[2017] UKFTT 167 (TC)

TC05659

Appeal number: TC/2014/05060

EXCISE DUTY – tobacco – penalty – ss 7 A-C Tobacco Products Duty Act 1979 – duty not to supply tobacco in circumstances where likely to be resupplied to smugglers – basis of imposition of penalty – Article 6 European Convention on Human Rights – whether a criminal charge – requirement of access to a court of full jurisdiction and scope of the Tribunal's jurisdiction under s 16 (5) Finance Act 2004 – burden of proof – citation of Hansard – relationship between initial notice and penalty notice – whether a breach of Articles 30 and 34-36 Treaty for the European Union – whether penalty an unlawful customs charge – whether a quantitative restriction on the free movement of goods – appeal allowed in part

FIRST-TIER TRIBUNAL
TAX CHAMBER

BRITISH-AMERICAN TOBACCO (HOLDINGS) LTD **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE GUY BRANNAN

Sitting in public at the Royal Courts of Justice, London on 19-29 July 2016

Philip Moser QC and Brendan McGurk instructed by Hogan Lovells International LLP for the Appellant

Melanie Hall QC, Eric Metcalfe and David Gregory, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

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DECISION

5 **Introduction**

1. The appellant ("BAT") appeals, under section 16(5) Finance Act 1994, against HMRC's decision made pursuant to section 7B(4) Tobacco Products Duty Act 1979 (as amended by the Finance Act 2006) ("TPDA") contained in a letter from HMRC dated 5 June 2014 ("the Penalty Notice"). The Penalty Notice was upheld on review
10 by a letter dated 13 August 2014 ("the Review Decision"). The Penalty Notice imposed a penalty of £650,000 on BAT.

2. This appeal is the first time that the penalty provisions of section 7 A-C TPDA have been considered and, therefore, both parties regarded this as a test case.

3. Essentially, the dispute concerns whether BAT was supplying hand-rolling
15 tobacco ("HRT") where the nature or circumstances of the supply made it likely that it would be resupplied to persons who were likely to smuggle the tobacco into the UK. Alternatively, HMRC argued that BAT were "otherwise facilitating" the smuggling of tobacco products into the UK. The circumstances in which HMRC could impose a penalty, the jurisdiction of this Tribunal, the application of the European Convention

on Human Rights (particularly Article 6 – the right to a fair trial) and the application of EU competition law were also among the many issues in dispute.

4. BAT is one of four main UK tobacco manufacturers. Evidence was produced in relation to the other three tobacco manufacturers to whom I shall refer as the
5 "Manufacturer" or the "Manufacturers", as the case may be. I shall, otherwise, refer to a tobacco manufacturer as a "TM".

Evidence

5. I was provided with twenty ring-binders of exhibits to witness statements, four folders of correspondence and one folder containing witness statements.

10 6. Six witnesses gave witness statements and oral evidence. For BAT the witnesses were:

(1) Ms Jelena Udicki, BAT's Anti-Illicit Trade Relationship Manager;

(2) Stefanie Borms, BAT's Legitimate Cross-Border Trade Manager for Belgium and Luxembourg; and

15 (3) Mr Lenard Fehrensen, BAT's Senior Business Insights Manager for Marketing Strategy, Planning and Insights.

7. For HMRC, the witnesses were:

(1) Mrs Susan Green, the HMRC officer, working within the "Large Business" division of HMRC's Business Tax team, who issued the Penalty
20 Notice;

(2) Mr David Fowler, an HMRC officer who, at the relevant time, was the Deputy Tobacco Supply Chain Manager within the Large Business section of HMRC and who conducted a supply chain audit of BAT in 2013; and

(3) Mr Mark Dickson, a professional statistician employed by HMRC.

25 8. In addition, Ms We Zen Cho, a solicitor employed by Hogan Lovells International LLP (solicitors to BAT), provided a witness statement but did not give oral evidence.

The legislation

9. The relevant provisions were inserted into the TPDA by the Finance Act 2006,
30 with effect from 1 October 2006. All statutory references in this decision are to the TPDA or the Tobacco Products Regulations 2001(SI20 2001/1712) (as amended) ("TPR 2001"), unless otherwise stated.

10. The first provision, section 7A, places a duty on tobacco manufacturers ("TMs") not to facilitate smuggling:

35 "7A Duty not to facilitate smuggling

> (1) A manufacturer of cigarettes or hand-rolling tobacco shall so far as is reasonably practicable avoid—
>
> (a) supplying cigarettes or hand-rolling tobacco to persons who are likely to smuggle them into the United Kingdom,
>
> (b) supplying cigarettes or hand-rolling tobacco where the nature or circumstances of the supply makes it likely that they will be resupplied to persons who are likely to smuggle them into the United Kingdom, or
>
> (c) otherwise facilitating the smuggling into the United Kingdom of cigarettes or hand-rolling tobacco."

11. In this appeal, it is common ground that section 7A(1)(a) is not engaged on the facts – there is no suggestion that BAT directly supplied tobacco to persons who were likely to smuggle it into the UK. Moreover, it is also common ground that this appeal is concerned with HRT rather than with cigarettes.

12. Section 7A continues by setting out further duties and a definition of the expression "smuggling products", as follows:

> "(2) In particular, a manufacturer—
>
> (a) in supplying cigarettes or hand-rolling tobacco to persons carrying on business in or in relation to a country other than the United Kingdom, shall consider whether the size or nature of the supply suggests that the products may be required for smuggling into the United Kingdom,
>
> (b) shall maintain a written policy about steps to be taken for the purpose of complying with the duty under subsection (1), and
>
> (c) shall provide a copy of the policy to the Commissioners on request.
>
> (3) In this section a reference to smuggling products into the United Kingdom is a reference to importing them into the United Kingdom without payment of duty which is—
>
> (a) chargeable under section 2, and
>
> (b) payable by virtue of section 1(1) of the Finance (No 2) Act 1992 (c 48) (power to fix excise duty point)."

13. Further, section 7A provides for HMRC serving, what I shall describe as, a "specification notice" and for HMRC to require a TM to supply information:

> "(4) The Commissioners may notify a manufacturer in writing that they think the risk of smuggling into the United Kingdom is particularly great in relation to—
>
> (a) products marketed under a specified brand name;
>
> (b) products supplied to persons carrying on business in or in relation to a specified country or place.
>
> (5) The Commissioners may by notice in writing require a manufacturer of cigarettes or hand-rolling tobacco to provide, within a specified period of time, specified information about—

(a) supply of products marketed under a brand name specified under subsection (4)(a);

(b) supply to persons carrying on business in or in relation to a country or place specified under subsection (4)(b);

5 (c) demand for cigarettes or hand-rolling tobacco in a country or place specified under subsection (4)(b).

(6) The Commissioners may issue guidance about the content of policies under subsection (2)(b).

(7) The Commissioners may make regulations—

10 (a) under which they are required to notify manufacturers of cigarettes or hand-rolling tobacco where products of a kind specified in the regulations are seized under section 139 of the Customs and Excise Management Act 1979 (c 2) in circumstances specified in the regulations,

15 (b) specifying the procedure for notification,

(c) including provision about access to seized products for the purpose of determining who manufactured them, and

(d) requiring manufacturers to provide the Commissioners with information or documents, of a kind specified in the regulations or 20 determined by the Commissioners, in relation to notified seizures."

14. The guidance referred to in section 7A(6) is contained in HMRC's Public Notice 477 ("Notice 477"). The regulations, contained in the TPR 2001 referred to in section 7A(7), are set out below.

15. Next, section 7B permits HMRC to deliver two types of notice to a TM. First, 25 HMRC may deliver an "initial notice" under section 7B(1). In addition, six months later, HMRC may then issue a "penalty notice" under section 7B(4). I shall refer to the initial notice issued to BAT under section 7B(1) as the "Initial Notice". I shall refer to the six month period following the issue of the Initial Notice and preceding the issue of the Penalty Notice as the "Warning Period" (terminology used by both 30 parties at the hearing and in the Consultative Document – see below). The relevant provisions of section 7B are as follows:

"7B Penalty for facilitating smuggling: initial notice

(1) Where the Commissioners think that a manufacturer has without reasonable excuse failed to comply with the duty under section 7A(1) 35 they may give him written notice that they are considering requiring him to pay a penalty.

(2) In determining whether to give notice to a manufacturer under subsection (1) the Commissioners shall have regard to—

(a) the content of the manufacturer's policy under section 7A(2)(b),

40 (b) compliance with that policy,

(c) action taken pursuant to any notice under section 7A(4),

(d) compliance by the manufacturer with any notice under section 7A(5),

(e) the number, size and nature of seizures of which the manufacturer has been given notice by virtue of section 7A(7)(a),

5 (f) compliance by the manufacturer with any requirement by virtue of section 7A(7)(d),

(g) evidence about the level of demand for the manufacturer's products for consumption outside the United Kingdom, and

(h) any other matter that they think relevant.

10 (3) A notice must specify the matters to which the Commissioners have had regard in determining to give it.

(4) After the end of the period of six months beginning with the date on which a notice is given to a manufacturer, the Commissioners shall give him notice in writing either—

15 (a) that they require payment of a penalty, or

(b) that they do not require payment of a penalty.

(5) The Commissioners shall comply with subsection (4) during the period of 45 days beginning with the end of the period specified in that subsection; and for that purpose they shall consider—

20 (a) any representations made by the manufacturer during that period in such form and manner as the Commissioners may direct, and

(b) action taken by the manufacturer during that period."

16. Finally, section 7C specifies the contents of the penalty notice and sets out the matters to which HMRC must have regard in determining the amount of the penalty:

25 "7C Penalty for facilitating evasion: penalty notice

(1) A notice under section 7B(4)(a) (a "penalty notice") must—

(a) specify the amount of the penalty which the manufacturer is required to pay, and

(b) state the grounds on which the Commissioners think that the
30 manufacturer has failed to comply with the duty under section 7A(1).

(2) The amount specified under subsection (1)(a) must not exceed £5 million; and in determining the amount to specify the Commissioners shall have regard to—

(a) the nature or extent of the manufacturer's failure to comply with
35 the duty under section 7A(1),

(b) action taken by the manufacturer to secure compliance with that duty,

(c) the content of the manufacturer's policy under section 7A(2)(b),

(d) compliance with that policy,

40 (e) action taken pursuant to any notice under section 7A(4),

> (f) compliance by the manufacturer with any notice under section 7A(5),
>
> (g) the number, size and nature of seizures of which the manufacturer has been given notice by virtue of section 7A(7)(a),
>
> (h) the loss of revenue by way of duty under section 2, or VAT, in respect of the products seized, and
>
> (i) any other matter that they think relevant.
>
> (3) Sections 13A to 16 of the Finance Act 1994 apply to a decision to issue a penalty notice as they apply to the decisions mentioned in section 13A(2)(a) to (h) of that Act."

17. Section 7D contains various supplementary provisions. In particular, parent and subsidiary companies are treated as a single undertaking. In this case, it is not in dispute that, if a penalty is due, it can be imposed on BAT.

