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**MAHAGÉBEN KFT & PÉTER DÁVID  
RE-DIRECTING THE EU VAT'S PERFECT STORM**

Boston University School of Law Working Paper No. 12-35  
(July 2, 2012)

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*MAHAGÉBEN KFT & PÉTER DÁVID*  
RE-DIRECTING THE EU VAT's *PERFECT STORM*

Richard T. Ainsworth

On June 21, 2012 the Court of Justice of the European Union (CJEU) rendered judgment on two Hungarian references, *Mahagében kft v. Nemzeti Adó-és Vámhivatal Dél-dunántúli Regionális Adó Főlgazgatósága* and *Péter Dávid v. Nemzeti Adó-és Vámhivatal Dél-dunántúli Regionális Adó Főlgazgatósága (Mahagében/Dávid)*.<sup>1</sup> The *Mahagében/Dávid* decisions clarify the CJEU's earlier holdings in the joined cases of *Alex Kittel v. Belgium* and *Belgium v. Recolta Recycling SPRL (Kittel/Recolta)*.<sup>2</sup>

*Kittel/Recolta* is a critically important decision. It is central to the EU's anti-fraud effort. It is one of three legal imperatives that earlier this year appeared to be coalescing into a *Perfect* (enforcement) *Storm*.<sup>3</sup> Both missing trader intra-Community (MTIC) fraud in goods,<sup>4</sup> and missing trader extra-Community (MTEC) fraud<sup>5</sup> in services are targeted.

After *Mahagében/Dávid* the *Perfect Storm* needs to be re-assessed, because *Mahagében/Dávid* limits *Kittel/Recolta* in some respects, while it broadly re-affirms it in others. This paper examines the relationship between *Mahagében/Dávid* and *Kittel/Recolta* and then updates the analysis of the *Perfect Storm*.

*Kittel/Recolta*

*Kittel/Recolta* stands for the proposition that a trader who enters into a transaction knowing or having the means to know that by doing so he is a participant in fraud, forfeits the right to deduct input tax incurred on purchases that were related to the fraud. Both the standards that are applied (the "known/should have known" formulation) and the scope of its application have been debated. *Mahagében/Dávid* largely resolves these debates.

*Facts*. Unfortunately, neither the facts of *Kittel* nor of *Recolta* helped to resolve the standards and scope issues in their time. As a result a re-examination of this area was inevitable. *Kittel* and *Recolta* present basic missing trader carousels. In both cases the taxpayer/litigant is the "broker" (the entity that pays VAT to the missing trader, claims a

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<sup>1</sup> Joined cases C-80/11 and C-142/11.

<sup>2</sup> CJEU judgment of 6 July 2006, Joined Cases C-439/04 and C-440/04 [2006] ECR I-6161.

<sup>3</sup> Richard T. Ainsworth, *A Perfect Storm in the EU VAT: Kittel, R, and MARC*, 66 TAX NOTES INT'L 849 (May 28, 2012). The other elements of the *Perfect Storm* are: (1) the *Criminal Proceedings against R*, ECJ judgment of 7 December 2010, Case C-285/09 and (2) Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties, and other measures, O.J. (L 84) 1 (2010).

<sup>4</sup> See: Richard T. Ainsworth, *Tackling VAT Fraud: 13 Ways Forward*, 45 TAX NOTES INT'L 1205 (Mar. 26, 2007) (assessing the MTIC problem at the time when mostly cell phones and computer chips appeared to be the medium of the fraud).

<sup>5</sup> See: Richard T. Ainsworth, *VAT Fraud: The Tradable Service Problem*, 61 TAX NOTES INT'L 217 (January 17, 2011) (discussing the morphing of MTIC fraud into MTEC fraud).

deduction, and then makes a zero-rated intra-community supply). In both cases the Belgian tax authority sought to deny the input tax deduction of the broker.

Nothing in these facts shed any light on how to negotiate the problems that have arisen since the *Kittel/Recolta* decision. In the first instance, there is nothing in the facts that helps divide the space between actual knowledge and no knowledge at all. In *Kittel* the broker had actual knowledge of the fraud; in *Recolta* the broker had no knowledge at all. So, what should happen when there is no actual knowledge of fraud, but there are reasons to believe that there should have been/ could have been/ might have been knowledge of fraud? There is nothing in the facts to help answer this question.

