

## Season 5

### Episode 1 – HMRC's approach to supply chain fraud, with Joshua Carey of Devereux Chambers

**Michelle:** Hello, and welcome to the relaunch of RPC's Taxing Matters, your one-stop audio shop for all things tax. Now coming to you on a quarterly basis and brought to you by RPC. My name is Michelle Sloane and I'm a partner in RPC's Tax Disputes and Financial Crime Team. I will be your guide as we explore the sometimes hostile and ever-changing landscape that is the world of tax and tax disputes. Taxing Matters brings you a roadmap to guide you and your business through this labyrinth, helping you navigate new developments, emerging risks and the challenge shaping the tax world today. In case any of you miss any crucial information or just want some bedtime reading, there is a full transcript of this and indeed every episode of RPC's Taxing Matters on our website. So welcome to the new quarterly series, let's get started.

I am delighted to be joined today by Barrister Joshua Carey from Devereux Chambers. Josh is a Barrister at Devereux Chambers in London, called to the bar in 2015. He specialises in complex tax, public law, commercial litigation and business crime matters, working for major corporates, governments and individuals alike.

Before the bar he was a solicitor advocate in Australia. Today we're going to be discussing the topic of supply chain fraud. So firstly, what is supply chain fraud? To start us off, I want to unpack what we actually mean by supply chain fraud in the tax context and outline the typical forms we're seeing in practice.

Supply chain fraud in the tax context generally refers to situations where businesses become involved in, whether knowingly or unwittingly, supply chains that contain fraudulent elements. For example, fraud in the value-added tax chain, goods or services supplied with VAT added, but the supplier disappears without accounting for the VAT to HMRC.

Labour supply fraud this is where PAYE and National Insurance contributions in a labour supply chain are not properly accounted or remitted to HMRC. Fake suppliers, this is where entities are set up merely to generate invoices and divert funds, impersonating legitimate businesses or acting as missing links in the chain.

So, the risk is not only direct fraud but also being drawn into a chain which HMRC then investigates.

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**Michelle:** So, Josh turning to the enforcement landscape, how is HMRC approaching investigations into supply chain fraud and what should companies be aware of in terms of enforcement risk?

**Joshua:** HMRC has clearly flagged supply chain integrity as a higher risk area and is deploying a robust enforcement strategy. Investigations will trace transactions through the supply chain, look for missing traders and fraudulent invoices being issued by various businesses, and then businesses may have their VAT reclaims or the input tax denied on the basis that they knew or should have known that their transactions were connected with fraud, which comes from the European case of *Kittell*, now relatively well known. It also means that if you're getting one of these decisions, penalties can follow and oftentimes now do follow in the [form] of 69C and 69D of the VAT Act. And so they're quite important things to keep in mind because that can be important for directors where the corporate veil is pierced, and can also sometimes lead to directors or the company officers in corporates being prosecuted for failure to prevent type offences, although at the moment they're relatively uncommon, but we expect there to be an increase.

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**Michelle:** I think Josh, when I was dealing with a lot of the MTIC fraud cases back in 2007 to 2012, HMRC often didn't issue penalties, but that's definitely changed now, hasn't it?

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**Joshua:** Yeah, there's definitely been a progression there. They moved away from the Schedule 24 penalties, which still exist for most other heads of tax. But for missing trader fraud and supply chain fraud, they've now imported a specific penalty, which allocates a 30% penalty, whether a company or individual knew or should have known.

That difference goes out the window as long as they can prove one or the other of those things and the penalty can follow on the corporate and then again follows through to the individual.

**Michelle:** Given the sums that are often denied, given the penalties can be starting at 30%, that can lead to quite a significant penalty liability.

I'd now like to talk through some of the signs that can indicate fraud risks within a supply chain. The red flags that I routinely warn clients about include use of cash-based payments or informal labour supply, particularly in high-risk sectors such as construction, labour supply and import-export businesses, where subcontracting is often complex. Suppliers who are new, unknown to the business or have minimal trading history or financial transparency.

So verifying their VAT, PAYE status is much harder.

Also invoices or documentation which look off, e.g. unusually high discounts, unusually large volumes for the size of the supplier, or payment requests being made outside normal procedures.