18. The reference in section 7D(3) to the provisions of the Finance Act 1994 applies certain provisions relating to appeals in respect of a penalty notified under section 7B(4). It was common ground that the relevant provision governing this appeal was section 16(5) Finance Act 1994. For reasons which will become apparent, it is necessary to set out section 16(4) as well as section 16(5) Finance Act 1994, as follows:

> "(4) In relation to any decision as to an ancillary matter, or any decision on the review of such a decision, the powers of an appeal tribunal on an appeal under this section shall be confined to a power, where the tribunal are satisfied that the Commissioners or other person making that decision could not reasonably have arrived at it, to do one or more of the following, that is to say—
>
> (a) to direct that the decision, so far as it remains in force, is to cease to have effect from such time as the tribunal may direct;
>
> (b) to require the Commissioners to conduct, in accordance with the directions of the tribunal, a review or further review as appropriate of the original decision; and
>
> (c) in the case of a decision which has already been acted on or taken effect and cannot be remedied by a review or further review as appropriate, to declare the decision to have been unreasonable and to give directions to the Commissioners as to the steps to be taken for securing that repetitions of the unreasonableness do not occur when comparable circumstances arise in future.
>
> (5) In relation to other decisions, the powers of an appeal tribunal on an appeal under this section shall also include power to quash or vary any decision and power to substitute their own decision for any decision quashed on appeal."

19. It will be noted that section 16(5) gives this Tribunal more extensive powers than an appeal in relation to an "ancillary matter" under section 16(4).

20. Section 16(6) Finance Act 1994 sets out the position as regards the burden of proof. In this appeal, none of the provisions referred to in section 16(6)(a) – (b) is applicable:

> "(6) On an appeal under this section the burden of proof as to—
>
> (a) the matters mentioned in subsection (1)(a) and (b) of section 8 above,
>
> (b) the question whether any person has acted knowingly in using any substance or liquor in contravention of section 114(2) of the Management Act, and
>
> (c) the question whether any person had such knowledge or reasonable cause for belief as is required for liability to a penalty to arise under section 22(1) or 23(1) of the Hydrocarbon Oil Duties Act 1979 (use of fuel substitute or road fuel gas on which duty not paid),
>
> shall lie upon the Commissioners; *but it shall otherwise be for the appellant to show that the grounds on which any such appeal is brought have been established.*" (Emphasis added)

21. As I shall explain, the issue of the burden of proof was one of the matters in dispute in this appeal.

22. Finally, regulations 29-31 TPR 2001, which (in common with sections 7A-C TPDA) took effect from 1 October 2006, provided:

> "29 (1) The Commissioners shall provide written notification of a seizure of cigarettes or hand-rolling tobacco under section 139 of the Customs and Excise Management Act 1979 ("the seized products") to a manufacturer in the circumstances specified in paragraph (2).
>
> (2) The circumstances referred to in paragraph (1) are—
>
> (a) the seized products consist of at least 100,000 cigarettes or 50 kilogrammes of hand-rolling tobacco; and
>
> (b) the Commissioners believe that the seized products were manufactured by, or that manufacture was arranged by, the manufacturer on or after 1st October 2006.
>
> 30 (1) The written notification shall be accompanied by a sample of the seized products.
>
> (2) The remaining seized products shall be available for inspection by the manufacturer at any reasonable time for a period of one month beginning with the day on which written notification was given to that manufacturer.
>
> (3) A manufacturer who wishes to inspect the remaining seized products shall notify the Commissioners of that fact in such form and manner as the Commissioners may specify.
>
> 31 (1) A manufacturer shall provide the Commissioners with the information specified in the Schedule.
>
> (2) The information shall be provided—

(a) before the end of the period of one month beginning with the day on which written notification was given to the manufacturer, or

(b) at such other time as the Commissioners may allow.

5 (3) The Commissioners may dispense with the requirement to provide any information specified in the Schedule where they are satisfied that a manufacturer is unable to provide that information despite taking reasonable steps to do so.

Schedule

1. Where the seized products were—

10 (a) manufactured by the manufacturer, or

(b) manufactured by a person with whom the manufacturer had arranged to have cigarettes or hand-rolling tobacco manufactured,

the manufacturer shall provide the information specified in paragraphs 4 to 10 below.

15 2. Where it appears the seized products were manufactured on premises occupied by—

(a) the manufacturer, or

(b) a person falling within paragraph 1(b),

20 other than in accordance with instructions given by, or with the agreement of, the manufacturer the manufacturer shall provide the address of those premises, the name of the undertaking occupying those premises and, if that undertaking is a subsidiary undertaking, the name of the parent undertaking.

25 3. Where the seized products do not fall within paragraphs 1 or 2 the manufacturer shall notify the Commissioners of that fact.

Information to be provided

4. The name of the undertaking who manufactured the seized products and, if that undertaking is a subsidiary undertaking, the name of the parent undertaking.

30 5. The address of the premises on which the seized products were manufactured.

6. The date the seized products were manufactured.

7. The total quantity of cigarettes or hand rolling tobacco bearing the same manufacturer's coding as the seized products.

35 8. The name of the country to which the seized products were, or were to be, supplied.

9. *The name and address of the first customer to whom the seized products were, or were to be, supplied.*

40 10. The date of the invoice issued to the first customer and the total invoiced quantity of cigarettes or hand-rolling tobacco."

(Emphasis added)

The facts

23. This appeal involved a considerable volume of evidence. Moreover, the events relevant to this decision took place over several years and it is convenient to set out some of the main events in sequence, although this chronological summary of events is by no means comprehensive. I shall return to a number of the factual issues in more detail later in this decision. I hope, however, that any element of repetition will be compensated for by a greater degree of clarity imparted by a chronological description of the main events.

Background and sequence of events

24. BAT is a member of a group of companies that manufactures tobacco products including a brand of HRT called Cutters Choice ("CC"). CC is manufactured in the Netherlands by a Dutch BAT group company and is then exported directly to Belgium upon its purchase by a Belgian BAT group company. In fact, the Dutch BAT entity sells the tobacco to a UK BAT company which then on-sells it to the Belgian BAT group company, but the goods move directly from the Netherlands to Belgium. The Belgian BAT company sells the product to independent Belgian wholesalers; this is the first supply outside the BAT group. The Belgian wholesalers then sell the tobacco on to Belgian retailers who in turn sell it to consumers.

25. As I have already noted, it is common ground that the Belgian wholesalers – BAT's direct customers – are not smugglers of tobacco products.

26. HRT (including CC) is liable to excise duty. All EU Member States are obliged to charge a minimum rate of excise duty on HRT, but some Member States have higher excise rates than others. The rate of excise duty in the UK is significantly higher than in Belgium. That differential creates an arbitrage opportunity for legitimate wholesale and retail businesses in Belgium who purchase HRT (such as CC and competitor products manufactured by or for other TMs) for sale in Belgium. The lower rate of excise duty on HRT in Belgium, in turn, creates demand from consumers in other Member States where rates of excise duty are higher, such as the UK, France and the Netherlands.

27. The purchase of tobacco products, e.g. HRT, for personal consumption as part of customs-free cross-border travel is entirely legal in the European Union. For UK residents, the excise duty saving on the purchase of HRT in Belgium is far in excess of the cost of a day-trip by coach (estimated to be between £40-60) from the UK to Belgium. The demand is particularly great in the South East of England.

28. The UK government sets minimum indicative limits for excise goods. If travellers import no more than those limits the excise goods will be presumed to be for personal consumption. The limit for HRT was 1 kg until 2002, at which time it was increased to 3 kg. In 2011 the limit was once again reduced to 1 kg. Travellers bringing into the UK amounts greater than the limit may be required to show that the HRT was intended for personal use.

29. In 2006, HMRC proposed introducing new supply chain control obligations on TMs by amending the TPDA and the TPR 2001. The amendments were to be made through the Finance (No 2) Bill 2006 and were part of the UK Government's strategy to address tobacco smuggling. HMRC provided the Tobacco Manufacturers Association ("TMA"), the UK tobacco industry trade body with a summary of the proposed legislation in January 2006 and this served as a basis for consultation ("the Consultation Document"). The consultation ran from January 2006 to around August 2006.

30. Prior to the TPDA amendments, HMRC entered into Memoranda of Understanding ("MoUs") with the four main UK TMs (including BAT). The non-legally binding MoUs were documents reflecting voluntarily agreed operational arrangements between HMRC and each of the four TMs. The first MoU to which BAT was a party was signed in 2002 ("the 2002 MoU") and this was the MoU in existence at the time HMRC sent the Consultation Document to the TMA. I shall examine BAT's MoUs in more detail later in this decision.

31. In March 2006 the TMs negotiated common MoU terms with HMRC which resulted in BAT signing a new MoU with HMRC, replacing the 2002 MoU ("the 2006 MoU"). The 2006 MoU referred to BAT cooperating with HMRC to deal with material quantities of tobacco product smuggled into the UK. In particular, clause 4.1 provided that:

> "Seizures will be considered material if they are of at least…50kg of hand-rolling tobacco."

32. On 14 August 2013, just over two months before the issue of the Initial Notice, HMRC and BAT entered into a new MoU ("the 2013 MoU").

33. The TMA expressed various concerns about the Consultation Document, including *inter alia* that:

(1) Given the jurisdictional difficulties for HMRC in enforcing penalties against tobacco manufacturers not domiciled or present in the UK, the proposed legislation would effectively only apply to UK manufacturers, with the effect that it would exacerbate inequalities in the market to the detriment of the UK-based manufacturers;

(2) The manufacturers would not be able to identify the first customer outside the TM's group in respect of seizures, as required by the Schedule to the TPR 2001, for the majority of customers and the majority of sales; and

(3) It appeared that the proposed legislation sought to subject the manufacturers to financial penalties for matters beyond their control, e.g. the practice of "hoovering" whereby smugglers purchase quantities of product at different retail outlets and consolidate them for smuggling.

34. In the Consultation Document of January 2006 it was stated that: "the legislation will complement the Memoranda of Understanding…that [HMRC] have entered into with a number of tobacco manufacturers."

35. In correspondence and meetings, HMRC gave the TMA various assurances that it was the intention that the new legislation would “reflect”, “mirror” or “complement” the MoUs. For example, in a letter from HMRC to the TMA dated 15 May 2006 HMRC stated:

> "Although not explicitly mentioned in the legislation, it has been our intention to mirror the operational arrangements agreed under the MoUs, and encourage a free and open dialogue between tobacco manufacturers and HMRC"

36. In addition, the Financial Secretary to the Treasury John Healey, in the course of the Parliamentary debate regarding the proposed legislation, said that the legislation:

> "is based on and complements the memorandums of agreement that are currently in place with the three major UK-based tobacco companies, which supply the majority of the UK market."

37. In the event, the proposed supply chain provisions were enacted in substantially unchanged form. The Finance Act 2006 was published on 19 July 2006. Sections 7A-7D TPDA and Part VII of the TPR 2001 entered into force on 1 October 2006. HMRC’s guidance on the new provisions was contained in Notice 477, which was also published in October 2006.