In addition, there is nothing in the facts that helps limit the scope of application of *Kittel/Recolta*. Is the entire supply chain implicated? Can the customer chain also be involved? In both *Kittel* and *Recolta* the fraudster (missing trader) was the immediate supplier, the party from whom the taxpayer/litigant purchased the goods that went around the carousel. These facts do not help answer questions about remote fraudsters nor do they help answer questions about fraudsters in the customer chain. *Kittel/Recolta* is silent on these points.

Answering these questions without factual support has become a linguistic exercise. Positions are staked out in French, which is “the language of the case,”<sup>6</sup> and are opposed by readings based in another official language (notably English).<sup>7</sup>

*Standards.* In terms of standards, *Kittel/Recolta* turns on a trader’s knowledge. The critical inquiry is whether the trader *knew or should have known* (in the English translation of the original French text) that by engaging in a particular transaction he was a participant in fraud. The question is: Is the expression *should have known* to be broadly or narrowly hewn? More precisely, does it mean *could possibly have known*, or does it have a far narrower meaning of *could not have helped but to have known*?<sup>8</sup>

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<sup>6</sup> “The language of the case,” is the language chosen by the parties from among the official languages of the European Union. Originally there were only four official languages (Dutch, French, German and Italian). Today the main courtroom in the new Court in Luxembourg is equipped with twenty-four interpreting booths. See: *Languages and interpreting at the Court of Justice of the European Union in Luxembourg*, (rev. Jan. 2010) available at: <http://eulita.eu/sites/default/files/Interpreting%20at%20the%20Court%20of%20Justice%20of%20the%20EU.pdf>

<sup>7</sup> RULES OF PROCEDURE OF THE COURT OF JUSTICE OF THE EUROPEAN COMMUNITY, Art. 29 indicates: The language of a case shall be Bulgarian, Czech, Danish, Dutch, English, Estonian, Finnish, French, German, Greek, Hungarian, Irish, Italian, Latvian, Lithuanian, Maltese, Polish, Portuguese, Romanian, Slovak, Slovene, Spanish or Swedish.

Available at: <http://eulita.eu/sites/default/files/Interpreting%20at%20the%20Court%20of%20Justice%20of%20the%20EU.pdf>

<sup>8</sup> The original French text is as follows (emphasis added):

56 De même, un assujéti qui *savait ou aurait dû savoir* que, par son acquisition, il participait à une opération impliquée dans une fraude à la TVA, doit, pour les besoins de la sixième directive, être considéré comme participant à cette fraude, et ceci indépendamment de la question de savoir s’il tire ou non un bénéfice de la revente des biens.

In the French text (reproduced in the prior footnote) the term “*savait*” is translated quite normally as “*known*.” The problem is in the next phrase “*aurait dû savoir*.” This expression has been subject to multiple translations: “*had the means to know*,” or “*should have known*.” Literally however, the French phrase is rendered as “*would have must to know*,” and this leads to an English translation of “*would have had to have known*.” Such a rendering would be a very narrow reading, and would suggest that the standard applied by *Kittel/Recolta* is strict and limiting (thus, the number of taxpayers who are swept into enforcement would be small). This reading would limit *Kittel/Recolta* very closely, almost coextensive with actual knowledge.

*Scope.* In terms of scope, *Kittel/Recolta* raises questions about proximity and direction. The proximity question is: How close of a connection does a trader need to have with the fraudster? Does the fraudster need to be the next-person-in-line, or could the fraudster be more remote? The directional question is: can a trader be denied the right to deduct input VAT *only* if he knows or should have known that his *purchases* are connected with fraud, or can he *also* be denied the right to deduct input VAT if he knows or should have known that his *sales* are connected with fraud?

There are two strands to the proximity question. The first is (once again) based on linguistics. At paragraph 59 the French (emphasis added) text reads: “... il participait à une opération *impliquée dans une fraude à la TVA* ...” The official English translation is: “... he was participating in a transaction *connected with fraudulent evasion of VAT*, ...”<sup>9</sup> Taxpayers have tried to persuade the English courts that expression “connected with” is too broad, and a narrower phrase is appropriate. The intent is to narrow the connection down to *only* the immediate supplier. That is, the taxpayer would need to have knowledge that his immediate supplier was a fraudster.

