[2013] UKUT 0374 (TCC)

Appeal number: FTC/29/2012

VALUE ADDED TAX – denial of repayment of input tax due to MTIC fraud – 'grey market' transaction in razor blades – nature of and terms on which transactions entered into – other parties to the transactions unconnected with the fraud – whether FTT erred in concluding on the facts that the only reasonable explanation for the circumstances in which the taxpayers' purchases took place was that they were connected with fraud – yes – whether taxpayers should have been aware of the connection with fraud earlier in the chain of transactions – no – appeal allowed

UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)

(1) DAVIS & DANN LIMITED
(2) PRECIS (1080) LIMITED

Appellants

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Respondents

TRIBUNAL: JUDGE MALCOLM GAMMIE CBE QC
JUDGE EDWARD SADLER

Sitting in public in London on 29 and 30 October 2012

David Scorey and Edward Brown, Counsel, instructed by Smith & Williamson, for the Appellants

Jonathan Kinnear QC and David Bedenham, Counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

Introduction

1. This case concerns what is known as MTIC fraud and is an appeal from the decision of the First-tier Tribunal (Judge Guy Brannan and Tribunal Member Mrs Shahwar Sadeque) that the Appellants should have known that the transactions in dispute were connected with fraudulent evasion of VAT, and that accordingly the Appellants were not entitled to deduct input tax (totalling £4,350,641.09) paid on the purchases of consignments of razor blades in the VAT periods 04/06 and 05/06.

2. There was relatively little dispute between the parties as to the facts and the relevant principles of law applicable in these matters. The dispute, therefore, relates largely to the application of those principles to the facts of the case having regard to the way in which the Respondents had pleaded their case and the evidence that they had produced to support it.

The basic transactions in outline

3. In summary (and with reference to the findings in the decision of the First-tier Tribunal) the transactions with which the appeal is concerned were as follows—

   a. The Appellants are long established traders, operating in particular in the 'grey market' for certain goods. With the exception of some trading in beverages, confectionery, tyres and metals, the Appellants' principal business activities have involved trading in the household goods sub-section of the so-called "fast moving consumer goods" ("FMCG") market (see FTT [32] and [33]).

   b. The 'grey market' is the market whereby goods are sold outside normal authorised distribution channels and has existed for many years (see FTT [43] to [46]). As regards the Appellants' role in this market, the First-tier Tribunal records the following—

> "47. Davis & Dann would buy stock on the grey market on an irregular basis when there was a particular supply available in the market which they believed would yield a profit or where a buyer was seeking to obtain a specific number or quantity of goods. Davis & Dann would regularly buy from different suppliers, seeking out the best deals available in the market. Davis & Dann would either seek out potential suppliers or would receive unsolicited offers. The transactions were essentially opportunistic – they would buy as and when an opportunity for profit presented itself."

Except where it intended to sell stock from their warehouse, the Appellants did not hold stock for lengthy periods in order to avoid tying up its capital (see FTT [36]).

c. On or around 11 January 2006 the Appellants were approached by Bristol Cash & Carry ("Bristol") with a view to their establishing a business relationship. The Appellants had not previously heard of Bristol but such unsolicited approaches were a normal incident of the Appellants' trade (see FTT [91]). The Appellants accordingly followed up this approach by making various enquiries about Bristol and visiting Bristol's premises.

d. On or around 27 January 2006 the Appellants received an introductory fax from a Spanish wholesaler, Complementos de Exportation Multifunctionales SA ("CEMSA") and the Appellants responded on 30 January 2006 expressing an interest in the possibility of doing business. The Appellants made various enquiries about CEMSA and on 6 April 2006 visited CEMSA's premises in Marbella.

e. Bristol was an independent wholesaler whose main business appeared to be in the drinks' trade, serving convenience stores and off-licences in and around Bristol. Shortly after the Appellants had visited Bristol's premises, however, Bristol offered to sell the Appellants Gillette M3 Power razor blades. Bristol's managing director explained that he had connections which meant that he was able to get hold of these razor blades. Bristol was not an authorised distributor of Gillette products but that is the essence of the grey market.

f. The Appellants negotiated a price with Bristol representing a reasonable discount of approximately 9 per cent to the list price, which was not unusual in the grey market. The Appellants offered the razor blades on a "first come, first served" basis to four different customers (three in continental Europe and one in the UK), including CEMSA (who had mentioned that they had a demand for Gillette products). CEMSA offered to purchase them. The Appellants accordingly visited the premises of the freight forwarder (1st Freight) where the razor blades were stored and inspected the goods to confirm their existence. They then arranged for the goods to be shipped as instructed by CEMSA to GR Distributions in France.

g. Between 6 April 2006 and 31 May 2006 the Appellants purchased from Bristol and resold to CEMSA 4,320,000 retail units of Gillette M3 Power razor blades representing 23,184,000 blades for a price paid by the Appellants (net of VAT) of £24,860,766. Davis & Dann Ltd entered into 24 separate deals (contained in 13 invoices) and Precis (1080) Limited entered into 12 separate deals (contained in seven invoices).

h. Broadly speaking the Appellants did not pay Bristol for the goods until after they had been paid by CEMSA. Although the goods were shipped at CEMSA's direction to GR Distributions before CEMSA had paid for them, this was on terms that 1st Freight was not to release the goods to GR Distributions until the Appellants had confirmed that CEMSA had paid for the goods.