38. Each of the four main TMs also entered into an EU Co-operation Agreement (“EUCA”) with the EU, both as represented by the European Commission and all the signatory Member States of the EU, including the United Kingdom. The intention of these EUCAs, as set out in the recitals to BAT’s EUCA, was to enable binding co-operation between the tobacco industry, the Member States and the EU and to establish ongoing means of cooperation to combat the production of counterfeit tobacco and the smuggling of tobacco products. BAT signed its EUCA on 15 July 2010. Under their EUCAs the tobacco manufacturers agreed to:

(1) Pay an annual amount to the EU (in BAT's case, €134 million over 20 years);

(2) Make additional payments to Member States in respect of seizures where the seized products were authenticated as their genuine (i.e. non-counterfeit) products;

(3) Implement Know Your Customer (“KYC”) procedures which, among other things, required standard Anti-Illicit Trade (“AIT”) clauses to be included in their agreements with relevant customers; and

(4) Implement “Track and Trace” in the countries within the scope of EUCA, i.e. the EU Member States plus additional identified countries. (Under the BAT EUCA this amounted to almost 50 countries.)

39. "Track and Trace" and “additional customer tracking” (“ACT”) were important features of this appeal. Track and Trace refers to a product marking, coding and scanning system enabling manufacturers to track the movement of its products through the supply chain, from the point of manufacture to the point of sale to the first

external (i.e. non-BAT) customer, and to trace any seized BAT products back to the economic operators which originally supplied these products. I shall use the expression "Track and Trace" to refer to the system that enables products to be tracked and traced to the first external customer level in Belgium and Luxembourg ("Belux"), i.e. to BAT's wholesale customers.

40. In contrast, ACT is used to refer to the system enabling products to be tracked and traced to retailers supplied by BAT's first customers (the wholesalers) i.e. tracked to persons who, in Belux, are a series of Belgian retailers with whom BAT does not have a direct supply relationship. The implementation of ACT was not a requirement of EUCA.

41. Upon entering into EUCA, BAT began to introduce Track and Trace on a phased basis. BAT's EUCA Track and Trace implementation timetable was set out in one of several side letters to EUCA and provided for Track and Trace to be implemented in three tranches: 2012, 2014 and 2016. Originally, Luxembourg was in the second tranche (2014) and Belgium in the third (2016). The side letter setting out the timetable suggests that the tranches were determined based on total factory production volume, with markets supplied by factories with the largest production volumes being given priority in terms of timing.

42. As regards the TPDA seizure notification and inspection process, Regulations 29-31 TPR 2001 (as amended in 2006) provide for HMRC to notify TMs of seizures of more than 100,000 cigarettes or 50 kg HRT ("qualifying seizures" / "notifiable thresholds"). HMRC are also required to provide the TM with a sample of the seized products. The remaining seized products are made available to the TM for inspection during a period of one month beginning with the day on which the written notification was given to the TM. The regulations oblige TMs to provide the information specified in the Schedule to the TPR 2001. More particularly, once HMRC notifies the TM of a seizure above the notifiable thresholds (i.e. a qualifying seizure) and provides a sample of the seized products, the TM then has a month to:

(1) liaise with Border Force to arrange an inspection at the warehouse where the seized products are held;

(2) inspect the seized products at the warehouse (BAT used a third party provider to conduct these inspections);

(3) confirm the authenticity of the products (BAT's in-house forensic analysts conduct the authentication at BAT's laboratory in Southampton); and

(4) send HMRC a report including a spreadsheet, in a format provided by HMRC, containing the information required by the TPR 2001, and a witness statement given by a BAT forensic specialist confirming that the sample of seized product provided by HMRC was either genuine or counterfeit.

43. Nearly one month before it entered into its EUCA, BAT received the first specification notice under section 7A(4) TPDA, dated 16 June 2010, from Ms Lorraine James (the Tobacco Supply Chain Manager at HMRC and Mrs Green's immediate predecessor). It specified CC as a brand and Belgium and Luxembourg (as

well as Spain and duty-free markets) as markets in respect of which the risk of smuggling into the UK was considered to be particularly great (the "First Specification Notice"). That notice stated that the specified brands had been identified as being:

5 "a substantial source of smuggled tobacco product into the UK."

44. The First Specification Notice did not provide details of the nature of the HMRC's concerns or how it was believed the product was smuggled. It did, however, require BAT to furnish HMRC with more detailed information which, so far as relevant for present purposes, included:

10 (1) Updates to the overview of the normal structure of the marketing and distribution channels;

(2) Information regarding the names and addresses of the top five customers in Belgium (and Luxembourg), including the address of their principal place of business and the addresses where supplies are delivered, as and when any 15 change occurred. Also required were updates of any contractual agreements or other terms and conditions of sale that may be agreed between the parties;

(3) The total quantity supplied to each of these top five customers on a quarterly basis;

(4) Any updates of any master file details that BAT used to make the various 20 credibility and security checks in relation to the top five customers in Belgium;

(5) A copy of any analysis undertaken by BAT of the smuggling risks in Belgium;

(6) A copy of any analysis undertaken by BAT of the demand commensurate with the legitimate consumption of CC in Belgium.

25 45. In addition, BAT was required to supply further information on a quarterly basis.

46. The Notice concluded by stating that it was HMRC's intention to monitor the indicators of smuggling of the specified product from the specified markets over the next 12 months. HMRC stated that, at the end of that period, it would carry out a 30 further evaluation before deciding whether to extend the period of the First Specification Notice.

47. In response to the First Specification Notice, BAT introduced a maximum quota for supplies of CC in Belux, which was established in accordance with BAT's assessment of legitimate demand for CC. Moreover, BAT began to send HMRC 35 monthly reports on volumes of the specified brands supplied in the specified markets and other European countries (although there was no obligation to supply information otherwise than in respect of specified markets).

48. In addition, a KYC process was introduced with BAT's customers (i.e. wholesalers) in Belux in either 2011 or 2012 (a copy of the KYC EUCA provisions 40 was sent to Ms James towards the end of April or the beginning of May 2012). This

involved customer due diligence being carried out by BAT in respect of its wholesale customers. It also involved BAT requiring that its wholesalers agree to apply the EUCA KYC agreement provisions (see below) and encouraging the wholesalers to adopt similar KYC principles when doing business with retailers.

5 49. On 21 January 2012, BAT gave a presentation to Ms James on the actions it had taken in relation to the supply of CC to Belux. The presentation stated that BAT:

(1) had put in place detailed KYC processes;

(2) was monitoring and controlling all volumes and sales of CC into the Belux markets, in accordance with its calculation of legitimate demand;

10 (3) was investigating all notified seizures of CC in relation to those markets;

(4) was committed to implement Track and Trace pursuant to its EUCA obligations to do so in its Groningen factory (which produced CC) in 2014[1];

(5) would be undertaking a review of current market conditions in those markets.

15 50. In May 2012, Ms James provided Ms Udicki (BAT's Anti-Illicit Trade Relationship Manager) with HMRC's market assessment report which identified Belgium and Luxembourg as two important markets for HRT. The estimate for legitimate demand in those two countries was 34 tonnes in total. As I shall explain, the estimate of legitimate demand for CC in Belux was a contentious issue in this 20 appeal.

51. In November 2012, HMRC issued a further revised specification notice citing CC as a specified brand and named four of BAT's main wholesale customers in Belgium and three of BAT's main wholesale customers in Luxembourg as specified customers.

25 52. In January 2013, Ms James was replaced as Tobacco Supply Chain Manager by Mrs Susan Green.

53. From January to June 2013, the National Audit Office ("NAO") carried out an audit of HMRC's Tobacco Strategy.

54. At the same time (from January to around October 2013), HMRC audited three 30 of the four TMs' tobacco supply chain policies (it is understood that these were BAT, and two other TMs and that a third TM's policies were audited later in 2014). HMRC informed BAT of the audit by a letter dated 29 January 2013 which stated as follows:

> "... As you are aware [the TPDA] has been in place for some time and whilst we have often discussed aspects of it with you, we have not 35 taken the opportunity to test the overall effectiveness of your policies and associated controls. This audit will help us inform future HMRC policy in this area, as well as ensuring that you are complying with the

[1] In fact, the proposal was that Track and Trace would be introduced in Luxembourg in 2014 and in Belgium in 2016.

> obligations laid down in section 7A [TPDA]. It is our intention to audit all the major tobacco manufacturers in the UK to whom these obligations apply.
>
> The audit team will be led by Sue Green….
>
> David Fowler, whom you already know, will also play a key role….
>
> You will be aware that the [NAO] is conducting a review of HMRC's Tobacco Strategy and there is a strong possibility that the Parliamentary Public Accounts Committee may wish to ask questions about the detail and effectiveness of that strategy. I see the audit as an essential component in supporting HMRC's response to any such questions. I am sure you will agree that it is in both our interests to be able to present our findings and conclusions if that eventuality arises. I would, therefore, welcome your full co-operation in progressing this audit quickly."

55. According to Ms Udicki' s evidence, which I accept, HMRC also told BAT that the purpose of the audit was to enable HMRC to determine supply chain best practices and provide recommendations to the tobacco manufacturers on best practice. That guidance was, however, only produced in April 2016, just a few months before the commencement of the hearing in this appeal.

56. Ms Udicki first met Mrs Green at a meeting with HMRC on 13 March 2013 to agree a plan for the audit. BAT and HMRC agreed to have a number of audit meetings, which took place on 17 April 2013, 22 April 2013 and 28 June 2013.

57. The date on which HMRC first raised its concerns with BAT that Belgium was in phase 3 (2016) for BAT's implementation of its EUCA's Track and Trace program was the subject of debate. I find that on the balance of probabilities it was raised in the course of the audit by HMRC and this occurred before August 2013 and probably in April 2013. As a result of these concerns, BAT took steps to accelerate Track and Trace implementation in Belgium, moving Belgium from phase 3 to phase 2 and thus accelerating implementation by two years. This change was approved by the BAT Track and Trace project board on 21 August 2013 but was not notified to HMRC until after the issue of the Initial Notice on 23 October 2013.

58. On 20 May 2013, Ms Green e-mailed to BAT what she described as the first "new style" seizure report (a format which was later used to notify BAT of seizures below the notifiable threshold i.e. 50 kg in relation to HRT) indicating that it was being sent to Ms Udicki "for us to discuss."

59. The report stated that:

> "On 23 March 2013, a HGV Freight Vehicle was stopped and controlled at Dover and 96 kg of Hand Rolling Tobacco was discovered in a concealment within the vehicle. 36 kg [but in the table above the narrative the quantity seized was referred to as 30 kg] of this tobacco was found to be the Cutters Choice Brand."

60. In other words, the amount of CC seized was below the 50 kg threshold specified in regulation 29 of TPR 2001 (which required HMRC to provide written

notification of the seizure and a sample and allow the TM to inspect the seized goods).