Another red flag is supply chains with multiple layers or opaque links where it is hard to trace the ultimate supplier of goods or services or verify that the actual delivery occurred. Over generous VAT input tax claims or transactions that don't fit the business's regular activity.

If a business sees these, they should raise their level of security.

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**Michelle:** **Josh moving on to the consequences. If a business becomes caught up in supply chain fraud, even unwittingly, what legal, financial, or reputational consequences can it face, and how does liability work in practice?**

**Joshua:** Yeah, I mean, the consequences can be relatively significant. For VAT, HMRC, as I say, may deny the right to deduct the input tax or make the input tax reclaim, if they're satisfied that a trader knew or should have known the transactions connected with fraud. That can lead to the corporate facing penalties, including relatively large interest claims if these things drag on, even if they are not the fraudsters themselves. And oftentimes, they won't be in fact, they're just part of a chain, or a larger chain, where others in the chain may be the ones actually committing the fraud. But the principal operates relatively harshly. And so, if the trader knows or has the means of knowing, they are deemed to be a participant in the fraud.

There's also, as I have alluded to already, the of knock-on effect to the individual, where if the acts of the individual that led to the wrongly claimed input tax are attributable to that individual, they themselves can have the penalty imposed on them. So, whilst operating through a limited company, for example, you might think your house isn't on the line. The personal liability notice penalties very much put the house at risk, so to speak. And so that's why these are matters to take incredibly seriously.

In more serious cases, you can even face criminal prosecution. There have been a number of well-documented prosecutions over the course of 10 to 15 years with very significant penalties. Penalties in tax cases, or sentences in tax cases, often result in very serious sentences being imposed. But then kind of stepping away from those kind of obvious consequences, the more subtle ones include reputational damage to the business. So, if you have a very healthy business that has a limb that gets caught up in a fraud, but is otherwise completely fine and trading legitimately, that can [cause] serious reputational damage to the business, affecting things like contracts, lender investment, confidence, insurance, and so on.

From a legal risk standpoint, it's no longer really sufficient to claim a business simply didn't know because whilst that is the legal test, HMRC does expect businesses to show that they took reasonable care and implemented proper controls. And if those are lacking, the business may effectively be judged negligent or careless. Which again, it's difficult when one comes then before the tribunal, because the tribunal will then hold a business when assessing the 'should have known' test to a standard of the ordinary reasonable business in the position of the corporate. And so if you have a very well-resourced corporate, the tribunal will likely hold you to a standard of a well-resourced corporate and so those kind of failings, if there are any in things like the due diligence processes, will probably be held against the business. And so, all of those kinds of things are very important to consider.

**Michelle:** In terms of prevention, I want to outline some practical measures businesses can implement to reduce their supply chain fraud risk. I would suggest at least the following:

Supplier due diligence. For any new supplier, and periodically for existing ones, perform background checks, check the VAT registration status, the PAYE registration status, trade references, credit rating, and trading history.

I would recommend businesses review their documentation and contracts, ensure that contracts clearly define the nature of goods and services being provided, guarantee delivery, payment terms and audit rights, verify invoices and documentation, look out for odd terms, substantially discounted prices and payments outside normal channels. I would also recommend implementing systems to track the movement of goods and services and ensure payment is linked to actual supply.

VAT reclaimed monitoring. Review VAT input tax claims carefully, especially for new suppliers or those with little track record or history, ask is the purchase consistent with business operations? Is the supply credible? There should also be staff training and awareness, businesses should ensure employees, especially procurement accounts, supply chain, logistics, know the red flags and are empowered to raise concerns. It is important a culture of vigilance is created.

There should also be regular audits and reviews of your supply chain. Do spot checks on suppliers and invoices and review whether controls are working. It is also important to engage legal and/or tax advisers early. If you spot something unusual or are unsure of a supplier, consult with your legal or tax advisor before you proceed.

Implementing these will not guarantee you're fraud-free, but will help demonstrate that you have taken reasonable care and thus mitigate risk of HMRC enforcement. So that leads neatly to investigations.

