VAT deregistration: the nuclear option?

Nicholas McLeman highlights HMRC's powers to tackle VAT fraud throughout supply chains

As HMRC's understanding of fraud and the approach of the Courts in dealing with fraud continues to evolve, landmark cases often shape the scope and direction of how HMRC uses its investigation powers.

One such ground-breaking ruling that has had a significant impact on how HMRC approaches VAT fraud cases was Kittel v Belgium [2006] ('Kittel').

In July 2006, the ECJ released the Kittel judgement, which established that a taxable person's right to deduct input tax will be lost not just where their transactions relate to VAT fraud, but also where that person 'knew or should have known' that their transactions were connected with the fraudulent evasion of VAT conducted by another party.

HMRC have now come to extensively use the Kittel principle to deny taxpayers the right to deduct Input VAT, carrying out continued campaigns within many trade sectors, more recently in the labour supply market.

HMRC often take action against other parties who may or may not be directly involved in the fraud. These supply chain investigations can often arise where the fraudulent party becomes a 'missing trader', disappearing without paying its output tax to HMRC, resulting in its clients being held liable for its fraud.

Our experience has been that HMRC's Fraud Investigation Service has shown a growing interest in this area, highlighted by an increase in the number of VAT fraud cases reaching litigation in the First Tier Tribunal and beyond.

While the Kittel principle exists to recover Input VAT from businesses within a supply chain, HMRC's wider powers in this area can also, in certain circumstances, include deregistering a business for VAT purposes such that it is no longer entitled to have a VAT number, or deny a business its right to register for VAT where that taxable person is solely or primarily committing VAT fraud.

This principle was established in the Ablessio case, released by the ECJ in March 2013.

It is important to note that before a decision to deregister a business for VAT is issued, there must be, or likely to be, a connection to VAT fraud. General non-compliance such as a failure to render VAT returns is not in itself a fraud, unless there is evidence to show that the non-compliance is part of, or is seeking to mask, a wider VAT fraud.

The current impact
In February 2022, the FTT expanded upon the Ablessio principle in its decision in Impact Contracting Solutions Limited [2022] ('Impact').

Impact was registered for VAT in the labour market. HMRC deregistered the company for VAT on the grounds that its VAT registration was being used for fraudulent purposes, citing the Ablessio principle. The company argued that it could not be deregistered under the Ablessio principle as HMRC had not made a direct accusation that the company itself was evading VAT.

The FTT carefully considered the company's representations, specifically whether the Ablessio principle was limited to instances where there was a direct accusation of fraud, or whether the principle also applied where there was a facilitation of another's fraud within the supply chain.

The FTT's decision found that simple facilitation itself is not sufficient for the principle to apply and for a trader to be deregistered. Instead, if a person who facilitated fraud perpetrated by someone else knew or should have known that it was facilitating the fraud of another, then the principle may apply.

The italicised text above has been the subject of much debate by the Tax Tribunal and Courts. Insight has been provided in a number of key cases as to the specific tests that should be applied in determining the scope of Ablessio.

In Megtian Limited [2010], Justice Briggs emphasised the distinction between the 'knew' and 'should have known' tests, stating that: "It is important to bear in mind, although the phrase 'knew or should have known' slips easily off the tongue, that when applied for the purpose of identifying the state of mind of a person who has participated in a transaction which is in fact connected with a fraud, it encompasses two very different states of mind. A person who knows that a transaction in which he participates is connected with fraudulent tax evasion is a participant in that fraud. That person has a dishonest state of mind. By contrast, a person who merely ought to have known of the relevant connection is not dishonest but has a state of mind broadly equivalent to negligence."

The Upper Tribunal further expanded upon the 'should have known test' in Davis & Dann Limited [2013], stating: "This test presents a high hurdle for HMRC... it is not enough that the circumstances of the taxpayer's transactions might reasonably lead him to suspect a connection with fraud; nor is it enough that the taxpayer should have known that it was more likely than not that his purchase was connected to fraud… He should have known that the transactions in which he was so involved were connected to fraud; he should have known that they were so connected because that is the only reasonable explanation that can be given inn the circumstances of the transaction."

In the absence of any positive evidence of direct involvement with fraud, it is the author's conclusion that these principles may only apply if a trader should have known that the only reasonable explanation for the transactions in which they were involved was that they were connected with fraud.

The nuclear option

As would be expected, the impact of these principles, be it a disallowance of Input Tax, or deregistration entirely can be disastrous for businesses. One such example was given in Ingenious Construction Ltd v R & C Commrs [2020]. This case concerned a construction company who specialised in domestic refurbishments who received such a decision.

The Company was supplied labour from a number of defaulting traders who had gone missing, failing to pay over Output VAT to HMRC. After HMRC made the company aware of this and subjected the business to a period of Trader Monitoring in which the business was subject to mandatory monthly discussions with HMRC, a decision was made to compulsorily deregister the Company for VAT.

Due to trading difficulties following the removal of the business's VAT number, the company appealed the deregistration to the FTT and applied for judicial review of the decision to deregister it before the FTT could hear its appeal.

The High Court, however, refused to grant interim relief as it did not consider it has been provided with "independent, compelling evidence of an imminent risk of business collapse".

The company subsequently entered liquidation.

How can businesses avoid the apocalypse?

As per Ingenious Construction, once a decision has been issued, it is unlikely to be reversed until a Tribunal hears the underlying appeal. As the Tribunal's backlog prevents a swift hearing, there can be a severe waiting period which would be difficult for any business to survive.

HMRC have been zealous in their pursuit of supply chain investigations, and we have seen some overly aggressive action taken against multiple businesses within a supply chain where fraud has been identified including instances where action has been taken prematurely, prior to a full investigation being conducted.

It is therefore important for companies to have a good understanding of their supply chain and have safeguards in place to combat this increase in VAT fraud and protect themselves from HMRC action.

Whilst HMRC may take a view and begin to aggressively pursue all parties in a supply chain, each individual case must be considered on its own merits as the facts

behind each party's involvement in the chain will be unique to their own circumstances.

The best mitigator is the introduction of robust controls to reduce the risk of becoming a party to VAT fraud. This includes enacting ongoing due diligence checks on suppliers and customers, undertaken not just as a 'box-ticking' exercise but as a measure to enable the business to make a judgement on the integrity of the supply chain and the suppliers, customers, and goods within it.

Examples of such checks have been provided by HMRC in guidance such as VAT Notice 726; however, each business should consider what level of due diligence is appropriate and proportionate for their own circumstances.

If the Fraud Investigation Service do, however, begin knocking at your door we would always recommend seeking support from an experienced professional advisor so as to begin building the best defence possible at the earliest opportunity.

• Nick McLeman is a Tax Investigation Consultant within Simmons Gainsford LLP's Tax Investigation and Dispute Resolution team. Email Nicholas.McLeman@sgllp.co.uk or call 020 7291 5650