4. The transactions contributed substantially to repayment claims for input VAT amounting to approximately £4,340,000 in the VAT periods 04/06 and 05/06. As it turned out, however, there was a fraudulent trader, Leeming Distribution Limited ("Leeming"), at the top of each transaction chain, which defaulted in accounting for the VAT charged on its sale. From Leeming the goods were sold through 'buffers' comprising Barato, Flaxley and Bristol before being sold to the Appellants. From the Appellants the goods passed to CEMSA and then, in most cases, to an Italian company, FAF International SRL.

5. HMRC rejected the Appellants' claim for repayment of the input VAT attributable to their purchases from Bristol. The only party alleged by HMRC to be involved in the fraud was Leeming. HMRC's case, however, was that the Appellants should have known that the transactions were connected with VAT fraud.

The law

6. As the First-tier Tribunal records, the basic legal principles applicable to these appeals were not in dispute. The First-tier Tribunal set out the summary of the relevant principles derived from *Axel Kittel v Belgium*; *Belgium v Recolta Recycling* joined cases C-439/04 and C-440/04 [2006] ECR I-6161 that was given by Lewison J (as he then was) in *Brayful Ltd v HMRC* [2011] UKUT 99 (TCC). We think it unnecessary for us to repeat that summary here, save as follows—

> "The test [to determine whether a trader loses the right to deduct input VAT] is simple and should not be over-refined. It embraces not only those who know of the connection [with fraudulent evasion] but those who "should have known". Thus it includes those who should have known from the circumstances which surround their transactions that they were connected to fraudulent evasion. 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." (§ 59)

> "The principle 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 must 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." (§ 60)

7. The burden of proof (to the civil standard) is on HMRC to show that the Appellants should have known that their transactions were connected with fraud and in this respect it was not solely a question of whether they acted with due diligence. The question is what conclusion should the Appellants have drawn from the circumstances of their transactions. In this respect HMRC had accepted that it was not enough for them to show that the Appellants were aware of the risk of VAT fraud but that they should have known that their transactions *were* connected to VAT fraud.

8. This final point illustrates why it is necessary to show (on the balance of probabilities) that the *only* reasonable explanation for the circumstances in which the transactions take place is the connection with fraudulent evasion. The trader concerned will not have known or had the means of knowing of such connection, but if the *only* conclusion that he could reasonably have drawn from the circumstances of his purchase was that fraud was involved then his knowledge is more than simply being aware that his transaction might be connected with fraud, and in consequence he has no entitlement to recover input tax on his purchases.

The First-tier Tribunal's Decision

9. As this brief summary of the applicable legal principles indicates, the burden that rests on HMRC in these cases is a high one. Nevertheless, the First-tier Tribunal concluded at paragraph 268 of its decision that HMRC had satisfied it that the Appellants should have known that its purchases were connected with fraudulent evasion of VAT (as it turned out perpetrated by Leeming).

10. At paragraphs 269 to 276 the First-tier Tribunal reprised the relevant legal principles that it had to apply. In particular, it expressed the view that—

    a. It was not necessary for HMRC to prove that the Appellants should have known the details of the specific fraud or that the fraud was carried out by Leeming (FTT [270])

    b. All the circumstances must be considered when applying the "only reasonable explanation" test (FTT [272])

    c. The "only reasonable explanation" test must be applied to the totality of the evidence and it was not a question of asking in relation to each particular circumstance relied upon by HMRC whether it had a reasonable explanation other than fraud (FTT [273]).

d. The fact that Leeming was the only alleged fraudulent party in the chain of transactions did not entitle the Appellants to disregard the circumstances of their transactions (i.e. the fact that neither Bristol nor CEMSA – as the parties with which the Appellants dealt – were alleged to be involved in the fraud does not absolve the Appellants) (FTT [274]).

e. It was not a question of what the Appellants could have done to know of the fraud but what conclusions they should have drawn from the known facts or the facts of which they should have been aware (FTT [275]).

11. At paragraph 276 of their decision the First-tier Tribunal provided this explanation of how they had reached their conclusion—

> "We should point out that our conclusions are based on the evidence considered as a whole. Some factors were, in our view, more compelling than others. Some aspects of the evidence were not conclusive by themselves but when viewed in the context of the evidence as a whole, supported our conclusion that the Appellants should have known that their transactions were connected with fraud."

