Has the Kittel boiled dry?

Gary Brothers explains how the Kittel principle can lead to HMRC unfairly pursuing innocent parties in a supply chain

Those well versed in, or facing, HMRC's increasingly aggressive VAT fraud challenges using the 'Kittel principle' will find helpful reading in the First Tier Tribunal case of Ronald Hull Junior Ltd (TC/2015/06501).

A 'Kittel' case is where HMRC investigate and challenge any trader in a supply chain of transactions, where the trader themselves have not perpetrated any fraud, but where HMRC still seek to recover VAT on a 'joint and several' liability basis from that trader.

Any actual 'fraud' in question is usually committed by a distinctly separate trader somewhere else in the supply chain.

The difficulty in defending a Kittel challenge is that the basis of the test is a massively subjective test – that the trader *'knew'* or *'should have known'* about fraud in the supply chain. This subjective test, often further in the chain means a taxpayer facing this HMRC challenge is often unsighted and detached from any "fraudulent" transaction, which in turn allows HMRC to investigate, almost on a "nod-and-a-wink" basis, with practitioners or clients, often conceding the point given the apparent difficulty of defending such an unsighted subjective test.

Success at the FTT

There is little doubt that the case of Ronald Hull Junior Ltd (TC/2015/06501) will prove uncomfortable reading for HMRC.

Having been the instructing professionals in this case, we played no small part in a very successful challenge to HMRC at FTT and successfully appealed against decisions by HMRC to deny almost £600,000 of input tax to a metal trader.

It helps to pinpoint why the decision was made in favour of the taxpayer, and the case provides a very useful, concise analysis of the approach HMRC ought to adopt, and in this case properly failed to do, when applying the subjective legs of the Kittel test.

In reaching their findings on the Kittel principle, Tribunal considered the specific requirements for HMRC to deny VAT input tax. While any such denial requires a 'tax loss' at the outset, the other three vital stages found to be necessary by Tribunal, and often overlooked by HMRC, are:

1. That tax loss is *a result of fraudulent evasion* of VAT, and
2. There is a *connection between that fraudulent evasion of VAT and the transactions* on which HMRC have denied the VAT input tax, and
3. If there is such a connection established, only then do we look at whether the trader *knew or should have known* that its transactions were connected with that fraudulent

evasion of tax.

It was accepted in the Ron Hull case that there was a tax loss in the supply chain but far away from the Appellant. Therefore, the Tribunal had to consider each of these points in relation to the Appellant's transactions for which VAT input tax had been denied. We can see these as the three hurdles that HMRC must overcome.

HMRC claimed there were two traders that were traced to supplies to Ron Hull where HMRC tried to deny the input tax – they were 'CCL' and 'BMC'.

CCL: the long arm of HMRC!

Showing the distance from the trader in Kittel cases, HMRC did not claim that CCL were a fraudulent trader.

Instead, they claimed a supplier to CCL was in fact the fraudulent defaulter, but they did not pursue CCL, instead they pursued Ron Hull, who had no knowledge of or contact with whatsoever with the truly defaulting trader.

On analysis if the evidence, Tribunal went so far as to find that this supplier to CCL was not a fraudulent defaulting trader. Of great interest, Tribunal pointed to HMRC as having "produced very little evidence" that this supplier to a supplier of Ron Hull was a fraudulently defaulting trader. Tribunal very firmly placed the onus on HMRC to prove that any supplier was a fraudulently defaulting trader.

While HMRC's contentions fell at the first hurdle – that tax loss was *a result of fraudulent evasion* of VAT - due to the possibility of fraud even further back along the supply chain, Tribunal went on to consider whether there were any connections between the purportedly fraudulent supplies and those made to the Appellant.

Tribunal again found firmly against HMRC. The decision provides a highly valuable insight into the methodology to be applied where HMRC allege fraud in the supply chain.

BMC: a fraudulently defaulting trader

In respect of transactions between the Appellant and BMC, Tribunal found that BMC was, indeed, a fraudulently defaulting trader.