A better English translation for the French expression “*impliquée dans*” is considered by these advocates to be “involved in.” “Connected with” from the official

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The official English translation is (emphasis added):

56 In the same way, a taxable person who *knew* or *should have known* that, by his purchase, he was taking part in a transaction connected with fraudulent evasion of VAT must, for the purposes of the Sixth Directive, be regarded as a participant in that fraud, irrespective of whether or not he profited by the resale of the goods.

<sup>9</sup> Paragraph 59 the Court’s judgment reads (in French, emphasis added):

Dès lors, il appartient à la juridiction nationale de refuser le bénéfice du droit à déduction s’il est établi, au vu des éléments objectifs, que l’assujetti *savait* ou *aurait dû savoir* que, par son acquisition, *il participait à une opération impliquée dans une fraude à la TVA* et ceci même si l’opération en cause satisfait aux critères objectifs sur lesquels sont fondées les notions de livraisons de biens effectuées par un assujetti agissant en tant que tel et d’activité économique.

The official English translation reads (emphasis added):

Therefore, it is for the referring court to refuse entitlement to the right to deduct where 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*, and to do so even where the transaction in question meets the objective criteria which form the basis of the concepts of ‘supply of goods effected by a taxable person acting as such’ and ‘economic activity’.

English translation is too broad. The taxpayer in *POWA (Jersey) Ltd. v. HMRC* makes this argument (unsuccessfully). The Court summarizes the argument as follows:

The French text indicates a closer involvement in the fraud than the broader English expression ‘connected with;’ and that the French text should be given priority since it is both the working language of the ECJ in which the judgment was drafted and the language of the case...<sup>10</sup>

Although raised in several UK cases, this linguistic approach to the “connected with” language in *Kittel/Recolta* does not seem persuasive.<sup>11</sup> The argument endeavors to make the language of the case adhere more tightly to the explicit facts of the case than the analytics of the case allow. In other words, there is nothing in the reasoning of *Kittel/Recolta* that suggests that just because the fraudster in both cases happens to be the immediate seller that the holding of the case is limited to factually similar situations.<sup>12</sup>

The second strand of the proximity question is found in French domestic legislation, at Article 271(3) of the *Code Général des Impôts*, and the related guidance (binding on the French revenue authority) as to how the law is to be applied (*Bulletin Officiel des Impôts*, 3 A-7-07, No. 124, 30/11/07). These provisions indicate that a taxpayer’s right to deduct input VAT can be called into question only when that person knew or had reason to know that he was participating in a transaction in which fraud was

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<sup>10</sup> [2012] UKUT 50 TCC (February 8, 2012) at ¶ 26.

<sup>11</sup> Justice Lewison understood the argument (but found it incompletely argued) in the joined cases of *HMRC v. Livewire Telecom Ltd.* and *HMRC v. Olympia Technology Ltd.* [2009] EWHC 15 (Ch) (January 16, 2009) at ¶¶ 53-61. *Megtian Ltd. v. HMRC* (LON/2007/0908) (Dec. 11, 2008) at ¶¶ 17-27. See also the similar results in *Spearmint Blue Ltd. v. HMRC* [2012] UKFTT 103 (TC) at 33 where a similar linguistic argument is made (with a similar result) involving the CJEU’s decision in *Criminal Proceedings against R:*

Spearmint Blue 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 opération impliquée dans une fraude à la TVA*’ in *Kittel*” and the meaning “aimed at” should be preferred to the meaning “connected with”

<sup>12</sup> This is the opinion of the Court in *Megtian Ltd. v. HMRC* (LON/2007/0908) (Dec. 11, 2008) where denial of an input tax deduction in a contra-trading case where Megtian Ltd. functioned as the exporting broker on the “clean chain” of a well orchestrated fraud that always involved two or three buffer companies – outlined in the appendix of the decision, and an admission [in apparent error] that Megtian Ltd. had “actual knowledge” that it was engaged in VAT fraud. The Court at ¶ 22 indicates:

Whilst it is true, as Mrs. Hamilton pointed out, that the Court did refer in paragraph 56 of the judgment, to the trader becoming involved in fraud “by his purchase” and that could suggest that only a direct connection with a fraudulent person was intended to lead to the loss of the right to deduct, we do not agree that is the only interpretation that can be put on those words. In that case the Court was dealing with cases where there was such a direct connection. The Court’s conclusions are expressed in more general terms in paragraphs 56 and 61 and we have no doubt that the wider construction is correct. That was also the conclusion of the tribunal in *Calltell Telecom Ltd and another –v- The Commissioners* (VTD 20266) at paragraph 46 and *Dragon Futures Ltd –v- The Commissioners* (VTD 19831) at paragraph 67

committed by the seller.<sup>13</sup> This argument is essentially “the French know best” with their statutory implementation of *Kittel/Recolta*, because the decision is in French. This has not been a persuasive argument in the UK courts.

