended the hearing) submitted that HMRC had not alleged in the statement of case that SB was a dishonest conspirator. They went on to assert that:

> "The Commissioners have not pleaded a case against the Appellant in conspiracy, nor was any such case advanced by the Commissioners at the hearing, nor was any such case put to the Appellant, nor was there any evidential base on which such a case could be put forward (and, for the avoidance of doubt, any such case would need to have been pleaded, advanced and put "fairly and squarely" on the basis of sound evidence)."

292. We take this submission as effectively arguing that since HMRC had not specifically pleaded and put their case on the basis of "conspiracy", it was not now open to the Tribunal to find the SB had actual knowledge of any fraud.

293. We consider this misses the point. The relevant legal test is not whether SB is guilty of conspiracy; it is whether it knew or should have known of the connection to fraud. HMRC's case throughout has been that SB either knew or should have known of that connection.

294. In HMRC's original decision letter dated 28 August 2007, they said:

> "The Commissioners are satisfied that the transactions set out in the attached appendix form part of an overall scheme to defraud the revenue. The Commissioners are also satisfied that there are features of those transactions, and conducted on the part of Spearmint Blue Ltd, which demonstrate that you knew or should have known that this was the case."

295. At paragraph 1 of the statement of case, HMRC said:

> "...The Commissioners grounds for this decision *[i.e. the decision to deny entitlement to input tax]* are that the input tax incurred by the Appellant was done so in a transaction or transactions connected with the fraudulent evasion of VAT and that the Appellant knew or should have known of this fact."

296. In paragraph 3 of HMRC's skeleton argument, they said:

> "... The transactions are therefore connected to a fraudulent tax loss and the Appellant knew or should have known that the transactions were connected with fraudulent evasion of VAT."

297. In addition, on numerous occasions during the hearing Mr Mandalia put it to Mr Chester that his actions (or omissions) were explained by the fact that he was well aware the transactions were all contrived.

298. We therefore do not accept SB's submission that a finding of actual knowledge of fraud on the part of SB is not open to the Tribunal.

299. So the question must be addressed: did SB have actual knowledge of either fraud that we have found?

300. First, we should reiterate that there are no primary facts that we have found which give rise to an irresistible inference that SB must have known of either fraud.

301. There are however a number of facts which could be taken to indicate such knowledge. These largely emerge from our findings of fact set out above, and include the following:

(1) Mr Chester initially insisted that mobile phone trading was no part of SB's planned activities, but the evidence quite clearly demonstrates that it was (as he was forced to admit).

(2) He downplayed the true level of his involvement in mobile phone trading activities while he was at MDS.

(3) He initially distanced himself from SB's incorporation and VAT registration application, which was done in a way which we found to be intentionally misleading.

(4) The financing for SB came through a source, in amounts and on terms which are all highly suspicious.

(5) Mr Chester was very well aware of the prevalence of fraud in export transactions generally (and not just in relation to mobile phones and computer parts) through SB's own experience and yet he continued to be involved in it.

(6) SB's approach to research on its trading partners and proper attention to its terms of trading and the practical details of its trading was lackadaisical in the extreme.

(7) Specifications of the goods being sold appeared to be changeable and unresolved mismatches between what was specified, what was sold and what was inspected do not appear to have caused any concern.

(8) Mr Chester was entirely confident that any problems that arose from SB's trading could be managed by the simple expedient of "cancelling" deals (which appears inconsistent with the concept of true arm's length trading).

(9) The documentation surrounding the eight deals under appeal was worded in a way which was entirely inconsistent with the way in which Mr Chester said SB did business.

(10) SB did not take any steps to check that the goods were insured, even though that was one of the very few responsibilities that it actually undertook in its agreement with 4A.

(11) There was obvious close coordination with Mr Morton and others in the payments that were made for the deals under appeal, with a number of suspicious features in relation to timing and shared use of an IP address.

(12) SB closed its eyes to the fact that it had only been able to put together a handful of "export finance" deals during its long period of operating in that market (due, Mr Chester said, to its discriminating and careful approach to finding trading partners) and yet Mr Morton seemed to have been able to generate a large number of such deals for it as soon as he started business through 4A.

(13) SB did not question the fact that the deals under appeal did not even require SB's export finance support (as 4A was acquiring the goods, as SB well knew, on a VAT free basis and therefore had no need of export finance to cover the VAT cost).