12. The first two sentences do not call for particular comment at this stage. The last sentence at least implies, however, that the First-tier Tribunal found some aspects of the evidence "conclusive" and that other aspects operated just to support the Tribunal's conclusion. This raises the question of the relative significance and weights that the Tribunal attached to the various factors and the evidence that was available to the Tribunal to support its view of them.

13. The First-tier Tribunal then proceeded at paragraphs 278 to 294 to set out the reasons for its decision and it was against these that Mr Scorey directed his attack. We provide a summary of the Tribunal's reasons below with a preliminary indication of those with which Mr Scorey took issue. The following section of our decision then examines various aspects of those reasons and Mr Scorey's attack on them in more detail.

14. In summary the Tribunal's reasons were as follows (with an indication of Mr Scorey's position in italics)—

a. From prior transactions and contacts with HMRC the Appellants were generally aware of MTIC fraud and that it could be conducted through the medium of razor blade deals (FTT [278]). They had been advised of certain characteristics ("quantity, value, the manner of approach by supplier and customer etc") that should alert them to the possibility of fraud (FTT [279]). *Mr Scorey did not take issue with either of these points.*

b. The unusually large repayment position ("greater than in any previous period") should have alerted the Appellants that the deals were unusual (FTT [280]). *Mr Scorey took issue with this on the basis that there was no necessary relationship between Leeming's fraud at the outset and the Appellants' export sales. The repayment position was not unusual for an exporter. The fraud (Leeming's default in accounting for output VAT) was unrelated to any export of the goods.*

c. Bristol's involvement should have provided several warning signals—

- Bristol was primarily a company trading in drinks not razor blades (FTT [281]). *Mr Scorey said that this was irrelevant because there was no doubt that the goods existed. Furthermore the Appellants were principally traders in FMCG which 'dabbled' in drinks; Bristol was the reverse – a trader principally dealing in drinks but 'dabbling' in FMCG.*

- Bristol was not an authorised Gillette distributor [FTT 282]. *Mr Scorey noted that this was a normal incident of the grey market.*

- Bristol had only been trading for a maximum period of less than 12 months and the Appellants failed to ask how long Bristol had been trading (FTT [283]). *Mr Scorey said that HMRC had produced no evidence about Bristol but from the Appellants' own inspection it was a substantial operation and already knowing that it had only traded for a maximum of 12 months, the omission to enquire how long Bristol had traded was an irrelevant consideration.*

- Bristol was able to offer the Appellants credit in very considerable amounts on their purchases and the Appellants made no enquiry as to how it was able to fund this or whether it had itself obtained the goods on credit (FTT [286]). *Mr Scorey said that HMRC had produced no evidence regarding Bristol's financial standing or how it had funded the transactions.*

d. Bristol's approach was unsolicited and proximate in time to CEMSA's approach. The coincidence of timing, readiness to sell and buy huge quantities of a particular product and the absence of an antecedent trading relationship should have made the Appellants suspicious (FTT [284] and [285]). *Mr Scorey said that neither Bristol nor CEMSA was alleged to be involved in the fraud nor had HMRC*

alleged that the transactions involved 'manoeuvering' or co-ordination. The only explanation therefore was coincidence.

e. The quantity and value of the razor blades made the deals exceptional. The Appellants dealings in valuable consignments of other products on the grey market were entered into with authorised distributors of the manufacturer (FTT [287]). *Mr Scorey noted that the Appellants as sellers were not authorised distributors.*

f. The quantity of razor blades involved and their value made the deals most unusual and extraordinary. The Appellants purchased a huge quantity and value of razor blades over a very short period of time such that the Appellants should have been on notice that the transactions were exceptionally odd (FTT [288] to [291]). The Tribunal rejected two possible explanations as to why so many razor blades could have appeared on the grey market at that time (FTT [292] and [293]). *Mr Scorey said that the Appellants could not have known that the quantities were extraordinary. As the goods existed, there was nothing in this to indicate fraud.*

g. Finally, the Appellants should have been put on enquiry by the fact that GR Distributions' business as "Wholesaler of wood, construction materials and sanitary equipment" was unrelated to what was being sold (FTT [294]). *Mr Scorey said that it was not alleged that GR Distributions was involved in the fraud nor did the Tribunal indicate what enquiry the Appellants could be expected to make.*

15. As we have noted, paragraph 276 of the First-tier Tribunal's decision indicated that the Tribunal accorded greater weight to some factors than to others ("more compelling") and that it might have found some aspects of the evidence conclusive. The statement of reasons does not entirely live up to this billing and one of Mr Scorey's criticisms of the Tribunal's approach was that it provided no analysis of what steps the Appellants could have taken to uncover the existence of the fraud. The Tribunal's reasons do, however, offer some indication of weighting. Thus—

a. The large repayment position, *of itself*, should have alerted the Appellants that their deals were unusual (FTT [280]);

b. The failure to ask how long Bristol had been trading was "a notable omission" (FTT [283]);

c. The value and quantity of razor blades involved made the deals most unusual and extraordinary (FTT [289]) and should have put the Appellants on notice that the transactions were exceptionally odd (FTT [291]).