61. As BAT pointed out, the covering e-mail did not suggest that there was a change in what constituted a qualifying seizure for the purposes of regulation. HMRC sent no sample of the seized CC as would have been required by regulation 30 TPR 2001 had the quantity of CC been 50 kg or more.

62. HMRC sent four such "new style" reports of CC seizures to BAT in 2013, but (apart from the 20 May 2013 notification) none of those was for seizures of below 50 kg of CC. As we shall see, the status and purpose of these "new style" (i.e. below 50 kg) reports was the subject of some debate at the hearing. HMRC contended that these reports reflected HMRC's increasing focus on what it described as "little and often" smuggling. It was hard, however, to see the first such report as dealing with "little and often" smuggling – the overall consignment of smuggled tobacco was 96 kg and involved concealment. "New style" seizure reports dealing with seizures of less than 50 kg were sent to BAT in 2014 (see below, under the heading: "*Little and often smuggling" and Project Falcon*).

63. It was in late 2014 to early 2015 (i.e. after the issue of the Penalty Notice) that HMRC began to request that BAT inspect non-qualifying seizures (i.e. seizures of volumes below the notifiable thresholds). Prior to that, BAT was only able to inspect such seizures where they exceeded 50 kg and were separately notified according to the usual TPDA seizure notification and inspection process for qualifying seizures as described above.

64. In June 2013 the NAO published its report on HMRC's performance in relation to its Tobacco Strategy, concluding that HMRC had fallen short of internal targets. There were various Parliamentary committee hearings in June and July 2013 and in 2014 at which HMRC representatives were challenged for not making full use of their powers under TPDA. These criticisms of HMRC's use of its powers under the TPDA were mentioned by Mrs Green during one of her meetings with BAT towards the end of the Warning Period.

65. On 3 July 2013, the Head of BAT's AITIU Ewan Duncan, together with Ms Udicki, had a meeting with Mrs Green. Mr Duncan told Ms Green that the Anti-Illicit Trade Intelligence Unit ("AITIU") was not responsible for investigating the smuggling of genuine product and suggested that that that would be the responsibility of BAT's security team. Ms Udicki had then stated that BAT's security team was not responsible for investigating seizures of genuine product. From this Ms Green concluded that BAT did not investigate the smuggling of genuine product. In a letter dated 10 July 2013, Mrs Green wrote to Ms Udicki stating:

> "As you know I asked [Mr Duncan] at the end of his presentation if … his [AITIU] also investigated genuine product that was found smuggled into the UK. His response was that it was not within his remit and suggested BAT's Security team would be responsible.

You kindly explained that BAT's security team is not responsible for investigating these incidents either. You said, I believe, that they are responsible if goods were stolen from one of your warehouses or stolen during transportation, essentially where in some form or another your security has been breached.

Am I correct in my understanding of what was said? If I am not can you please correct me?

If I am correct can you please explain to me who investigates seizures notified to you under s. 7A (7) TPDA 1979? Did I understand correctly that you said that no investigations are carried out?"

66. Ms Udicki replied by letter to Mrs Green on 18 July 2013 and said as follows:

"As you are aware, we have plans to implement a Seizure Event Response Procedure which we have presented to you. Once this procedure has been implemented, actions taken pursuant to all seizures will be a matter for the AIT team working with the relevant end markets. However, the actions it [BAT] will take pursuant to any one seizure will depend upon the extent and nature of the information available to us.

We are fully aware of our obligations under TPDA. We are also familiar with the associated guidance set out in Notice 477. In relation to seizures notified to us by HMRC pursuant to s 7A(7) TPDA, BAT diligently analyses the information provided to us by HMRC, as well as that available to us internally, BAT evaluates its supply chain controls, and considers whether such controls can be further improved to reduce the likelihood of similar events occurring in the future.

Despite our best efforts, and as we previously set out in our letters to David Fowler dated 21 November 2012, we have, to some extent, been hampered in our ability to conduct as extensive evaluations as we would ideally carry out due to the lack of information from HMRC concerning respective seizures. In particular, we note that we have not always even been supplied with all the information envisaged by paragraph 4.5 of Notice 477, nor further information that would necessarily assist us such as evidence taken from the alleged smugglers.

As you will no doubt appreciate, the types of investigations that could be carried out upon receipt of a seizure notice will differ depending on the place and nature of any individual seizure. It may be a security issue (for example if there has been an incidence of theft from within the supply chain), in which case it will be a matter for our Security team. It may be a matter for the BAT company in an end market to address with its customers. Alternatively, if there is evidence to suggest that a particular seizure is connected with a broader anti-illicit trade investigation, then that would be a matter for the Intelligence Unit to investigate. Matters are not therefore automatically referred to the Intelligence Unit and that was what Ewan Duncan was trying to convey. We apologise if that was not made clear."

67. Ms Udicki requested that BAT be provided with more information about seizures, including the information and samples referred to in Notice 477, including as much detail relating to the circumstances of the seizure and the individuals from whom the product was seized.

5 68. It seemed to me that Ms Udicki's reply to Mrs Green indicated that BAT's response to seizure notifications had been fragmented i.e. that there was no one with overall responsibility to coordinate a response. In this respect, I consider Mrs Green's concerns to have been well-founded and that BAT intended to introduce a seizure event response procedure to deal with the shortcomings which had been highlighted.

10 69. On 17 September 2013, towards the end of the supply chain audit period, HMRC sent a report, about what was called "Project Falcon", to BAT.

70. BAT contends that this was the first time HMRC had explained its understanding of "little and often" HRT smuggling from Belgium to the UK and informed BAT of their specific concerns about the UK cross-border relating to 15 Belgium. The report described UK consumers travelling in coach parties to Belgium to purchase tobacco (referred to by HMRC as "baccy buses") and stated that this represented a high smuggling risk. HMRC argued that "little and often" smuggling had previously been mentioned to BAT at meetings. I shall return to this conflict of evidence later.

20 71. At this point I should add that most of the "baccy buses" went to a small Belgian village on the Franco-Belgian border called Adinkerke. This small village is dominated by between 30 to 40 retail tobacco outlets. The "baccy bus" passengers would buy their tobacco in Adinkerke and re-board the coach which would then head back to the cross-Channel ferry.

25 72. HMRC accepted that many "baccy busses" were legitimate instances of cross-border shopping but considered that a number of others were organised and controlled by criminal gangs.

73. On 2 October 2013, three weeks after the release of the Project Falcon report, BAT received an undated formal request from HMRC pursuant to s.7A(5)(c) TPDA 30 seeking, within 30 days, information regarding BAT's legitimate demand calculation for CC in the specified markets. BAT responded on 1 November 2013, providing a legitimate demand calculation. BAT subsequently presented a detailed model of its calculation to HMRC at a meeting on 17 March 2014 (discussed in more detail below when I consider the issue of legitimate demand).

35 74. On 17 October 2013, BAT and HMRC had a meeting (attended by BAT's Global Head of AIT, Mr Pat Heneghan, among others) at which the Project Falcon report was discussed. Mr Heneghan explained that BAT made more profit on sales of CC in the UK than in Belgium so it was not in BAT's interests to over-supply HRT in Belgium. Ms Udicki confirmed that the profit margin in the UK was three times that 40 made in Belgium.

75. BAT subsequently held meetings with its wholesale customers and gave presentations on AIT issues to them, explaining that this was being done in the context of the Project Falcon report provided by HMRC. BAT also conducted AIT training for retailers supplying the cross-border market in Belgium and met the three main retailers of CC in Belgium mentioned in the Project Falcon report to discuss the contents of the report.

76. HMRC provided its initial findings from its supply chain audit to BAT on 23 October 2013 – the same day on which HMRC issued its Initial Notice to BAT.

77. In its initial audit findings, HMRC highlighted a number of positives about BAT's policies and procedures, as well as raising concerns and making recommendations. HMRC recognised that:

(1) BAT had a "detailed process for collecting and recording KYC information" which included a "substantial operational manual … to ensure continuity and uniform collection [of] data";

(2) BAT took its EUCA obligations seriously;

(3) BAT's Standards of Business Conduct, which included BAT's commitment to AIT initiatives, were "firmly embedded" in the BAT business, with "clear evidence of a governance structure and annual sign off process";

(4) BAT had implemented specific measures in relation to CC in response to increased seizures and the concerns raised by HMRC in the First Specification Notice in 2010, such as the sales quota and Cutters Choice Sales Policy; and

(5) BAT had an "empowered and independent" internal audit function and was able to share "powerful examples" to demonstrate the effectiveness of action taken in response to whistleblowing incidents.

78. Concerns raised by HMRC included the following issues:

(1) that BAT did not give its TPDA obligations the same priority as its EUCA obligations, noting that EUCA was an agreement whereas the TPDA was primary legislation;

(2) there was inadequate follow up work undertaken on notified seizures, particularly those involving genuine BAT products. In this connection HMRC noted the lack of any Track and Trace capability in Belux. This meant that BAT could not provide all the seizure information required by the Schedule to the TPR 2001, could not identify weaknesses in their own supply chain which may have led to a seizure and was unable to provide additional information about specific seizures when HMRC had requested it; and

(3) that BAT had been reluctant to share a copy of its sales plan for CC (which HMRC regarded as one of the mechanisms by which legitimate demand could be judged) and had not provided the justification for a 15% increase in sales of CC in Belux.

79. The recommendations included in the interim report included:

(1) the acceleration of Track and Trace in Belux; and

(2) establishing an interim measure to allow some level of tracing in the Belux market immediately.

80. In relation to the first recommendation, it should be noted that BAT had already decided to accelerate the implementation of Track and Trace in Belux. HMRC were unaware of this fact because BAT had not communicated its decision to HMRC.

81. As BAT noted in its submissions, the report made no complaint in relation to BAT's response to Project Falcon or "little and often" smuggling, the terms of BAT's contractual agreements with wholesalers, or the absence of ACT; these concerns were only specifically raised later by HMRC.

82. As regards HMRC's concern about the adequacy of follow up work on notified seizures, BAT's response was to pilot its Seizure Event Review Process ("SERP") in September - November 2013. BAT's intention was that SERP should serve to provide a structure and internal guidance for dealing with notifications of seizures of BAT products and recording decisions made and actions taken pursuant to such notifications. Following the pilot, SERP became operational from 14 November 2013, although in her oral evidence Ms Udicki considered it was still being piloted in April 2014. As we shall see, SERP was largely ineffective prior to the introduction of Track and Trace.

83. Also on 23 October 2013, HMRC issued the Initial Notice to BAT pursuant to s.7B(1) TPDA. The text of the Initial Notice is set out in Appendix 1.

84. During the period 9 January to 5 June 2014, BAT received 12 "new style" reports of seizures of CC, six of which related to seizures of CC below the 50 kg threshold. The other six were of seizures of volumes above the notifiable thresholds.