**Michelle:** **Josh, if a business finds itself under HMRC investigation or suspects that it may be part of a fraudulent supply chain, what immediate steps should it take?**

**Joshua:** Yeah, this is a really good question and certainly one that I often get asked in practice. The key immediate steps first, just stop and assess what it is that the business is doing. Because once you suspect something is wrong, you really do need to pause, inspect the transactions with the particular supplier or suppliers, and assess what is known and what isn't. And that assessing process must include looking backwards. If there's been, for example, a number of previous suppliers to the business that have kind of inexplicably popped up and then disappeared, thinking about why they originally popped up and then subsequently disappeared. And if you notice a pattern that there's no overlap between these businesses, one day they're there, the next day they're not. And then suddenly you've got a new business offering you the same supplies that the previous business was asking yourself, well, hang on, how do they know that I now need a new supplier? Why did the last one disappear? Those kinds of things. So, it's important to step away from a very focused view of the business about what's going on immediately and look at what's happened as part of a wider and more historic picture.

The next thing to do is gather and preserve any evidence. So, looking for some of the key documents, due diligence documentation, contractual documentation, evidence of negotiations, looking at your invoices, correspondence with these people that are supplying you and you are supplying, delivery receipts and records, payment flows. Really at that point, if you haven't already and you should be looking at these things but scrutinising some of those documents like the invoices. If you have had that series of previous suppliers to the business, having a look at all of their invoices, you know, it might be something as basic as looking at the format of them. Does the format of them all look the same inexplicably when you're supposedly dealing with arm's length traders with no connection to each other?

Seeking professional advisory input very early on. So, looking to engage solicitors and counsel, forensic accountants if needed. You may want to consider voluntary disclosures to HMRC at that point and to engage relatively proactively with HMRC. Review some of your internal controls at that point as well, because sometimes businesses get into the trap of having put in place quite robust measures that have worked very well for the business over four or five years, ten years, whatever the case may be. But as time's gone on, they've not refreshed them, not kept them up to date. And so, the controls that were once very robust are perhaps now no longer so. And that also tells HMRC that you're taking this seriously, that you didn't intend to be caught up in what was going on.

Also, you need to be a little careful when thinking about your next steps about the potential criminal exposure. If there's a possibility of criminal liability, directors, officers, facilitation, you'll need to coordinate with criminal law specialists potentially and consider some of the issues of privilege, internal investigations and board involvement.

The final thing that I would say is communication is key and so look at your communication strategies both with HMRC and internally, externally obviously, if necessary, but be cautious about admissions. We all know that if the

revenue have organised a visit, they're likely to have someone there as second officer taking notes of the meetings, what's going to be said or what is being said. And you won't necessarily get to see those notes until possibly a decision's made adverse to the business. And then you're in litigation and you think, hang on a minute, I don't recall saying that at the time. So, make sure you're, you're protecting the business to that extent, keeping your own notes, potentially even of those visits but making sure that you are engaging constructively with HMRC but also trying to preserve your position as well.