The Appellants' attack on the Tribunal's conclusion

16. Mr Scorey's extensive attack on the Tribunal's conclusion, as reflected in his lengthy skeleton argument and his oral submissions, involved three main elements: first, he considered the relevant background to the deals. He noted that the transactions took place in a legitimate trade sector in which the Appellants' experience and knowledge was unquestioned. There was no allegation of fraud or wrongdoing against any intermediate trader, in particular against Bristol. He drew our attention to the procedural history of the case in the course of which HMRC had been forced to abandon allegations that the Appellants had been complicit in and/or had actual knowledge of the fraudulent evasion and HMRC's evidence alleging that any parties other than Leeming were fraudulent evaders was required to be deleted.

17. Mr Scorey summarised the context of HMRC's pleaded case (as he had for the First-tier Tribunal, see FTT [241]) in the following terms—

    a. Leeming, the importer, fraudulently failed to account for output tax.

    b. No allegation was pleaded by HMRC of actual knowledge or complicity by the Appellants, Bristol or CEMSA in respect of MTIC fraud.

    c. The M3 Power razor blades purchased by the Appellants did in fact exist, notwithstanding the fact that they were purchased in high volumes and constituted a large market share (by reference to the retail market, but not by reference to the grey market).

    d. There was no allegation that the goods had been "carouselled" or were part of a contrived deal chain (such allegations, made "on the hoof" by HMRC during the hearing having been ruled inadmissible) (FTT [186]).

    e. The goods were traded at normal grey market prices. There was no suggestion that the price had been artificially depressed by reason of fraud or prior evasion of VAT.

18. The second element of his attack comprised an outline of the relevant legal principles. Mr Scorey emphasised the fundamental character of a trader's right to deduct input tax. This led to an examination of the European case law aimed at demonstrating just how high a hurdle the European Court had set for Revenue authorities before it could be concluded that the right of deduction was lost. Finally he cited extensively from *Mobilx Ltd (in Administration) v HMRC; HMRC v Blue Sphere Global Ltd; Calltel Telecom and Another v HMRC* [2010] STC 1436.

19. His third element comprised the 9 grounds of appeal in respect of which the Appellants had been granted permission. Each ground focussed on a different aspect of the First-tier Tribunal's decision but, overall, they attacked the conclusion that the Tribunal had drawn having regard to the facts that it had found and the way in which HMRC had pleaded its case (or had failed to do so) and the evidence that HMRC had produced in support.

20. We summarise in the following paragraphs this third element of Mr Scorey's attack without distinguishing the way in which they were divided into nine different grounds of appeal. In our view what those nine grounds essentially amounted to was an argument that the Tribunal had erred in law by going beyond HMRC's pleaded case and arriving at findings of fact and a conclusion on the facts that were not supported by the evidence that HMRC had adduced in support of its case. The particular significance of HMRC's pleaded case in the current circumstances depends on the fact that the burden of proof lies with HMRC to show on the balance of probabilities that the Appellants should have known that their transactions were connected with fraud.

Bristol's involvement in the transactions (Grounds 1 & 2)

21. Mr Scorey first focussed his attention on what the Tribunal had said about Bristol. The Tribunal recorded that the Appellants had run a credit check on Famecraft Ltd (the company which traded under the name "Bristol Cash & Carry"), the contents of which did not present the Appellants with any concern (FTT [89]-[96]). The Appellants had also visited Bristol's premises, where they had observed a large amount of stock and significant commercial activity taking place, which led them to conclude that, "even if Bristol had only recently started trading, it was a bona fide enterprise". Mr Scorey said that the Tribunal's description of the transactions and the steps that the Appellants had taken to verify the existence of the goods was consistent with genuine and legitimate high-volume trading in the grey market. Given the Tribunal's finding (at FTT [146]) that the Appellants bought and sold the actual quantity of razor blades in question and given that there was no allegation of fraud or wrongdoing against Bristol, Mr Scorey said that the only permissible finding was that Bristol was a bona fide supplier of Gillette razor blades. He pointed out that HMRC has adduced no evidence that would undermine the legitimacy of Bristol's business, nor had they made any disclosure about Bristol.

22. Having regard to these findings, Mr Scorey said that the Tribunal had no basis in terms of the pleadings or the evidence for its 'negative' findings regarding Bristol and the Tribunal's conclusion that "the Appellants failed to read the warning signals in respect of Bristol". He said that the Tribunal's conclusions at paragraphs 281 to 286 of its decision implied that there was something wrong with the purchases from Bristol. There was, however, no allegation of impropriety on the part of Bristol. The Tribunal had therefore erred by attaching probative weight to the factors that it had outlined regarding Bristol. It was logically impossible for any of the factors that the Tribunal had

identified, individually or cumulatively, to give rise to any inference of fraud. The additional finding that they were only explicable by reason of connection to fraud was simply untenable.