85. On 7 January 2014, HMRC provided its revised legitimate demand assessment to BAT. Its estimate of legitimate demand in Belux was revised upwards to 37 tonnes. HMRC's paper indicated that it was unclear how BAT determined the legitimate levels of demand for HRT, rather than overall demand. In her covering letter Mrs Green noted that HMRC's analysts considered that BAT's methods were inadequate to arrive at an acceptable estimate of legitimate demand. HMRC stated that they believed that the "majority of the illicit HRT market of the genuine product is made up from 'little and often' smuggling". This was, in my view, a significant statement and it emphasised the importance attached to "little and often" smuggling by HMRC in their dealings with BAT.

86. BAT had a total of five meetings with HMRC during the Warning Period to discuss the concerns raised by HMRC and the actions taken by BAT to address these concerns. These took place on 18 December 2013[2], 15 January 2014, 18 February 2014, 17 March 2014 and 8 May 2014. At the meetings, HMRC raised perceived deficiencies (of which BAT argued they had not been previously aware) which were

[2] The notes of the meeting were incorrectly dated 19 December 2013.

regarded as potential TPDA breaches by HMRC. BAT argued that these alleged deficiencies had not been included within the Initial Notice, such as, for example, the absence of specific contractual provisions in BAT's agreements with wholesalers and the failure of BAT to implement ACT (so that it could track goods beyond its first wholesale customer). I shall return to this issue (and to the remedial steps which BAT had taken) later in this decision.

87. At the meeting on 18 December 2013, Mrs Green stressed that it was for BAT to take steps to address the issues identified in the Initial Notice during the Warning Period (which expired on 22 April 2014).

88. On 24 February 2014, BAT wrote to HMRC enclosing its methodology for validating BAT's estimate of legitimate demand for CC. On 17 March 2014 there was a meeting with HMRC relating to the Initial Notice, attended by Mark Dickson (HMRC statistician) and Lenard Fehrensen (Head of Strategy, Planning & Insights for BAT Benelux at the time) at which the parties discussed their respective legitimate demand assessments.

89. In April 2014, BAT implemented Track and Trace to wholesaler level in Belux and had started to pilot ACT with a Belgian wholesaler.

90. Mrs Green had been due to meet BAT on 14 April 2014 in Belgium to view their Track and Trace technology at BAT's warehouse. In accordance with normal protocol, Mrs Green required permission from the Belgian authorities for the visit. Unfortunately, however, because of administrative delays (which were unspecified in Mrs Green's evidence) Mrs Green was unable to obtain permission from the Belgian authorities in time for the visit and was therefore unable to visit the warehouse. Consequently, Mrs Green did not witness a demonstration of BAT's implementation of Track and Trace. I should note, however, that at a meeting between HMRC and BAT on 18 December 2013, it was clear that a site visit by HMRC to BAT's Belgian warehouse on 22 April 2014 was envisaged. Therefore, it seemed to me that HMRC must take responsibility for the failure to ensure that the necessary authorisations were obtained in time; certainly, the failure was not the fault of BAT.

91. The Warning Period expired on 22 April 2014.

92. The Penalty Notice was issued on 5 June 2014 and is set out in full at Appendix 2.

93. Subsequently on 17 June 2014, pursuant to a request from BAT's solicitors, HMRC provided BAT with a legitimate demand calculation setting out the detailed assumptions upon which HMRC relied.

Legitimate demand

94. The question of the quantum of the legitimate demand for CC in Belux featured in both the Initial Notice and the Penalty Notice. In the Penalty Notice HMRC indicated that the question of legitimate demand was one of its "most significant"

concerns identified in the Initial Notice and legitimate demand was taken into account as Factor 9 in the calculation of the amount of the penalty.

95. I heard statistical evidence from Mr Dickson (for HMRC) and Mr Fehrensen (for BAT) in relation to the calculation of legitimate demand. Neither Mr Dickson nor Mr Fehrensen was, strictly, an expert witness but no objection was taken by either party on this ground.

96. I note that on 1 November 2013, BAT provided a legitimate demand calculation. That calculation appeared to be largely based on the sales (including forecasts of sales) of CC in Belgium and Luxembourg, as well as trends in travel based on information from the Office of National Statistics. It seemed to me that this document was inadequate. It did not seem to attempt to distinguish between legitimate as opposed to overall demand.

97. As already noted, based on its calculations, HMRC estimated the legitimate demand in Belux for CC as being 37 tonnes whilst BAT estimated that legitimate demand at 225 tonnes (although in the 12 months to 30 June 2013 BAT supplied 269 tonnes to the Belux market).

98. Both Mr Dickson and Mr Fehrensen were in broad agreement on the methodology to be employed in calculating legitimate demand for CC. There was, however, disagreement on a number of the assumptions to be made in the calculation.

99. There were four key points of disagreement:

(1) the average amount of CC purchased by a consumer on a trip to Belgium (BAT's estimate was 2.98 kg and HMRC's estimate was 1.04 kg);

(2) the percentage of UK visitors to Belgium who purchased tobacco (BAT's estimate was 26.4% whereas HMRC's estimate was 13.1 %);

(3) the proportion of visitors to France who made a detour to Belgium; and

(4) the average amount of tobacco in a "stick" (i.e. in a cigarette made using HRT).

100. It was accepted by both Mr Dickson and Mr Fehrensen that (1) and (2) accounted for the major part of the difference between BAT's and HMRC's estimates of legitimate demand. Mr Dickson's and Mr Fehrensen's estimate of BAT's market share in Belgium for CC was broadly the same at 10% and 12.6% respectively.

101. Mr Dickson and Mr Fehrensen both also accepted that a UK consumer on a visit to Belgium would purchase approximately seven to eight months' supply of HRT. Mr Fehrensen considered that a consumer would buy eight months' supply whereas Mr Dickson considered that a consumer would buy approximately seven months' supply.

102. There was, however, no agreement on what that amount would be.

103. Mr Fehrensen's evidence was that 26.4% of the 1.66 million UK travellers (aged 18 or over) whose main purpose was to visit Belgium would take the

opportunity to buy HRT in Belgium. This was three times the estimated UK regular HRT smoking incidence of 8.8% (of the total adult population). Mr Fehrensen made this assumption on the basis of the financial incentives for UK consumers to travel to Belgium for the purposes of purchasing HRT. Mr Fehrensen further assumed that 30% of UK HRT smokers (as regards whom Mr Fehrensen estimated 8.8% of UK visitors landing in Calais were HRT smokers) who travelled to Calais without the main purpose of visiting Belgium would cross the Belgian border to purchase HRT before travelling back to the UK. Mr Fehrensen accepted in cross-examination that these assumptions were not based on empirical evidence (there was, he said, an absence of empirical evidence) but rather on his experience working in the area for 10 years. It seemed to me that this admission weakened Mr Fehrensen's evidence on this point.

104. In addition, Mr Fehrensen's view that UK-based consumers visiting Belgium would purchase, on average, 2.98 kg of HRT (subsequently adjusted to 2.29 kg), rather than an amount closer to the minimum indicative limit of 1 kg, was based on an annual consumption rate of 4.5 kg. Although the 4.5 kg figure was not directly challenged in cross-examination, Mr Fehrensen's assertion that 2.98 kg (i.e. two-thirds of 4.5 kg, being the estimate of the amount that a UK consumer would buy on a trip to Belgium) was challenged and, in my view, this implicitly challenged the 4.5 kg figure. Mr Fehrensen's estimate of annual consumption of 4.5 kg was based on 0.8 g per stick (derived from BAT's global consumer survey) and his estimate that regular HRT smokers in the UK consumed on average 15.3 cigarettes per day.

105. Mr Fehrensen accepted that his estimate of UK resident visitor numbers to Belgium included all visitors travelling to Belgium by air, train and bus, although he accepted that HRT smokers were probably amongst the more price sensitive smokers i.e. were more likely to travel by bus. At the meeting of 17 March 2014 between BAT and HMRC (attended by Mr Fehrensen and Mr Dickson) Mr Fehrensen had (in his view, mistakenly) indicated that a UK visitor would buy 2.5 kg of HRT but later corrected that estimate to 2.98 kg. Mr Fehrensen based his 2.98 kg figure on the assumption that a UK consumer visiting Belgium would buy at least eight months' supply of HRT. There seemed to me, however, to be no empirical evidence supporting this assumption. Moreover, the eight months' supply assumption did not take into account, in my view, the fact that UK consumers might make multiple trips (as appeared to be the case from the evidence). Nonetheless, Mr Fehrensen's eight month assumption was not very different from the seven month assumption made by Mr Dickson. It therefore did not appear to be obviously wrong.

106. Mr Dickson, by contrast, concluded that the proportion of UK adults who visited Belgium and who purchased HRT was 13.1%. This was based on the International Passenger Survey ("IPS") – a publicly available survey administered by the Office for National Statistics. Mr Dickson also based his estimate of the average volume of HRT purchased in Belgium (1.04 kg) from the IPS. Mr Dickson also estimated that 12% of sea, rail and ferry passengers travelling to France and Germany also visited Belgium. The 12% estimate was based on information supplied by another TM. Mr Dickson assumed that 13.1% of these passengers would buy HRT. Mr Dickson estimated, on the basis of the IPS that the average annual consumption

was 1.8 kgs (based on consumption of 13 sticks per day and 0.4g per stick). In cross-examination, Mr Dickson accepted that the 0.4 g per stick figure was not based on empirical evidence but was, rather, based on what he described as "anecdotal evidence" which had been established within HMRC before Mr Dickson's arrival in post.

107. In relation to the average number of sticks consumed per day, Mr Fehrensen estimated this to be 15.3 sticks (based on BAT's UK General Consumer Survey 2013 – a market research study conducted by an independent market research firm). Mr Dickson estimated the number of sticks per day to be 13.

108. As regards the tobacco content of an average stick, Mr Fehrensen estimated this to be 0.8 g, based on BAT's group standard calculation for HRT, significantly greater than the 0.4 g figure estimated by Mr Dickson. Mr Dickson, however, considered that the difference between 0.8 g and 0.4 g per stick would make very little difference in estimating legitimate demand. Mr Dickson also accepted evidence from another Manufacturer that the amount of tobacco per stick was 0.46 g; he also accepted that that Manufacturer's figure for HRT bought abroad was 2.29 kg (i.e. higher than HMRC's estimate). In cross-examination Mr Dickson noted that the basis for Mr Fehrensen's estimate of 0.8 g per stick was not explained to HMRC at the meeting between HMRC and BAT on 17 March 2014. Mr Dickson accepted, however, that views could legitimately differ as to the appropriate amount of HRT used in a cigarette.

109. The EUCA agreement considered that 0.0325 ounces (i.e. 0.92 g) of HRT was equivalent to one individual cigarette. It seemed to me that this provided some independent support for Mr Fehrensen's estimate.

110. Mr Moser criticised the use of the IPS. In particular, Mr Moser questioned Mr Dickson on the small size of the sample of travellers questioned (173) and the propensity of travellers to underestimate the amount of tobacco which they bought. Mr Dickson, however, had taken account of the fact that there was likely to be a smaller sample (although he was not aware of the actual sample size of 173 people) and he accepted that some people may under-report, but noted that he had seen no evidence to support this. Moreover, the statistics produced by the IPS in relation to the proportion of UK adults visiting other countries and purchasing HRT (e.g. Spain) gave Mr Dickson confidence in relation to the figures concerning Belgium.