<b>Michelle:</b>	<p>Looking ahead, there are a number of enforcement and behavioural trends companies should be aware of. Based on current intelligence, sectors such as construction, labour supply, wholesale, import-export businesses remain high risk, especially those with subcontracting chains in cash-based transactions.</p> <p>Supply chains involving cross-border movement, goods and transit, and complex layering of suppliers are increasingly scrutinised. In addition, HMRC is increasingly looking at the entire chain, not just the first tier, meaning businesses further upstream may be implicated even if they don't deal directly with the fraudulent element.</p> <p>Digitalisation means HMRC has better data and tracing capabilities. So, there's less room for 'we didn't know' type defences.</p> <p>The concept of reasonable care will become more crystallised. What does a business have to do to show that it took reasonable care? The controls will need to match the risk, so businesses should anticipate greater enforcement, higher expectations on governance, and more focus on supply chain integrity as a key tax risk.</p>
<b>Michelle:</b>	<p><b>So, Josh, from the legal side of things, what changes, whether through case law or HMRC practice, do you think we may see that could sharpen liability or change how businesses need to prepare?</b></p>
<b>Joshua:</b>	<p>Look, there are some possible pointers here. We all know that there are going to be further decisions that all follow the kind of <i>Kittel Mobilx</i>, that's the kind of domestic Court of Appeal authority on the issue, where we're looking at whether someone knew or should have known of a connection with fraud. There are obviously some cases where you look at them and think, if we end up in the tribunal, we should be in a position to argue that we didn't know nor should have known because we're kind of like that case over there.</p> <p>So I think there's likely to be some more development in that area, trying to bring different corporates within existing case law to make sure that if you do unhelpfully get caught up, that you might have a way out before the tribunal.</p> <p>I also expect we would see HMRC publish further guidance or public statements on a supply chain risk and what kinds of controls they expect. We already kind of see that in things like section six of HMRC public notice 726. The how to spot a missing trader fraud leaflet, all of those kinds of things businesses really should be quite familiar with if they're dealing in high-risk sectors. Things like labour supply, which also [has] the labour supply fraud leaflet, it's something that HMRC would expect those businesses to be familiar with. But kind of metals and carbon credits, you know, PPI, this kind of fraud does permeate a number of different industries.</p> <p>I also think we can expect probably in the coming even days, weeks and months, more decisions around section 69C and 69D, the penalty provisions. There's been no, (to my knowledge anyway), no successful 69D case before the tribunal at the moment. And so, I think we're likely to see some development in the tribunal when that first one gets issued. There have been a couple of 69Cs that have progressed. But as I said, to my knowledge, no successful 69Ds and how the tribunal intends to approach those.</p> <p>More enforcement action generally - this is an alternative that the revenue seem to use criminal prosecution because it's a way for them to deny the money and say the money never escapes the Treasury. Whereas obviously bringing criminal cases is very costly to the public purse.</p> <p>Judicial reviews and public law challenges for the kind of adjacent areas to supply chain fraud, those kind of deregistration on the basis of abuse. And we've already seen some movement in this area, the recent case, I was involved in the Court of Appeal, <i>Impact Contracting Solutions</i>. There have been a few others as well, <i>Thames Wines</i>, <i>Ingenious Construction</i>, those kinds of [cases], where it may be that temporary Registration is sought if the VAT number has been temporarily taken away and you might need to consider some public law challenges in the Administrative Court allied to an appeal in the First-tier tribunal.</p> <p>For companies, board level oversight governance risks will become more important, particularly as we expect to see more of a role for the failure to prevent type offences in the criminal sphere and so the role of the in-house council</p>

compliance teams will need to increase. And so, it's not just a tax issue, this is one that we would expect wider governance needs to engage with within any corporate.

**Michelle:** To wrap up, so if I had to prioritise key things businesses should do today, they would be review your supplier base and conduct enhanced due diligence for any new supplier, and also spot check existing ones.

Order your recent VAT input tax claims and supply chain invoices to identify any unusual patterns or unknown suppliers that you haven't traded with before. Strengthen your documentation and contract templates. Make sure you train staff on red flags and procedures, including internal escalation.

**Michelle:** **And Josh, what about you? What are your top three?**

**Joshua:** Yeah, I mean my three. Probably first, undertake a risk mapping exercise, identifying your supply chains at all tiers. Highlight where you have little visibility or control and prioritise those as high risk. Secondly, prepare for scenario responses. Have a defined process for if you identify a supplier or transaction that you think looks a bit unusual by reference to some of the factors that are in the various HMRC guidance and also acknowledging that you know your own industry. And so, if something in your own industry isn't working as you would expect it to, I would at that point stop, investigate, engage solicitors, counsel, advisers as needs be and preserve those documents for further analysis.

And then finally, review the governance and oversight, ensuring that the appropriate board compliance levels, oversight of supply chain, tax risks, are all born in mind, ensuring that any legal solicitors tax counsel [are] regularly involved in those kind of management issues and helping to understand the risks facing any business. And so, to that extent rather, it is important to remember HMRC's starting point is usually their guidance, whether they're right to or wrong to, that's usually their starting point. And they will have a variety of factors in their mind, most of which I think are set out in section six of Notice 726, and also the "how to spot a missing trader fraud" leaflet, and also the labour supply fraud leaflet. There are a number of factors there that they think are pretty common across industries. And so, it might be a good place to start whilst also recognising that your own governance needs to address the risks associated with your specific industry.

**Michelle:** **Josh, thank you very much for joining me today and thanks to all of you for listening to this episode of our newly relaunched quarterly series of Taxing Matters.**

A full transcript of this episode is available at [www.rpclegal.com/taxingmatters](http://www.rpclegal.com/taxingmatters). We look forward to seeing you again next quarter. Until then, stay informed and stay vigilant.



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