23. As regards the specific warning signals referred to by the First-tier Tribunal, Mr Scorey said that the Tribunal's reliance on Bristol's drinks trade as a warning signal ignored the fact that the Tribunal had already found that Bristol "was looking to develop its business by creating new long-term relationships with purchases of certain products, including toiletries." A subsequent toiletries transaction could not be taken, therefore, as an indicator of fraud. Furthermore, no case had been advanced that Bristol did not also trade in these goods in addition to its cash and carry trade in drinks; nor was it explained why trading in other goods should have warned the Appellants of the connection to fraud. The Appellants traded occasionally in drinks as the opportunity arose and Bristol could occasionally trade in FMCG in the same way.

24. Mr Scorey said that the same was true of the 'warning signal' that Bristol was not an authorised distributor of Gillette products. This was not part of HMRC's pleaded case. Furthermore it ignored the fact that the trade was taking place in the parallel grey market and not in the authorised white market. No case was advanced that Bristol was not a bona fide trader in the Gillette blades grey market as a non-authorised dealer. It was not permissible to conclude that a transaction between grey market traders somehow carried the inference of fraud. On that basis there was no "factor to be taken into account" as the Tribunal did.

25. He also criticised the Tribunal's view that a further 'warning signal' was the fact that Bristol had only been trading for a limited period and was supplying a high volume of Gillette blades. As the Tribunal had found, the Appellant had inspected the goods to verify their existence. He criticised the Tribunal's view that it was a "notable omission" that the Appellants did not ask precisely for what period Bristol had been trading. The Appellants knew that it was less than a year from the credit report they had obtained and from their visit to Bristol's premises they had been able to conclude that Bristol was conducting a bone fide trading operation. This made it irrelevant to determine precisely how long it had been trading. The Appellants had also asked Bristol's managing director to explain how it had sourced the razor blades and had been told that he had connections that had enabled him to get hold of them. As such Bristol had the benefit of a commercial grey market opportunity of precisely the sort that the Appellants themselves exploited to generate profit. How long it had been trading was therefore irrelevant and would not have warned of the connection with fraud.

26. Mr Scorey said that it was not part of HMRC's case that the Appellants should have exercised caution because Bristol was not an authorised Gillette distributor. It was, however, HMRC's case that the favourable trade terms that

the Appellants had achieved through the credit that Bristol had extended should have led the Appellants to conclude that the only reasonable explanation was a connection with fraud. The Tribunal instead had noted that the Appellants had not asked how Bristol was able to fund the provision of credit or whether it had itself obtained the goods on credit. Mr Scorey said that HMRC had not pleaded any case on the quantum of credit or that the Appellants' due diligence was defective. There had been no attempt to explain why the provision of credit necessarily put the Appellants on notice of the antecedent fraud.

The volume and premium nature of razor blades traded (Grounds 3, 4 & 5)

27. As regards the quantities of razor blades traded, Mr Scorey noted that HMRC's case merely referred to the number being significant when compared to the numbers sold by Gillette itself. Mr Scorey said that the Tribunal was mistaken in saying that the volume traded was one of "the most hotly disputed issues" in the appeal because the Appellants accepted that they were trading large volumes. Their point had been that they were experienced in high-volume trades. He also complained that HMRC had made no case – and had adduced no evidence – to show the logical or causal connection between the volume of the goods traded and the fact of the antecedent fraud.

28. There was no suggestion that the goods did not exist (an aspect negated by the Tribunal's own finding) or had been carouselled (an allegation that was precluded by the Tribunal's preliminary ruling). HMRC had also not alleged that the Appellant should or could have known how the volume of transactions compared to global or other volumes, neither had it been pleaded that there was any relevance to the razor blades being a "premium product". The Tribunal at paragraph 148 of its decision referred to the significance of the volume of the particular type of razor blade as a factor that should have alerted them to the connection with fraud. He said that there was no pleaded case regarding the particular type of razor blade. The Tribunal's finding that the premium market was smaller and that the Appellants should have appreciated that the M3 Power razor blades would sell in smaller quantities (see FTT [150]) contained a fundamental error by implying that goods could not ordinarily be sold in such quantities notwithstanding that the goods had actually been sold. As the goods had in fact been placed on the grey market in large quantities, it was irrelevant that they were larger than white market sales for the product at that time. The Tribunal was wrong to conclude, therefore, that this made the deals "most unusual" and "extraordinary" and "exceptionally odd".

The Tribunal's reliance on other matters (Grounds 6 & 7)

29. Mr Scorey complained that the Tribunal had incorrectly relied on the fact that the transactions as exports gave rise to a large repayment claim. This was the natural consequence of the VAT system and had no necessary connection with

Leeming's fraud, which would have been no different whether the Appellants exported or sold in the UK market.