111. Mr Moser also put to Mr Dickson in cross-examination a number of criticisms of the IPS survey made by one of the other Manufacturers. Taking those criticisms into account, I did not consider that they weakened Mr Dickson's evidence. For example, Mr Moser's suggestion that UK consumers might deliberately give a misleadingly low estimate of the amount of tobacco they had bought seemed to me to be speculation. Moreover, Mr Dickson recognised that under-reporting could be an issue, but considered that the IPS, which effectively asked passengers how much tobacco they had just bought, was rather different from a survey which asked people how much they smoked and which was, in his view, more likely to be susceptible to under-reporting. He accepted that smokers tended to under-report quite significantly

the number of cigarettes they smoked per day. That did not, however, cause him to consider that the IPS results were invalid.

112. Mr Moser also suggested to Mr Dickson that he had "cherry-picked" information from that other Manufacturer, using information which supported his analysis whilst disregarding information which contradicted it. Mr Dickson denied this. He had asked himself the question, in relation to the information submitted by the other Manufacturer, whether the information put forward by it was better than that contained in his model. In his view, the other Manufacturer's information was not better e.g. he considered that the survey carried out by that Manufacturer was less representative than the IPS.

113. Mr Dickson was also cross-examined about a table in a 2013 report by the University of Bath which referred to four studies that would have been available to HMRC in March 2014 when the question of legitimate demand was being considered. Those studies showed a range between 0.3 to 0.88g of HRT per cigarette. Mr Moser suggested that the average of the four surveys was around 0.6 g. Mr Dickson objected to this approach saying that it was not possible simply to take an average of different surveys unless more was known about the surveys in question and the size of the samples taken. It seemed to me that Mr Dickson's objection had some justification.

114. In June 2015 BAT instructed an external market research agency, TNS, to conduct research to assess the accuracy of the key assumptions in Mr Fehrensen's calculation of legitimate demand. Obviously, TNS's report was not available to HMRC when the Initial Notice and the Penalty Notice were issued.

115. The first part of the research was intended to check Mr Fehrensen's assumptions about the proportion of travellers from the UK to Belgium who purchased HRT in Belgium. TNS interviewed UK residents travelling on ferries from Calais to Dover and Dover to Calais aged 18 and over to determine the percentage of UK travellers with a primary destination of Belgium, or who passed through Belgium even though it was not their primary destination, and buy HRT in Belgium. The survey indicated that among the UK travellers who visited or passed through Belgium in the past 12 months, with Belgium as their main destination on at least one of these trips, 28.8% were regular HRT smokers. Of the UK travellers who had visited Belgium in the past 12 months, with Belgium as their main destination on at least one of these trips, 35.6% had purchased HRT in Belgium in the past 12 months (including those who had purchased HRT as gifts).

116. The second part of the research was designed to check Mr Fehrensen's assumptions about UK cross-border shoppers purchasing and consumption patterns, particularly Mr Fehrensen's estimate that HRT smokers bought 2.98 kg of HRT when visiting Belgium, used 0.8 g of HRT in each cigarette and smoked 15.3 cigarettes per day. The interviews were conducted with consumers outside eight tobacco retail outlets in Adinkerke, Oostende, Snaaskerke and De Panne. The second part of the research concluded that UK consumers visiting Belgium bought, on average, 2.29 kg of HRT, used 0.69 g of HRT in each cigarette and smoked on average 23.1 sticks per day.

117. Based on the above findings, Mr Fehrensen estimated that the legitimate market for CC in Belgium was approximately 225 tonnes.

118. Mr Dickson raised a number of concerns with the TNS survey. In particular, his primary concern was that the survey was not representative i.e. the results could not be reliably scaled up to represent the whole population. He was more confident that the IPS was representative. For example, the interviews conducted by TNS took place over a period of only seven consecutive days in one month. Secondly, the TNS survey appeared to ask respondents about tobacco purchased on previous trips over the preceding 12 months. Thirdly, as regards the first part of the research, only respondents on ferries were questioned. Mr Dickson accepted that ferry passengers were more likely to buy tobacco than those travelling by rail or air, but the focus on ferry passengers was likely to inflate tobacco purchasing rates. Fourthly, Mr Dickson did not have information in relation to the sampling methodology employed by TNS. Fifthly, he considered that the average amounts of tobacco purchased according to the TNS survey were unlikely to be representative. The second part of the research appeared to be based on exit interviews conducted outside large tobacco supermarkets. Mr Dickson's opinion was that greater amounts of tobacco were likely to have been bought at these large stores than at smaller tobacconists. Finally, Mr Dickson had concerns over the conclusion that the average weight of HRT per stick was 0.69 g. This final concern was based on the fact that respondents were asked how long a pouch of tobacco lasted and how many sticks they smoked per day. His experience was that respondents tended not to respond accurately to questions about consumption levels and the number of cigarettes smoked per day.

119. Mr Fehrensen noted that the minimum indicative limit had been 3 kg until as recently as 2011. Although the minimum indicative limit had then been reduced to 1 kg, he doubted whether actual consumer consumption would have reduced in the same manner.

120. There was a disagreement about the admissibility of a statement by Mr John Healey, the Financial Secretary to the Treasury, to Parliament in October 2002 in which Mr Healey said regulations would be introduced to:

> "…increase the Indicative Levels for tobacco from 800 to 3200 cigarettes and from 1 to 3 kg of hand rolling tobacco, representing around six months' supply for an average smoker."

121. BAT relied upon this statement to indicate that HMRC in 2002 considered that a six month's supply of HRT was approximately 3 kg.

122. Mrs Hall submitted that Mr Healey's statement did not satisfy the requirements of *Pepper v Hart* [1992] UKHL 3 and should be excluded. Mrs Hall cited the decision of Blake J in *Age UK, R (on the application of) v Secretary of State for Business, Innovation & Skills & Ors* [2009] EWHC 2336 (Admin) where the following principles were explained:

> "[48] In *Office of Government Commerce v Information Commissioner* [2008] EWHC 774 (Admin) 11th April 2008, Mr Justice Stanley

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Burnton (as he then was) allowed an appeal from a decision of the Information Tribunal where it had placed reliance upon parliamentary evidence adduced before it when a Minister was giving a view as to whether certain information was exempt or not under the provisions of the Freedom of Information Act. His Lordship reviewed the decisions in *Prebble, Hamilton, Bradley* and his own decision in *R (Federation of Tour Operators) v HM Treasury* [2007] EWHC 2061 (Admin). He concluded (at [59] of his judgment) that it would be wrong for a party to rely upon an opinion of a Parliamentary Committee and equally it must be wrong for the Tribunal itself to seek to rely upon it :

'If the Tribunal either rejects or approves the opinion of the Select Committee it thereby passes judgment on it. To put the point differently in raising the possibility of its reliance on the opinion of the Select Committee, the Tribunal potentially made it subject to submission as to its correctness and of inference which would be a breach of Parliamentary privilege'.

[49] He was aware ([61] & [62] of his judgment) that the courts had referred to such opinions from time to time including in *Hamilton v Al Fayed* itself but accepted the submission advanced by the Attorney General that that was an exceptional case and generally inferences cannot be drawn from the fact of references made by the court on the reports of Parliamentary Committees in cases where no objection was taken to so doing. He observed that much will depend upon the purpose for which the reference is made. There could be no objection to a court making reference to the conclusions of a report that leads to legislation since in such a case the purpose of the reference is either historical or made with a view to ascertaining the mischief at which the legislation was aimed; the reference is not made with a view to questioning the views expressed as to the law as at the date of the report.

[51] In my judgment, what the constitutional principles identified in *Prebble, Al Fayed, Bentley* and the *OGC* case indicate are as follows:

i) The court must be astute to ensure that it does not directly or indirectly impugn or question any proceedings in Parliament in the course of judicial proceedings.

ii) 'Impugn or question' extends beyond civil or criminal sanction for any statement in Parliament but includes a judicial determination as to whether a statement in Parliament is right or wrong. The judge cannot receive evidence of what is said in Parliament for the purpose of agreeing or disagreeing with it."

123. Mrs Hall argued that this Tribunal was being asked to agree or disagree with the statement made by Mr Healey in relation to the six months' supply of HRT for an average smoker.

124. Mr Moser, however, submitted that it was permissible to refer to *Hansard*, as long as proceedings in Parliament were not questioned or "impeached". In this case the passage was referred to merely to show what the Financial Secretary had said; it

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was a fair inference (and in no way questioned what was said in Parliament) that that was HMRC's view at the time.

125. I have decided to exclude Mr Healey's statement. First, Mr Healey's statement was made in 2002, almost 10 years before the events relevant to this appeal and there was no evidence from which I could assess whether the buying habits of smokers had remained unchanged or had altered. Secondly, and more importantly, it seems to me that I would be using Mr Healey's statement to endorse the evidence of Mr Fehrensen. Whether Mr Fehrensen's evidence on this issue is correct is a matter which I have to determine. If, taking Mr Healey's statement into account, I were to consider Mr Fehrensen's evidence to be incorrect, I may thereby indirectly be taken to cast doubt on Mr Healey's statement. Similarly, if I were to conclude that Mr Fehrensen's evidence was correct, I would indirectly be passing an approbative view on Mr Healey's statement. That is territory into which this Tribunal should not stray and, therefore, Mr Healey's statement should be excluded.

126. I note, however, that when the UK reduced the indicative limit from 3 kg to 1 kg this was stated to be partly in order to prevent illicit on-sales of excess tobacco allegedly bought for personal consumption and partly to promote public health (an issue, however commendable, which was unrelated to any estimate of average actual individual consumption).

127. In drawing together the various strands of evidence concerning legitimate demand, it is important to appreciate – as both parties accepted – that the calculation of legitimate demand could not be a precise one. In this case, however, I consider that HMRC were right to be concerned about Mr Fehrensen's assumption that 26.4% of the 1.66 million UK travellers (aged 18 or over) whose main purpose was to visit Belgium would take the opportunity to buy HRT in Belgium. This was three times the normal incidence of HRT smokers in the UK population (8.8%). This seemed to me very high, although the opportunity to purchase HRT at significantly lower prices in Belgium would, I accept, result in a higher percentage than 8.8% purchasing HRT. Nonetheless, Mr Fehrensen's assumption was unsupported by empirical evidence. On this point, I preferred the evidence of Mr Dickson who gave the lower percentage of 13.1% based on the IPS. I am aware of the criticisms made of the IPS, but consider it to be the best empirical evidence available. I am also aware of the results of the TNS survey (which was not, of course, available in 2014) which indicated a higher percentage of 35.6% of UK purchasers of tobacco. I am, however, mindful of the reservations in relation to the survey voiced by Mr Dickson, which in my view seemed valid.