302. On the other hand, however, there are certain facts which tend to suggest that SB was not a knowing participant. Most significantly, there was a significant length of time when SB had large amounts of funding in place and would have been financially well able to carry out a large volume of "export finance" deals but did not do so. Mr Chester said this was because he was unable to get comfortable with most of the prospective trading partners he spoke to. Whatever the actual reason, the fact remains that SB had the ability to carry out many more deals than it actually did. If it had been a knowing participant in a VAT fraud scheme, we would have expected it to have carried out much greater levels of exporting activity while it had the ability to do so. Additionally, a certain degree of inattention to the normal commercial details might perhaps be understandable (though not excusable) in a situation where a trader acts as little more than a middleman in a pre-arranged transaction between two other parties in order to provide bridging finance for the VAT cost of that transaction.

303. The burden lies on HMRC to establish that SB knew or should have known of one or other of the underlying frauds. Whilst there is some evidence to support a finding of actual knowledge, we have found that evidence insufficient to discharge the burden that lies on HMRC in relation to actual knowledge. We therefore find that SB's actual knowledge of fraud is not proven.

Should SB have known of either fraud?

304. But that is not the end of the matter. The next question to address is whether SB should have known of either of the frauds. This is obviously a qualitatively different question from the question of actual knowledge, and a different range of evidence will be relevant to it.

305. SB's closing submissions addressed the question of knowledge and what could be called "means of knowledge" at some length. They cited the comments of

Lewison J in *Brayfal* and the Chancellor in *Blue Sphere Global* extensively. At the heart of their submissions was the following passage from Lewison J's judgment in *Brayfal* at [16]:

> "Where the impugned transactions are transactions in the clean chain, this presents evidential problems for HMRC. As the Chancellor pertinently asked in *[Blue Sphere]*: how can a trader who is not part of a conspiracy *know* of a fraud before it happens? If there is a regular course of conduct in which the trader knows that his transactions are connected with subsequent transactions that he knows ex post facto are fraudulent, there may come a time at which he can be credited with knowledge of the future. But that is not the case that HMRC advanced in this case."

306. SB submits these comments apply equally to the present case. In *Brayfal* the Tribunal accepted the appellant's evidence that it "could only check Brayfal's own customers and suppliers.... In other words they found that he had no knowledge or means of knowledge of the dirty chain." Lewison J was not prepared to interfere with this as a finding of fact. SB submits we should reach the same conclusion – i.e. that since SB was in the clean chain, it would have no means of knowing of any fraud in the dirty chain.

307. The first point to make about these submissions is that in the Court of Appeal in *Blue Sphere* (where the contra trader was not acting fraudulently), Moses LJ came close to overturning the Chancellor's view that the Tribunal's findings were insufficient to establish "means of knowledge" of connection with fraud. He pointed out that the Tribunal came "very close" to making a finding that "the only reasonable explanation for the circumstances in which it entered into the impugned transactions was that those transactions were connected with fraud", and he said that the only reason he stepped back from reaching that conclusion himself was because the findings of the Tribunal included references to the "risk" of connection to fraud and because of the Tribunal's:

> "undue focus on whether Mr Peters *[Brayfal's Managing Director]* had exercised due diligence or done 'enough to protect himself'. That is not the only question."

Moses LJ went on to say (at [76]):

> "Accordingly, the importance of BSG may be in the Tribunal's recognition of the surrounding uncommercial circumstances which it identified in the questions I have set out above."

308. The questions to which Moses LJ was referring related to the wider commercial context of the deals, rather than the standing of BSG's counterparties in those deals. In other words, Moses LJ was giving a very clear indication that in assessing "means of knowledge" in contra trading cases, it is appropriate to look at the overall circumstances of the trading (in particular, "surrounding uncommercial circumstances") and not just focus on the question of "due diligence" in relation to

trading counterparties. To the extent these comments of Moses LJ conflict with the observations of Lewison J in *Brayfal*, we should clearly follow the higher authority.

309. To conclude otherwise would fly in the face of the wording of the *Kittel* decision itself. As has been made clear on many occasions since *Kittel*, means of knowledge of fraud can be inferred in many different ways. As Moses LJ said in *Mobilx* at [82]:

> "But that is far from saying that the surrounding circumstances cannot establish sufficient knowledge to treat the trader as a participant. As I indicated in relation to the BSG appeal, Tribunals should not unduly focus on the question whether a trader has acted with due diligence. Even if a trader has asked appropriate questions, he is not entitled to ignore the circumstances in which his transactions take place if the only reasonable explanation for them is that his transactions have been or will be connected to fraud. The danger in focussing on the question of due diligence is that it may deflect a Tribunal from asking the essential question posed in *Kittel*, namely, whether the trader should have known that by his purchase he was taking part in a transaction connected with fraudulent evasion of VAT. The circumstances may well establish that he was."