30. Mr Scorey said that the fact that GR Distributions was a "wholesaler of wood, construction materials and sanitary equipment" was also irrelevant to the question of Leeming's fraud. No evidence had been advanced regarding GR Distributions and the Tribunal had not explained what further enquiry would have been relevant to the fraud given that no allegation had been made in HMRC's pleaded case regarding GR Distributions of any wrongdoing or involvement in the fraud.

Grounds 8 & 9

31. As Ground 8 Mr Scorey said that the *Mobilx* test required that a party was only culpable if he had the means of discovering the fraud. Mr Scorey emphasised that this was not a case where individual factors that could each be explained took on a different complexion when viewed cumulatively. None of the matters relied upon by HMRC individually or cumulatively would have allowed the Appellants to uncover the fraud. Finally, in Ground 9, Mr Scorey said that the Tribunal's approach in finding facts on issues which had not formed part of HMRC's pleaded case or which had not been put to the Appellants by HMRC infringed its right to a fair trial under Article 47 of the EU Charter of Fundamental Rights.

HMRC's submissions in support of the Tribunal's decision

32. Mr Kinnear's submissions in support of the First-tier Tribunal's conclusion were in comparison relatively brief. He naturally endorsed the reasons given by the Tribunal which we have previously summarised. He noted that the Court of Appeal in *Mobilx* had warned against over-refining the "only reasonable explanation" test and that that was the process in which Mr Scorey was engaged. In particular, he said that the Tribunal had correctly rejected Mr Scorey's attempt to look at and explain each factor in isolation to reach the conclusion that the test was not satisfied.

33. In relation to the Tribunal's findings regarding Bristol, Mr Kinnear drew attention to the undisputed facts of what the Appellants knew about Bristol—

    a. Bristol was primarily a drinks' trading company;

    b. Bristol was not an authorised Gillette distributor;

    c. Bristol had only been trading for a maximum period of less than 12 months;

    d. Bristol had made an unsolicited approach to the Appellants, and

e. The Appellant received credit from Bristol in very considerable amounts.

34. Mr Kinnear said that these represented some of the objective factors known to the Appellants at the time. The Tribunal had properly taken these factors into account in assessing whether the Appellants should have known that their transactions were connected with fraud but these were just some of the factors and the FTT had looked at all the circumstances in the round. The fact that Bristol was not alleged to be part of the fraud did not mean that one could ignore the objective circumstances in which the transactions took place or treat them as untainted.

35. Mr Kinnear accepted that the burden placed on HMRC at first instance is a high one. He said, however, that on appeal the position is reversed. He said that it is not for us as an appeal Tribunal to ask whether we would have reached the same conclusion as the First-tier Tribunal. The hurdle is set much higher than that. Either we must be satisfied that the First-tier Tribunal applied the wrong legal principles or applied the relevant legal principles incorrectly, or we must be satisfied that the First-tier Tribunal reached its conclusion based on facts for which there was no evidence or for which the evidence was such that no reasonable Tribunal could have concluded as the Tribunal did, and that as a result their decision was based on an error of law (see *Edwards v Bairstow* [1956] AC 14).

36. Mr Kinnear said that Mr Scorey's attack on the conclusion reached by the First-tier Tribunal was a thinly disguised attack on their findings of fact. As such it was an impermissible attack. As regards the quantities of razor blades traded, Mr Kinnear said that it was not a complete answer to say that the razor blades existed. Even if they did, the fact that the transactions involved huge quantities – bigger than the Appellants had ever traded before – was still an objective factor that was known to the Appellants at the time and which the Tribunal was entitled to take into account in arriving at its conclusion. Furthermore, the Appellants had been warned in 2003 that deals involving large numbers of razor blades were almost certainly indicative of an involvement with fraud.

Discussion

37. As Mr Scorey pointed out in opening, the Appellants are not challenging the facts that were found by the First-tier Tribunal nor is there any substantive disagreement between the parties as to the relevant legal test that is to be applied to those facts. They were agreed that the correct test was "the only reasonable explanation" test enunciated most notably by Lord Justice Moses in *Mobilx*.

38. This test presents a high hurdle for HMRC which we think is most easily appreciated by noting that 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. In other words, he can appreciate that everything may not be right about the transaction but that is not enough. He should have known that the transactions in which he was 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 in the circumstances of the transactions.

39. The main difference between the parties, as Mr Kinnear for HMRC puts it, relates broadly speaking to the conclusion that a First-tier Tribunal is entitled to draw from the combination of all the circumstances. Thus, he suggests, in this case the Appellants seek to say that because they can provide a reasonable explanation for each of the elements of the Appellants' purchase and sale of the Gillette razor blades, the Tribunal was not entitled to conclude that the 'only reasonable explanation' test was satisfied by the combination of those factors. In Mr Kinnear's submission, the combination of all the elements may be such that it is 'too good to be true', so that the only explanation of the combination is a connection to fraud.