128. I am less troubled, however, by Mr Fehrensen's conclusion that the average purchase of HRT would be 2.98 kg. It seemed to me that his methodology and assumptions (including the number of sticks smoked per annum and the amount of tobacco contained in each stick) were relatively sound or, at least, not unsound. The amount of tobacco contained, on average, in each HRT stick could of course vary but Mr Fehrensen's estimate did not seem unreasonable. Moreover, his conclusion on the number of HRT cigarettes smoked also seemed reasonable. For these reasons, I do not think that this particular assumption made by Mr Fehrensen was unsound.

129. The other assumptions in dispute (the proportion of UK visitors to France and Germany who would make a detour to Belgium to buy HRT and the amount of tobacco per stick) were of considerably less importance. As I have indicated, in relation to the amount of tobacco per stick, I do not regard BAT's estimate as unreasonable. As regards the proportion of UK visitors to France and Germany who would pass through Belgium and buy HRT, neither Mr Fehrensen's nor Mr Dickson's assumption seemed to be based on empirical evidence. It was, therefore, impossible to determine whether their assumptions were correct.

130. On this basis, it seemed to me that BAT (as a result of their 26.4% assumption) overstated legitimate demand. Equally, I have concluded that HMRC (as a result of their 1.04 kg assumption) have understated legitimate demand. Exactly what the correct estimate of legitimate demand should be is impossible to determine with any accuracy but I believe the true position to lie somewhere between HMRC's and BAT's estimates.

131. In her witness statement Mrs Green indicated that legitimate demand remained "a serious concern for HMRC." In her oral evidence, however, Mrs Green appeared to have had a change of heart. She described legitimate demand as "a side show". She said that she considered the legislation merely required that the level of legitimate demand be "considered before the supplies were made" and that legitimate demand was "not a major issue."

132. In addition, in her opening submissions, Mrs Hall appear to minimise the importance of legitimate demand by stating that all that BAT was obliged to do:

> "…is to consider whether the size or nature of the supply suggests that the products may be required for smuggling into the United Kingdom.
>
> So, that is, we say, a very low level obligation which involves [BAT] simply considering size or nature of the supply. I initially said it was not directly engaged principally because of the word 'consider' because all [BAT] has to do is to have regard to it…."

133. In her oral closing submissions, Mrs Hall referred to the issue of legitimate demand this being "the biggest red herring in this case" and said "the calculation for legitimate demand is far from centre stage…."

134. It certainly seemed to me that HMRC were downplaying the significance of legitimate demand. Nonetheless, Mrs Hall maintained her submission that HMRC's objection to BAT's calculation of legitimate demand was simply that a number of the assumptions upon which the calculation was based were not independently verified.

Track and Trace and Additional Customer Tracking ("ACT")

135. I have explained (at paragraphs 39-40 above) the expressions "Track and Trace" and "Additional Customer Tracking" ("ACT"). To recap, Track and Trace allows BAT to trace HRT to its first external customer (i.e. wholesalers) so that, if consignments of HRT are seized by HMRC, BAT can determine which wholesaler

supplied the goods in question. Track and Trace was an obligation undertaken by BAT under EUCA.

136. When BAT entered into EUCA on 15 July 2010, it committed to a timetable in accordance with which BAT would have Track and Trace coverage for all the EU Member State signatories and 20 other countries covered by EUCA (subject to agreed exceptions) by the end of 2016. This timetable was agreed by the EU Commission and EU Member States, including the UK Government. I accept, therefore, that HMRC knew or should have known of the timetable by which BAT proposed to introduce Track and Trace pursuant to EUCA before it raised its concerns with BAT at some time between March and August 2013.

137. ACT, which was dependent on the existence of Track and Trace[3], enabled goods to be tracked beyond the first external customer to the BAT group so that any goods seized by HMRC could be tracked to the retailer supplied by the wholesaler. ACT was not an obligation imposed by EUCA (which BAT signed on 15 July 2010).

138. Track and Trace required unique codes to be printed onto labels which were then applied to packs of cigarettes and HRT. These codes were then scanned as the goods moved along the supply chain. The scanning was carried out using handheld scanning devices.

139. Under the phased introduction of Track and Trace pursuant to EUCA, Luxembourg was scheduled to be in the second phase (2014) and Belgium in the third phase (2016). As I have explained, the letter dated 14 July 2010 setting out the timetable suggests that the phases were determined based on total factory production volume, with markets supplied by factories with the largest production volumes being given priority in terms of timing. The UK was, of course, a party to EUCA and there was no evidence that HMRC had raised concerns about the timetable for the phased implementation of Track and Trace in specific countries during the negotiations.

140. HMRC was informed by BAT at a meeting in January 2012 of BAT's proposed timetable for the roll-out of Track and Trace under EUCA and, apparently, no objections were raised by HMRC.

141. As already explained, in the course of its audit of BAT's supply chain controls, HMRC appears to have raised the fact that Belgium was in phase 3 (i.e. 2016) for BAT's implementation of its EUCA's Track and Trace program and with the result that BAT was unable to identify the first external customer for seized product. As a result, BAT took steps to accelerate its Track and Trace implementation in Belgium, moving Belgium from phase 3 to phase 2 and thus accelerating implementation by two years i.e. from 2016 to 2014. This change was approved by the BAT Track and Trace project board on 21 August 2013. Ms Udicki had initiated the internal BAT

[3] There was some evidence that other manufacturers introduced temporary solutions which allowed a version of Track and Trace and ACT to be implemented before a fully-fledged version of the EUCA compliant Track and Trace was put in place. It was, however, unclear whether these solutions would have been workable for BAT's products and packaging.

approvals process required to ensure the acceleration of the implementation of Track and Trace in Belgium – a fact that seemed to me to be at odds with Mrs Green's assertion that Ms Udicki was not closely involved with BAT's response to smuggling or that she was unable to influence matters through an internal governance process.

5 142. Track and Trace was a complex system and I accept Ms Udicki's evidence to the effect that it required not only coordination of operations but the fitting out of factory machinery. The introduction of Track and Trace in Belgium was the first time the system had been used in a factory which manufactured HRT. Because of the different packaging of HRT (as distinct from factory-made cigarettes), it required the 10 introduction of processes which were new to BAT. In particular, there were technical difficulties involving laser printing on laminate pouches. These new processes and the need for testing, meant that the implementation of Track and Trace required time.

143. BAT informed HMRC of the progress in relation to the implementation of Track and Trace at meetings on 18 December 2013[4] and 14 January 2014.

15 144. At the meeting on 18 December 2013 (attended by Mrs Green), HMRC indicated that a number of other TMs were tracking products beyond their first customer and that BAT's failure to do so was an issue of concern for HMRC. BAT appeared to be unaware that other TMs were tracking products beyond their first customer but confirmed that BAT's Track and Trace solution should be capable of 20 delivering the same level of transparency as other TMs. It seemed to me, on the evidence before me, that this was the first occasion on which HMRC raised their concern about BAT's inability to track their products beyond the first customer (i.e. the wholesaler). In other words, this was the first occasion on which the absence of ACT was clearly raised by HMRC.

25 145. Track and Trace was implemented in Belgium in April 2014. As already noted, Mrs Green was unable to attend a scheduled demonstration meeting in April 2014 (shortly before the expiry of the warning period on 22 April 2014) at BAT's Belgian warehouse to see the Track and Trace system because of protocol difficulties with the Belgian Government.

30 146. At a meeting with HMRC (including Mrs Green) on 15 January 2014, BAT explained that it hoped to complete its systems testing for the implementation of Track and Trace slightly earlier than first envisaged, by around 4 April 2014, and that HMRC could visit its warehouse from 10 April 2014. BAT also explained that it was developing a system for ACT and proposed to run a pilot test with one of its 35 customers in April or May 2014.

147. A further meeting between HMRC (including Mrs Green) took place on 18 February 2014. BAT provided an update on the roll-out of Track and Trace in Belgium and Luxembourg. BAT also updated HMRC on its plans to pilot ACT and hoped to have an agreement in place with one of its wholesalers prior to the next

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[4] The meeting note was incorrectly dated 19 December 2013.

meeting with HMRC. Mrs Green noted that she was awaiting agreement of the Belgian authorities to her proposed site visit.

148. The next meeting took place on 17 March 2014. BAT indicated that the roll-out of Track and Trace in Belgium and Luxembourg was expected to meet the proposed deadlines. Mrs Green noted that she was still awaiting agreement from the Belgian authorities for her visit. Mrs Green also noted that after the expiry of the six month period under the Initial Notice it was intended that a panel of HMRC "stakeholders" would consider all the available evidence before making a final decision about BAT's progress. Mrs Green had set up this panel on an ad hoc basis to assist her in the evaluation of the progress made by BAT during the warning period. She explained that she wanted her conclusions to be tested and challenged by colleagues who understood the issue in depth but who had not been as directly involved in the process. Following a discussion with the panel, four questions had been identified that HMRC's work had "so far… not clarified in sufficient detail to enable the decision [in relation to the Penalty Notice] to be made." Mrs Green then put the four questions to BAT and asked for a response in writing. The four questions were:

> (1) How is Track and Trace going to allow BAT to better control their supply chain and reduce the level of smuggling?
>
> (2) How will BAT respond if a wholesaler refuses to take part in the next stage i.e. [ACT]?
>
> (3) What changes will BAT make to their policies to support Track and Trace?
>
> (4) Is BAT intending to make any changes to the contracts that they hold with their first customers in respect of their contracts with their retailers (for example, anti-smuggling clauses)?

149. BAT responded in writing to these four questions on 4 April 2014. In relation to question (1), BAT stated:

> "1.1 By implementing track and trace, BAT will be better able to identify where there is leakage of product from its supply chain into the illicit market. When product is seized, the track and trace technology will be able to show to which first customer BAT sold that product. When [ACT] is enabled, BAT will be able to track the product further down the supply chain to the other economic operators.
>
> 1.2 Where the volume of product falling into the illicit market might be higher than expected, this will assist BAT's investigations in identifying economic operators within the relevant market, will enable BAT to decide whether action is justified in relation to specific economic operators, either directly (if a BAT first customer) or indirectly (for economic operators further down the supply chain).
>
> 1.3 BAT will be able to share its track and trace information with HMRC, which will assist HMRC's independent enquiries or with any joint action conducted by HMRC with BAT. Relevant information passed from HMRC to UK Border Force may assist their enforcement activity also."

150. BAT's response to question (2) was as follows:

> "2.1 Given the terms of the Tobacco and Related Products Directive ("TPD"), requiring all economic operators involved in the trade of tobacco products before the first retail outlet to be involved with track and trace, and subject to any legal challenge to the TPD, it is envisaged that this question will only be relevant for a limited period.
>
> 2.2 In the meantime, whilst we cannot compel our first customers to take part in ACT, we will be engaging with them about the benefits of becoming involved as an "early-adopter" of ACT. In relation to certain key first customers, such as [name of wholesaler], we are also considering giving financial compensation in respect of the additional time and/or resources required by their ACT adoption. This will likely encourage their uptake."