These arguments however, have apparently persuaded Advocate General Van Hilten before the Dutch Supreme Court (Hoge Raad).<sup>14</sup> In the common annex to five joined MTIC cases the AG argues that *Kittel/Recolta* can be applied to deny the right of deduction only when the fraud arises in a supplier who is in privity of contract with taxpayer. The Hoge Raad has not rendered an opinion in these joined cases (yet).

The second question, the directional one, is theoretical. It is based on a plane reading of *Kittel/Ricolta*. It states: Is there anything in the *Kittel/Ricolta* decision that restricts the decision to a trader’s purchase side? Could the tax authority just as easily deny a trader’s input deduction if the taxpayer had knowledge of fraud in the customer chain? This would be knowledge that by his onward sale the trader was facilitating fraud.

This hypothetical was considered in the *Perfect Storm* under *Kittel* Stage 2: The Gathering Storm. The resolution of the hypothetical suggests that enforcement could easily develop in this direction as the Community searches for new tools in the fight against missing trader fraud.<sup>15</sup> The *Perfect Storm* indicated:

Stage 2 *Kittel* takes advantage of the lack of temporal or jurisdictional limitations in the ECJ decision. *Kittel’s* linchpin is whether or not the taxpayer’s transaction is *connected* to fraudulent evasion of VAT, and whether or not he knows or should have known about this *connection*. It is not important “when” or “where” the fraud occurs, it could be before or after the current transaction, and it could be within the taxpayer’s Member State or in any of the other Member States of the Community.<sup>16</sup>

This paper asks: Is this hypothetical and proposed resolution still viable after *Mahagében/Dávid*? The answer is no, not at all. The *Perfect Storm* needs revision.

*Mahagében/Dávid*

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<sup>13</sup> See the unsuccessful arguments made in *Fonecomp Ltd. v HMRC* [2012] UKFTT 102 (TC) at ¶ 244: During the course of the hearing the appellant had suggested that the approach taken in *Mobilx* was wrong. It referred to the apparent conflict between interpretation of connection adopted by the French legislature, which appeared to regard the connection required by the test as existing only if the seller was fraudulent, and the broader test adopted by the English Courts. It was suggested that we should consider making a reference to the ECJ if this or any other issue was not *acte claire*.

<sup>14</sup> LJN: BW5440 (May, 11, 2012) available (in Dutch) at: [http://zoeken.rechtspraak.nl/ResultPage.aspx?snelzoeken=true&searcht...eerd&sortby=rechtsgebied\\_rechtspraak+asc+ljn&instantie\\_uz=Hoge+Raad](http://zoeken.rechtspraak.nl/ResultPage.aspx?snelzoeken=true&searcht...eerd&sortby=rechtsgebied_rechtspraak+asc+ljn&instantie_uz=Hoge+Raad).

<sup>15</sup> EU Commission, *Communication from the Commission to the European Parliament and the Council on concrete ways to reinforce the fight against tax fraud and tax evasion including in relation to third countries*, COM(2012) 351 (June 27, 2012) (considering the connection between VAT frauds in goods and services as a window to wider tax fraud in corporate and personal income tax regimes) available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0351:FIN:EN:PDF>

<sup>16</sup> *Perfect Storm*, *supra* note 3 at 859-60.

Two aspects of *Mahagében/Dávid* provide subliminal commentary on the placement of this decision – (a) the absence of an Advocate-General’s Opinion, and (b) the inverted sequencing of the case analysis.

*Advocate-General’s Opinion.* Pursuant to Article 44(2) of the consolidated version of the Rules of Procedure of the CJEU<sup>17</sup> and Article 20 of the Protocol (No. 3) on the Statute of the CJEU,<sup>18</sup> an Advocate-General’s Opinion may be dispensed with if the Court considers that the case raises no new point of law. By foregoing an Advocate-General’s opinion in *Mahagében/Dávid* the CJEU is putting the legal community on notice that this decision is only a clarification or re-application of existing law.