40. For his part Mr Scorey denies that the Appellants' case is as Mr Kinnear portrays it: he says that whether looked at individually or in combination, the only possible conclusion to be derived from the facts as found by the First-tier Tribunal is that the 'only reasonable explanation' test is failed. In essence, the Appellants' case is that ordinary grey market trading comprises the combination of elements that consists of the Appellants' transactions and in the absence of any allegation or evidence from HMRC to suggest the contrary, ordinary grey market trading provides a reasonable explanation for the transactions, with the consequence that the Appellants' transactions must fail the test that the 'only reasonable explanation' for the circumstances in which the transactions took place is that they were connected with fraudulent evasion of tax.

41. Mr Kinnear also suggests that Mr Scorey's attack on the Tribunal's conclusion amounts to no more than an *Edwards v Bairstow* attack, namely to say that the Tribunal's findings of fact are unsupported by any evidence or that its conclusion based on those facts was one that no tribunal, properly directing itself, could have reached. He therefore says that in this Tribunal it is the Appellants who face a high hurdle and not HMRC.

42. It is true that the burden is on the Appellants to persuade this Tribunal that the First-tier Tribunal erred in law in reaching its decision, just as the burden was on HMRC before the First-tier Tribunal to demonstrate, on the balance of probabilities, that the only reasonable explanation for the Appellants' transactions was that they were connected with fraud. In this respect, however, we do not think that Mr Kinnear's comparison of the respective hurdles that each party faces is entirely apt. In this Tribunal in this case the

relevant legal principle that has to be applied is whether, on the facts found by the First-tier Tribunal, the only reasonable explanation for the circumstances in which the transactions into which the Appellants entered took place was that they were connected with fraud. If looking at the facts found by the First-tier Tribunal – without in any way seeking to add to or to detract from or to ignore them – this Tribunal considers that there is a reasonable explanation for those circumstances *unconnected* with fraud, we would be bound to conclude that the First-tier Tribunal had failed to apply the correct legal principle unless, for example, it had provided a credible explanation why the reasonable alternative explanation that this Tribunal would otherwise accept could not be regarded as reasonable in the circumstances of the Appellants' transactions.

43. Another area of disagreement between the parties is what conclusion can or should be drawn from the fact that the only acknowledged fraud was by Leeming and that no allegation was permitted to be made regarding Bristol or CEMSA. Mr Scorey relies on this to say that it must be assumed that they were 'innocent' parties entering into bona fide commercial transactions and that implicit in the First-tier Tribunal's conclusion is a suggestion that they were in some way connected with the fraud or in any event guilty of some wrongdoing.

44. Mr Kinnear in reply says that the Tribunal did not stray from the facts that it had found as to Bristol's and CEMSA's part in the transactions and had appropriately assessed the objective factors that were relevant to determining whether the Appellants should have known that its transactions with Bristol and CEMSA were connected with fraud.

45. Nevertheless, it was for HMRC to demonstrate on the balance of probabilities that the only reasonable explanation for the circumstances in which the Appellants' transactions took place is that those transactions were connected to fraud. In this respect, it fell to HMRC to say how it was pleading its case to that effect and, in particular, it was for HMRC to produce the evidence to make good its case. In an ordinary tax appeal HMRC are entitled to say that the appellant has not produced the evidence necessary to displace the assessment. In the present circumstances a taxpayer is entitled to say that HMRC have not produced the evidence necessary to establish that the taxpayer should have known that its transactions were connected to fraud.

46. In the course of his submissions, Mr Kinnear illustrated a point relating to whether a person could or should to have known or believed that they were receiving stolen goods by referring to an offer to sell plasma screens normally worth £1,000 each for a price of only £100 per screen. In such circumstances the terms of the deal that is offered could go beyond raising suspicion to a conclusion that a person buying the screens on those terms should be taken to know or believe that the screens were stolen. Later in his submissions, in an exchange with Judge Sadler, Mr Kinnear made the point that there could be a perfectly reasonable explanation for a sale at a price significantly below the

market price but the fact of such reasonable explanation would not automatically destroy a conclusion that the only reasonable explanation in the circumstances was that the person was acting dishonestly.

47. Mr Kinnear's point illustrates, however, the importance of accurate pleading so that a party knows the case he has to answer and can ensure that the actual circumstances of the case are established by appropriate evidence. If the transaction is at a demonstrably low price (for which there would need to be evidence) that was then unexplained, an appropriate inference may be drawn; similarly, if the low price is explained but the explanation is not accepted or believed. Once the low price is satisfactorily explained, however, it may no longer be possible to draw that inference from the low price. The question that arises in relation to this is who must explain and what should the Tribunal say to demonstrate whether it has accepted or rejected the explanation.