310. It follows that it is perfectly possible to establish that a trader knew or should have known of a connection to fraud before that fraud actually happens; Moses LJ saw no difficulty with that concept in *Mobilx* when he said (at [62]):

> "The principle of legal certainty provides no warrant for restricting the connection, which must be established, to a fraudulent evasion which immediately precedes a trader's purchase. If the circumstances of that purchase are such that a person knows or should know that his purchase is or will be connected with fraudulent evasion, it cannot matter a jot that that evasion precedes or follows that purchase. That trader's knowledge brings him within the category of participant. He is a participant whatever the stage at which the evasion occurs."

311. And we should not forget that this chronological awkwardness arises just as much in cases where no contra trading is involved – in many such cases, the fraud of the defaulter postdates the purchase of the broker and this has given rise to no difficulties in such cases.

312. It is also clear that for HMRC to succeed, it is not necessary for them to show that SB knew or should have known of the particular fraud which, in the end, is found to have taken place. See the comments of Briggs J in *Megtian* referred to at [9] above.

313. We therefore do not accept SB's submission that there is any special evidential hurdle arising for HMRC as a result of this being a contra trading case. The *Kittel* test remains the same, and we simply apply it.

314. Having dealt with the submissions raised by SB, we now turn to the question of whether SB should have known of the connection to fraud of its purchases.

315. As we have found above, 4A was acting as a fraudulent contra trader. We have also found that SB was acting purely as "export financier" for 4A in its dealings with it – i.e. SB was simply executing pre-arranged deals which had already been lined up between 4A and Pateo, rather than generating its own deals. If it were otherwise, we would have no had difficulty in finding that the way in which SB approached these trades showed it had actual knowledge of the underlying fraud that was taking place.

316. It is axiomatic that for SB to have a legitimate export finance role, there must be a VAT liability which required to be financed. In fact, because 4A had itself acquired the goods free of VAT from another EU trader (Mighty Mobile), there was no VAT liability requiring to be financed on 4A's sale of the goods back to Pateo in Portugal.

317. SB was well aware that 4A had acquired the goods from Spain free of VAT. Mr Chester gave evidence that although he had been aware that 4A had acquired the goods from Spain, he had not understood that this meant 4A had no VAT liability to finance. If this evidence was not true, then SB clearly had actual knowledge of the commercial and financial pointlessness of its involvement in the transaction. But if this evidence was true, then we still find that SB should have been aware that its involvement was commercially and financially unnecessary. SB's business had after all been specifically established (according to Mr Chester's evidence) in order to provide a financing facility for the VAT cost involved in such transactions and as such SB should have had a good working knowledge of the VAT system and how it worked in practice in connection with overseas trade.

318. Given this fact and the other circumstances surrounding the transactions:

(1) the removal of the goods to the UK from a seller in Spain and immediately out again to a buyer in Portugal at significant cost to no obvious advantage,

(2) the fact that SB's customer (with whom there was no long established course of dealing) was prepared to make payments of millions of pounds to SB (a company which had made losses since its incorporation and could not, on any view, be regarded as a sound credit risk) without any real certainty that the goods for which it was paying would indeed be supplied to it,

(3) the fact that (at least in relation to deals 1 to 4) Pateo was prepared to pay in full for the goods before they had even been inspected,

(4) the fact that lack of clarity or actual changes in the specifications of the goods supplied did not seem to concern Pateo,

(5) the fact that (in relation to deals 1 to 4) the required "urgent" delivery was not in fact actioned until nine days after the deal (and payment in full) and yet Pateo appeared unconcerned,

(6) the fact that 4A was apparently achieving major success in generating significant volumes of business in a matter of months operating out of Mr Morton's home, while SB had been trying to generate such activity working from a much more businesslike operation for three years without any real success,

(7) the fact that Mr Chester was well aware from his own experience that VAT fraud was rife, not just in the area of mobile phones and computer parts,

we find that SB should have been well aware that the only explanation for these transactions was that they were connected to VAT fraud, either on the part of 4A itself or on the part of some other person in its chain of supply.

## Conclusion

319. We have found that the eight purchases by SB the subject of this appeal were connected with fraudulent evasion of VAT (see [287] above).

320. We do not consider that HMRC have discharged the evidential burden that lies upon them to show that SB knew of any connection between its purchases and VAT fraud (see [303] above).

321. We are however satisfied that SB should have known of the connection of its purchases to VAT fraud (see [318] above).

322. HMRC are accordingly entitled to deny SB the right to deduct the input tax incurred by it in those transactions and SB's appeal is therefore dismissed.

323. 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.

**KEVIN POOLE**
**TRIBUNAL JUDGE**
**RELEASE DATE: 7 February 2012**