What does *Mahagében/Dávid* clarify? It clarifies *Kittel/Recolta*.

*Inverted sequencing.* The *Mahagében/Dávid* references for preliminary rulings arrived at the Court one month apart and were assigned case numbers accordingly. The first to arrive was *Mahagében* C-80/11.<sup>19</sup> *Dávid* C-142/11 arrived later.<sup>20</sup> In standard fashion, the Court presents the facts of these joined cases in their order of arrival – *Mahagében* first (¶16 to ¶22) and *Dávid* second (¶23 to ¶34).

However, the legal analysis is (surprisingly) set out in reverse order. *Dávid* (a services case) is considered first (¶35 to ¶50) and *Mahagében* (a goods case) second (¶51 to ¶66). Why the dissonance?

The reason for the inversion is that *Dávid* is the re-statement (and re-emphasis) of *Kittel/Recolta*.<sup>21</sup> *Mahagében* simply applies *Dávid* (i.e. it applies *Kittel/Recolta* indirectly) to a goods fact pattern (and continues with an extended critique of tax authorities that mistakenly require taxpayers to engage in extraordinary due diligence as a condition of securing their rightful input deductions).

*Kittel/Recolta* underpins the results in both the *Dávid* and the *Mahagében* portions of the joint decision, but there are notable differences in the way this is accomplished. In *Dávid*, *Kittel/Recolta* dominates the legal reasoning. There are nine distinct references to *Kittel/Recolta*. In *Mahagében* *Kittel/Recolta* is cited only once (at ¶53). However, *Mahagében* is all but decided in a single internally referenced paragraph (at ¶52) that simply indicates that *Dávid* “... also applies in the case of the supply of goods ...”

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<sup>17</sup> *Rules of Procedure of the Court of Justice of the European Union* of 19 June 1991, O.J. (L 176) 7.

<sup>18</sup> *Protocol (No. 3) On the Statute of the Court of Justice of the European Union*, O.J. (C 83) 210 (March 30, 2010).

<sup>19</sup> The *Mahagében* reference came from a decision of February 9, 2011 of the Baranya Megyei Bíróság (Regional Court, Baranya), and was received by the Court on February 22, 2011.

<sup>20</sup> The *Dávid* reference came from a March 9, 2011 decision of the Jász-Nagykun-Szolnok Megyei Bíróság (Regional Court, Jász-Nagykun-Szolnok), and was received by the Court on March 23, 2011.

<sup>21</sup> Each of the analytical paragraphs in the *Dávid* portion of the decision reference *Kittel/Recolta* (¶¶38, 39, 40, 41, 42, 45, 46, 47, & 48), and none of the other sections reference any case law (¶¶ 36, 37, 43, 44, 49 & 50).



Thus, the reason we do not have an Advocate-General's Opinion in *Mahagében/Dávid* is that the reasoning of the case is structured as a cascading reaffirmation of *Kittel/Recolta*, first in detail in a services fact pattern, and then very swiftly in a goods fact pattern.

*Dávid facts.* A Hungarian taxpayer (general contractor) sought to deduct VAT on payments made to subcontractors for the services of laborers. The tax authority refused to allow the input VAT deduction, even though it was clear that the work was done, and the VAT was paid. The reason for the denial was alleged improper acts by the subcontractors. In one instance the subcontractor failed to ascertain that a further subcontractor he had hired was a missing trader.<sup>22</sup> In another transaction the immediate subcontractor was in liquidation without records or representative.<sup>23</sup> Under Hungarian rules *Dávid* was supposed to have documentation available for the VAT auditors on the status of his sub-contractors, as well as his sub-contractor's sub-contractors.

The subcontractors are missing traders. The first is more traditional as it sends out invoices with valid VAT ID numbers to buyers, collects the VAT, but does not file a return or pay the tax over to the government. The second falls into a kind of missing trader pattern where sales are made, VAT collected, and then the firm liquidates before audit (commonly without a return being filed and VAT being remitted).