In its decision, Tribunal made clear though that HMRC needed to *"show that there was an intention to default"*. Again, this aspect is often overlooked, that the onus is on HMRC to prove this point and overcome the first hurdle.

So, in the Ron Hull case, Tribunal were satisfied that tests (1) and (2) were met for BMC, which is that (1) there was a tax loss *is a result of fraudulent evasion* of VAT, and (2) there was a *connection between that fraudulent evasion of VAT and the transactions* on which HMRC have denied the VAT input tax.

The third leg then came into play - whether the Appellant *"knew or should have known"* that they were participating in a transaction connected with the fraudulent evasion of VAT. Again, the burden of proof was on HMRC in this respect.

Tribunal found heavily favour of the Appellant again finding that the Appellant did not know and should not or could not have known that its transactions were connected to fraud because:

"…these transactions were in the ordinary course of its business"

"…there was nothing in the transactions themselves that were suspicious."

"(The Appellant) …did not have the means of knowledge to uncover the history of the businesses"

"…further due diligence would not have revealed conclusive indicators of fraud"

Hallmarks of a successful Kittel defence

From the Tribunal's decision we can identify why they found in the Appellant's favour, essentially in two areas:

1. Nature of the transactions

In concluding that the Appellant neither *"knew or should have known"* that the transactions were connected to fraud, Tribunal considered the nature of the transactions in relation to the ordinary course of the business.

It was important here that there is a degree of commonality between the transactions in question with the CCL and BMC traders and transactions conducted by the business with other traders. That is to say, the CCL and BMC transactions were "ordinary business".

There was nothing to mark out the CCL or BMC transactions as out of the norm – the same material was bought from them as would be routinely bought from other suppliers.

2. Levels of Due Diligence

Tribunal considered the due diligence conducted by the Appellant at length and found that, while not perfect, it was certainly sufficient.

More importantly, it explicitly found that any additional due diligence conducted by the Appellant "would not have revealed *conclusive* indicators of fraud."

This is important as Tribunal rightly drew out that case law makes the "should have known" test a very high hurdle, with the Judge stating: "It is not sufficient it was more likely that not that the transaction was connected to fraud. It requires that fraud is the only reasonable explanation."

Of particular note is the commentary surrounding "credit checks", and the clear indication from Tribunal that these would be a largely useless process of due diligence in circumstances where good are being acquired and the trader is the payer, so no credit is in fact extended.

For this point, HMRC continually pointed to the suppliers in question having a nil advised credit rating. Tribunal found emphatically that a nil credit rating was no great helper of evidencing VAT fraud, stating the most that would have been revealed would have been businesses operating with commercial uncertainty and it simply likely that some caution would be taken until a relationship was forged.

It is noteworthy that when considering the due diligence performed, Tribunal also noted the positive history of the Appellant's business in terms of cooperation with HMRC. The Appellant had previously notified HMRC of a suspicion regarding a supplier (without response from HMRC) and that during police investigations around the industry in general, the Appellant was fully cooperative.

Again, it is of interest that the totality of the evidence was considered, not simply that of the transactions relating to the suppliers in question. The importance of cooperation and engaging with HMRC while going about the ordinary course of business is noted by Tribunal in a positive manner.

Conclusion and lessons learned

With Kittel challenges often leaving practitioners over-whelmed and feeling that HMRC have the power-hand, this case is a highly helpful analysis and reminder of the hurdles that HMRC themselves need to successfully traverse to prevail in a Kittel case.

We ourselves remain vigilant to the, sometimes, vague and unreasonable avenues of questioning posed by HMRC officers, and VAT officers in particular.

What Ron Hull shows us is that, for the legitimate trader caught in a supply chain where they are removed from the defaulters or operate to common sense levels of commercial due diligence, there remains scope to persuade, or indeed prevail, if HMRC reach for their subjective Kittel weapon.

***Gary Brothers**, Partner, The Independent Tax & Forensic Services LLP*