48. In this case HMRC have pleaded no wrongdoing in respect of Bristol and CEMSA and have made no disclosure in respect of them. If, for example, HMRC wanted the First-tier Tribunal to draw any inference adverse to the Appellants from the fact that Bristol sold the goods on credit terms to the Appellant then it would have been necessary for HMRC to plead that and to produce evidence in support.

49. Similarly, Mr Kinnear said that the fact of dealing in large quantities of razor blades and much bigger quantities than you have ever traded before, even if you establish that they do exist in that quantity (as was found here), is an objective factor which was known to the Appellants when they carried out their deal. The question, however, is what can you conclude from that? Mr Kinnear noted that the Appellants had been told in 2003 that transactions involving large quantities of razor blades were almost certainly indicative of an involvement with fraud. Was there evidence, however, for that assertion and does "almost certainly" achieve the necessary connection to fraud or is it merely grounds for suspicion?

50. As we have noted, the First-tier Tribunal sets out its reasons for concluding as it did starting at paragraph 278. It starts by noting the large repayment position that emerged from the transactions. This was, however, an ordinary consequence of the transaction size and the fact that the goods were being exported. As the Tribunal found, export sales was one of the ordinary incidents of the Appellants' business and we therefore think that little turns on this factor independently of the transaction size.

51. The 'warning signals' relating to Bristol do not seem to us to amount to much: the Tribunal recognises that a company dealing in drinks may deal in toiletries and that there is nothing unusual about this in the market in question. This must be particularly so when it is shown that the goods actually exist. The grey market by definition is populated by traders who are not authorised distributors and are dealing outside ordinary distribution trains. Given that the

Appellants knew that Bristol was a 'young' company but had verified from personal inspection that it was engaged in significant commercial activity, we fail to see the significance of failing to ask precisely how long Bristol had traded.

52. Bristol's unsolicited approach was not unusual for the market in question and the only aspect of this was its proximity to CEMSA's unsolicited approach. In the absence of any allegation or evidence to the contrary, however, the reasonable inference is that this was indeed a coincidence. Even if, as the Tribunal suggests, the Appellants should have had their suspicions aroused by this, suspicion is not good enough. The Appellants in fact offered the goods to three other potential purchasers (including one based in the UK) in addition to CEMSA.

53. Finally as regards Bristol there is the question of the credit that it offered the Appellants. However, the Tribunal makes no findings about the financial standing of Bristol or its ordinary terms of trade, presumably because it had no evidence on which it could make any such finding. It may be a legitimate question to ask how Bristol was financing its transaction but in the absence of any evidence to suggest an answer there seems no reason why an adverse inference should be drawn. Its profit from the transaction and the likelihood that the Appellants acting in the ordinary course of the grey market would sell quickly may provide the only explanation that one needs. To the extent that different conclusions should be drawn the investigating authority in these cases is HMRC and it will usually be better placed than any taxpayer to suggest some explanation and produce the evidence to support it.

54. That leaves the 'exceptionally odd' quantity and value of razor blades that the Appellants bought and sold (in the context of the quantum of monthly sales by retailers worldwide of this particular type of razor blade). That, however, has to be set against the fact that the razor blades were shown to exist. The fact that they were stored with a freight forwarder that the Appellants did not ordinarily use was obviously regarded as a particular feature of the transactions that the Appellants had satisfactorily explained. The First-tier Tribunal, however, at no point attempts to explain what it is about these various features of the transactions that point to a connection with fraud.

55. The impression is that the quantity of razor blades purchased and sold by the Appellants was a more compelling factor and, possibly, a conclusive factor. It appears to us, however, having regard to the Tribunal's description of the Appellants' business and the grey market in which they operated, that the transactions were entirely explicable as ordinary market transactions. In the absence of any evidence to demonstrate why they were not and without any explanation by the Tribunal as to why the factors to which they refer necessarily point to a connection with fraud, it seems to us that the Tribunal erred in concluding that the only reasonable explanation for the circumstances in which the Appellants' purchases took place was that they were connected to

fraud. That is so, in our judgment, whether the various factors identified as relevant to their decision by the First-tier Tribunal are examined individually or as a cumulative whole.

56. This appears to us to be consistent with the overriding right of a taxpayer to recover input tax and the requirement for legal certainty for traders dealing in a market such as this. If the terms of dealing are broadly consistent with the way in which transactions in the market are ordinarily conducted, it can hardly be said that the only reasonable explanation for the circumstances in which the transactions took place is that the transactions are connected with fraud, even if some facets of the transactions might raise a suspicion of fraud. That is the case with regard to the Appellants in this appeal. HMRC may not be appreciative of the existence of a market that enables those who are intent on fraud to trade goods to that end. On the other hand there is no reason to penalise innocent traders in that market merely because it offers that facility.

Conclusion

57. The Appellants' appeal is accordingly allowed.

Judge Malcolm Gammie

Judge Edward Sadler

RELEASE DATE: 6 August 2013