*Mahagében facts.* Mahagében kft is a small Hungarian wood mill and processing plant that purchased acacia logs from another domestic business, Rómahegy-Kert kft (RK). Proper invoices were issued and paid (along with VAT). Mahagében filed a timely return and deducted the VAT paid.<sup>24</sup> 70% of Mahagében's business is export, so it is likely that *Mahagében* returns were largely refund claims.<sup>25</sup>

On audit of RK the tax administration determined that RK did not have a sufficient quantity of acacia logs in inventory to meet the invoiced demand of Mahagében, nor did it have a lorry to make deliveries of the logs. The tax authorities concluded that the invoices did not accurately reflect commercial transaction.<sup>26</sup> Mahagében's invoices were invalidated, and its input deduction denied.<sup>27</sup>

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<sup>22</sup> *Mahagében/Dávid*, *supra* note 1, at ¶26 (indicating that the sub-sub-contractor was found to have no equipment, no registered employees during the period of the contract, filed no VAT return and paid no tax).

<sup>23</sup> *Mahagében/Dávid*, *supra* note 1, at ¶28 (indicating that in this case there was no evidence of a price paid, and that the parties indicated on the invoices were genuine, and that due diligence was not performed by *Dávid* who did not confirm that this sub-contractor could perform the services needed).

<sup>24</sup> *Mahagében/Dávid*, *supra* note 1, at ¶16 (indicating that RK declared all of the invoices on its returns and paid the VAT due, and *Mahagében* included these amounts in inventory and sold all stocks to third parties).

<sup>25</sup> Dél-Dunántúli Energetikai Klaszter (South Trans-Danubian Energy Cluster – an internet-based business locator service) (indicating that *Mahagében* is a small family business started in 1998 with one mill and 13 employees) available at:

[http://www.ddeklaszter.hu/index.php?option=com\\_content&view=article&id=22:mahageben-kft&catid=1:tagok&Itemid=3&lang=en](http://www.ddeklaszter.hu/index.php?option=com_content&view=article&id=22:mahageben-kft&catid=1:tagok&Itemid=3&lang=en)

<sup>26</sup> *Mahagében/Dávid*, *supra* note 1, at ¶17.

<sup>27</sup> *Mahagében/Dávid*, *supra* note 1, at ¶18.

*Questions before the CJEU.* Briefly, the questions under consideration in *Mahagében/Dávid* may be summarized as, can a business be held accountable for a VAT fraud or be penalized by the loss of its right to deduct input tax if another trader elsewhere in the transaction chain is acting fraudulently?<sup>28</sup>

The concept embedded in the questions set before the CJEU are at the heart of the Member States efforts to combat MTIC/MTEC frauds. Stated another way, the question presented is: How much accountability does a taxpayer assume for the fiscal security of the VAT chain? *Kittel/Recolta* and now *Mahagében/Dávid* place limits on this accountability. If the invoices are valid, accountability is coextensive with the taxpayer's knowledge of fraud in the chain (barring additional conditions placed on the right of deduction by the Member State in accordance with Article 273)<sup>29</sup>. *Mahagében/Dávid* solves *Kittel/Recolta*'s standards and scope problems.

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<sup>28</sup> In a little bit more detail, the questions were:

*Mahagében* –

- (1) if the invoicing requirements have been fully satisfied can the tax administration nevertheless require more documentation from a buyer that would prove that his supplier: (a) actually possessed the goods stated on the invoice, or (b) was able to deliver the stated goods; and (c) satisfied tax its obligations – by filed a return and paying over the VAT.
- (2) Does the exercise of due diligence by a taxpayer include being able to prove (with auditable documentation) that a supplier: (a) entered the purchases (of the items that are re-sold to the buyer) in the company books (as inventory records); (b) has valid invoices recording these purchases; and (c) filed the necessary returns and paid the tax on the purchases and subsequent re-sales to the buyer.
- (3) Does the VAT Directive preclude national legislation (or practice) that requires a taxable person to verify tax compliance of the businesses that issues it invoices? *Mahagében/Dávid*, *supra* note 1, at ¶22.

*Dávid* –

- (1) Does the VAT Directive allow the right to deduct input VAT to be restricted (or prohibited) if the issuer of an invoice cannot guarantee the VAT compliance of further subcontractors (strict liability for all VAT in the supply chain);
- (2) If the tax administration concedes the validity and accuracy of invoices, as well as the economic activity, may it nevertheless deny the right to deduction on the basis that other subcontractors are “missing” or undeterminable, or invoices issued by them are invalid?
- (3) In the situation in (2) is a tax administration obligated to prove that the taxable person was aware of (or colluded in) the unlawful conduct of the subcontracting companies further up the subcontracting chain? *Mahagében/Dávid*, *supra* note 1, at ¶33.

<sup>29</sup> The analysis of Article 273 is sparse in *Mahagében/Dávid*. None of the conditions and procedures of the Hungarian tax authority were appropriate. In *Mahagében* this included documentation that would prove that the person who drafted the invoice (the seller):

- (1) was in possession of the goods;
- (2) could have delivered the goods.
- (3) could satisfy the obligations of the contract (actual performance capability not just promise of performance)
- (4) placed the goods [acacia logs] he was selling into his inventory when he purchased them from his supplier.
- (5) had a good [four corners] invoice for the goods [acacia logs] he purchased from his supplier.
- (6) declared the purchase from his supplier, and for the subsequent sale to the taxpayer on his VAT returns.
- (7) paid the VAT on the purchase from his supplier, and reported the VAT on the subsequent sale to the taxpayer on his VAT returns.

*Solving Kittel/Recolta's standards problem.* This problem revolves around the official English translation – *should have known* – of the French expression – *aurait dû savoir*. Would this French expression be better rendered as: *could possibly have known*, or as *could not have helped but to have known*, or as *would have had to have known*?

The answer? *Should have known* has a broad reading. It simply means *ought to have known*.

The CJEU sets out this answer clearly, although a bit indirectly. *Kittel/Recolta* is referenced nine times in *Mahagében/Dávid*, and in none of these instances is the critical term *should have known* or any of its common synonyms ever used. Instead, whenever the *Kittel/Recolta* standard is referenced the text uniformly adopts the expression *ought to have known*.<sup>30</sup> It is used four times in *Dávid's* restatement of the *Kittel/Recolta* holding, once in *Mahagében* where *Dávid* (i.e. *Kittel/Recolta*) is applied to resolve this case, and then in the final ruling.

Without stating so expressly, the CJEU seems to have told the legal community that it will translate the expression *aurait dû savoir* for purposes of *Kittel/Recolta* as *ought to have known*.<sup>31</sup>

*Solving Kittel/Recolta's scope problem.* This is the directional and proximity question. Does *Kittel/Recolta* apply only to awareness of fraud on the taxpayer's supply side, or is it equally applicable on the sales side? In addition, does *Kittel/Recolta* apply throughout the commercial chain, or is it confined to privity relationships of the next-person-in-line?

The answer provided by *Mahagében/Dávid* seems clear. The scope of *Kittel/Recolta* is throughout the supply chain, and it is not limited to privity relationships

Neither *Dávid* nor *Mahagében* present facts that would require the CJEU to specifically reject an assertion that *Kittel/Recolta* applied in the customer chain. However, there are a number of instances in *Mahagében/Dávid* where the CJEU expressly applies *Kittel/Recolta* to the entire supply chain (only). Thus, *Kittel/Recolta* is broader than privity, but it does not carry over into customer chains.

The third question presented to the CJEU in the *Dávid* reference specifically asks about the supply chain. It asks if a tax authority seeks to deny a right of deduction is it required to prove that the taxpayer was aware of unlawful conduct, "... in the

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In *Dávid* the same questions are asked, but in this case the required proof extends further up the supply chain to the person who drafted the invoice for supplies made to the person who then made supplies to the taxpayer (the supplier's supplier).

<sup>30</sup> *Mahagében/Dávid*, *supra* note 1, at ¶¶45, 46, 49, 50 52, and 67(1).

<sup>31</sup> This of course does not answer the question of how to divide the space between actual knowledge of fraud in the supply chain and no knowledge at all. There will be cases on both sides. What it does is confirm that there is a space between actual knowledge of fraud in the supply chain and no knowledge at all. There is expected to be a lot of cases that fall within this space, and distinctions will need to be drawn.

subcontracting chain ...”<sup>32</sup> The CJEU answered this question in the affirmative. Identical language is found in three other places (¶¶49, 50 and 52):

Articles 167, 168(a), 178(a), 220(1) and 226 of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax must be interpreted as precluding a national practice whereby the tax authority refuses a taxable person the right to deduct, from the value added tax which he is liable to pay, the amount of the value added tax due or paid in respect of the services supplied to him, on the ground that the issuer of the invoice relating to those services, or one of his suppliers, acted improperly, without that authority establishing, on the basis of objective evidence, that the taxable person concerned knew, or ought to have known, that the transaction relied on as a basis for the right to deduct was connected with fraud committed by the issuer of the invoice *or by another trader acting earlier in the chain of supply*.<sup>33</sup>

*Mahagében/Dávid* therefore ends the linguistic debates over the precise English meaning of the French term *impliquée dans*, and whether the English term *connected with* is sufficient to cover the court’s intent. The Court has now made it clear that the entire supply chain (but not the customer chain) is within *Kittel/Recolta*’s scope.

#### Re-directing the *Perfect Storm*

After *Mahagében/Dávid* the *Perfect Storm* needs to be re-assessed, because the decision restrictively clarifies *Kittel/Recolta* - both standards and scope have been addressed. If we paraphrase the earlier statement of *Kittel/Recolta*’s holding (with the *Mahagében/Dávid*’s modifications underscored and italicized) that statement becomes:

*Kittel/Recolta* stands for the proposition that a trader who enters into a transaction knowing or ought to have known that by doing so he is a participant in his supplier’s fraud, or the fraud of any prior trader in the supply chain (but not the fraud of his customer or any subsequent buyer in the customer chain) forfeits the right to deduct input tax incurred on purchases that were related to the fraud.

The *Perfect Storm* needs revision at Stage 2 and *Hypo III*. *Hypo III* illustrates how a trader that knew or should have known that its *sale* made him a participant in this customer’s fraud would lose its right to deduct.

In *Hypo III* it was assumed that E in Slovenia intended to be a missing trader after he sells the goods he has received from D (a French taxpayer) to F, another Slovenian taxpayer. The goods are delivered to E from the UK, because D is a middleman purchasing and re-selling goods from C (a UK trader). D functions as a conduit (or a “buffer”) for C.

The hypothetical then indicates that after F pays E (with VAT), E disappears. However, because C knew or should have known of the fraud by E, the hypothetical

<sup>32</sup> *Mahagében/Dávid*, *supra* note 1, at ¶33(3).

<sup>33</sup> *Mahagében/Dávid*, *supra* note 1, at ¶67(1) (emphasis added).

concludes that C could be compelled to forfeit its input deduction on its purchase of the goods it sold through D (in France) to E in Slovenia.

*Mahagében/Dávid* makes it clear that *Hypo III* is incorrect. If a transaction is actually carried out, under an invoice that contains all the information required by Directive 2006/112, and with all the substantive and formal conditions fulfilled, then: ... a taxable person can be refused the benefit of the right to deduct *only on the basis of the case-law resulting from paragraphs 56 to 61 of Kittel and Recolta Recycling*, according to which it must be established, on the basis of objective factors, that the taxable person to whom were supplied the goods or services which served as the basis on which to substantiate the right to deduct, knew, or ought to have known, that *that transaction was connected with fraud previously committed by the supplier or another trader at an earlier stage in the transaction.*<sup>34</sup>

Thus, even though each Member State has an obligation under the EC Treaty,<sup>35</sup> and the European Parliament to protect each other's revenues,<sup>36</sup> that protection cannot come at the expense of the right to deduct based on fraud in the customer chain. The *Perfect Storm* is re-directed.

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<sup>34</sup> *Mahagében/Dávid*, *supra* note 1, at ¶45 (emphasis added).

<sup>35</sup> Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, *concerning the need to develop a co-ordinated strategy to improve the fight against fiscal fraud*, COM (2006) 254, at 6.

Article 10 of the EC Treaty obliges Member States to take all appropriate measures, whether general or particular, to ensure fulfillment of the obligations arising from Community acts, which include administrative cooperation, and that Article 280 obliges Member States to co-ordinate their actions in order to protect the financial interests of the Community.

<sup>36</sup> European Parliament resolution of 4 December 2008 *on the European Court of Auditors' Special Report No. 8/2007 concerning administrative cooperation in the field of value added tax* (2008/2151(INI)) (2010/C 21 E/03), at ¶33.

**Stepping up cooperation between judicial authorities**

[The EU Parliament] Calls on Member States to remove legal obstacles in national law which hamper cross-border prosecution, in particular in cases where the VAT losses occur in another Member State;