151. BAT's response to question (3) was:

> "3.1 We do not consider any changes are required to our supply chain and/or KYC policies to support track and trace. Those policies have been drafted to support BAT's legal obligations under, among other things, the TPDA and EUCA. As such, those policies fully support track and trace implementation and, indeed, as you know, we have been implementing track and trace in line with our EUCA commitments since 2010.
>
> 3.2 When track and trace has been fully implemented, we will be able to use the information obtained upon seizures to support our supply chain compliance controls such as SERP."

152. I shall deal with BAT's response to question (4) later in this decision under the heading *Contractual Terms.*

153. Mrs Green's evidence was that other TMs were more compliant with the TPDA than BAT and that BAT's conduct overall fell significantly short of its competitors. In particular, as regards Track and Trace, Mrs Green noted that although EUCA required the introduction of a standardised Track and Trace technology, other TMs introduced their own tracking systems before Track and Trace. Although these systems were not as effective as Track and Trace, the systems enabled the other TMs to respond effectively to HMRC Seizure Notifications. She took the view that this was in contrast with BAT whom, she said, took the position that it was not required to do anything to trace its products before the deadline for the implementation of Track and Trace.[5]

154. I should note, however, that according to the notes of meetings between HMRC and two other Manufacturers, HMRC raised Track and Trace with those Manufacturers at an earlier stage (e.g. in September 2012 in the case of the first other Manufacturer). I accept that concerns were raised with BAT at a later stage because BAT had a significantly smaller market share for HRT in Belux. I shall say more about this under the heading *Competitors*.

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[5] But see footnote 3. above.

155. As I have noted, I consider that HMRC first raised its concerns about BAT's timetable for the implementation of Track and Trace in Belux in the course of its audit at some time between April and August 2013.

156. Ms Udicki's recollection was that the issue was first raised during the HMRC audit in April 2013. I have reviewed the internal BAT approval dated 21 August 2013 which clearly accelerated Belgium into phase 2 for Track and Trace. Ms Udicki told us that it took a few months to obtain this approval because it was first necessary to secure a budget for the changes. In my view, BAT's acceleration of Belgium into phase 2 was more likely than not, by virtue of the timing, to be the result of concerns expressed by Mr Fowler in the course of his audit or by Mrs Green at a meeting with BAT on 17 April 2013. At this meeting, it became clear to Mrs Green, but not to HMRC, for the first time that Belgium was in phase 3 – a concern which she subsequently discussed with Mr Fowler. Mrs Green's concerns were not recorded in writing. The first time that HMRC's concerns about the timing of Track and Trace were put in writing to BAT was in Mr Fowler's initial audit findings sent to BAT on 23 October 2013, the same day as the Initial Notice.

157. I accept, however, that prior to HMRC raising its concerns in April 2013 about Track and Trace, in the course of Mr Fowler's audit, HMRC had raised no concerns with BAT about its proposed timing for the introduction of Track and Trace. In particular, at a meeting between BAT and Ms James of HMRC on 3 August 2012, HMRC's note of the meeting records no objection being raised by HMRC to the proposed schedule for the introduction of Track and Trace. In addition, in a presentation made by BAT to HMRC on 21 January 2012, BAT stated:

> "We have committed to implement track and trace under our co-operation agreement with the EU from July 2014 in our Groningen factory which produces Cutters Choice."

158. Certainly, BAT's understanding was that, prior to April 2013, HMRC was content with, or at least acquiesced in, the proposed timetable for the implementation of Track and Trace. Mrs Green's evidence was that she had mentioned her concerns to BAT on at least one previous occasion, but the notes of her meetings with BAT contained no mention of the issue to support this. In any event, Mrs Green's first meeting with BAT was on 13 March 2013 and that meeting was held for the purpose of planning the audit of BAT's supply chain. The notes of that meeting are silent on this issue. Accordingly, I have concluded that until April 2013 HMRC raised no concerns with BAT concerning its timetable for the implementation of Track and Trace – a timetable of which HMRC was or should have been fully aware – and that, until that time, it was reasonable for BAT to consider that HMRC was content with or acquiesced in that timetable.

159. In 2014, BAT piloted ACT with a Belgian wholesaler. This involved addressing various technical issues. BAT implemented ACT with all its wholesalers in Belgium in September 2015, with the result that BAT could then identify the Belgian retailer that originally sold any CC that was later seized by HMRC. It was accepted that ACT could not have been implemented before Track and Trace became functional.

160. The Initial Notice identified the absence of Track and Trace as one of HMRC's principal concerns. For example, in relation to section 7B(2)(a) and (b) TPDA (BAT's written policy of steps to ensure compliance with section 7A (1)), HMRC noted that BAT was unable to identify its first customer outside the BAT group. HMRC also noted that BAT did not provide the information about seized products in accordance with the Schedule to the TPR 2001. This was also, obviously, a Track and Trace concern.

161. Furthermore, in relation to section 7B(2)(c), HMRC noted:

> "… BAT's first tranche implementation of its track and trace system for certain tobacco products failed to take into account those countries identified by HMRC as high risk in relation to smuggling. HMRC understands that implementation of track and trace to these particular areas is not scheduled to be completed until 2016. This is too late and the track and trace system for these high risk areas needs to implemented as soon as possible."

162. Next, in the Initial Notice, after setting out its conclusion that the number and size of notifiable seizures demonstrated that BAT was not applying sufficient controls to deter smuggling of HRT in the particular market, HMRC stated in relation to section 7B(2)(e):

> "BAT should consider urgently bringing forward the introduction of the track and trace system to those countries specified by HMRC as being of concern so that BAT are able to provide the information required. An interim solution should be devised until this the track and trace system is available."

163. In cross-examination, Mrs Green accepted that the implementation of Track and Trace would remedy HMRC's concern on this point. Furthermore, BAT had not informed Mrs Green of its decision, taken in August 2013, to accelerate the introduction of Track and Trace and only did so after the issue of the Initial Notice in a letter dated 22 November 2013.

164. In relation to section 7B(2)(f) HMRC expressed concern about BAT's compliance regarding the supply of information and documents to HMRC about seizures as set out in the TPR 2001:

> "BAT has also failed to show who the first customer outside the BAT corporate group to which the supply of the relevant products was made on 31 occasions in accordance with paragraph 9 of the Schedule to the TPR 2001. BAT did not provide the date of invoice and total invoiced quantity of cigarettes/HRT on any occasion in accordance with paragraph 10 of the Schedule to the TPR 2001. In HMRC's view, BAT has not taken reasonable steps to provide all the information specified in paragraphs 4 – 10 of the Schedule to the TPR 2001."

165. It is clear, therefore, that HMRC in issuing the Initial Notice regarded BAT's failure to implement Track and Trace in a more timely manner as a significant failure.

166. That HMRC regarded the absence of Track and Trace as an important failure was emphasised by a letter from HMRC (Mrs Green) to BAT on 19 December 2013. In paragraph 5 of that letter Mrs Green expanded on the points made in the Initial Notice (in response to a letter from Hogan Lovells dated 28 November 2013). In relation to section 7B (2) (a) and (b) TPDA, Mrs Green wrote:

> "*Our key concern is that BAT Holdings cannot trace specific products from its production factories to its first customer outside the BAT group*. This is evident in that BAT Holdings has been unable to tell us to whom they supplied goods when these goods have subsequently been seized. We considered that this inability to trace specific BAT products to its first customer outside the BAT group demonstrates that the policy in operation has a fundamental weakness because it prevents BAT from identifying where those goods have or could have been transferred to persons who are likely to smuggle those goods into the United Kingdom."

167. At paragraph 15 of her letter, Mrs Green continued:

> "To be clear, HMRC does not conclude that the TPDA necessarily requires the implementation of a track and trace system. The TPDA (in conjunction with the TPR 2001) require a tobacco manufacturer to have adequate controls in place to ensure that it does not facilitate smuggling, and where there are examples of the relevant TMs products being smuggled, to be able to identify who that products [sic] was supplied to, outside the corporate group."

168. The Initial Notice, in my view, made no mention of ACT. In relation to section 7B(2) (a) and (b) the Initial Notice stated as follows:

> "*BAT does not provide the information about the seized product (s) in accordance with the Schedule of the TPR 2001.*
>
> HMRC has provided BAT with all the information it sets out in its guidance (Public Notice 477) and the relevant legislation but no action is taken to establish where BAT's supply chain has been compromised. Although BAT's letter to me dated 18 July 2013 asserts that HMRC has not provided all the necessary information for BAT to carry out its evaluation on its supply chain controls, HMRC's view is that all the necessary information has been provided, and of course our guidance is simply indicative of what we would aim to supply if it is available to us. This does not remove the obligation the legislation imposes on BAT to have a clear sight of the route to market of BAT's product(s)."

169. Mrs Hall submitted that this paragraph indicated HMRC's concern that BAT should have the means to track its products through to the retailer i.e. that it should have implemented ACT. For the reasons given below, I do not think that this is correct.

170. In the Penalty Notice, however, it was stated as follows:

> "In the Initial Notice, BAT was made aware that HMRC believed BAT was failing in its obligation to have a robust supply chain policy. A

> number of concerns were raised in the Initial Notice. In summary, the most significant concerns were as follows:
>
> 1. The written policy (required under section 7A(2)(b)) was defective in that it employed no mechanism to enable BAT to trace the point at which their product had entered the illicit market and been smuggled into the United Kingdom nor did it contain a mechanism to adequately investigate seizures where HMRC had provided information on those seizures.
>
> 2. BAT was unable to comply with its obligations under the TPR 2001 to provide the information required to identify its first customer outside the BAT group of companies.
>
> …."

171. I observe that in paragraph 1. above, HMRC's complaint has changed from a failure by BAT to identify its first customer outside the BAT group (a point made in paragraph 2.) to a complaint that BAT was unable "to trace the point at which their product had entered the illicit market". This is clearly a reference to BAT's failure to implement ACT or an equivalent system. As I have indicated, this complaint was not, in my view, raised by the Initial Notice. In this connection, the words used in the Initial Notice referring to the legislation imposing on BAT an obligation "to have a clear sight of the route to market" of its products were, in context, a reference to the first customer outside the BAT group because the relevant paragraph was dealing with BAT's obligations to provide information under the TPR 2001. These provisions specifically obliged a TM to identify its first customer. Indeed, the whole tenor of the Initial Notice as regards the tracing of BAT's products was that the essential concern was that BAT could not identify its first customer outside the BAT group. Mrs Green's letter of 19 December 2013 described BAT's inability to trace its HRT products to its first external customer as HMRC's "key concern" and it was this weakness that prevented BAT "from identifying where those goods have or could have been transferred to persons who are likely to smuggle those goods into the United Kingdom."

172. I note, by contrast, in the Penalty Notice when Mrs Green wishes to refer to ACT (i.e. tracking/tracing beyond the first external BAT customer) her meaning is plain. I, therefore, reject Mrs Hall's submission that these words were a reference to the need to introduce ACT. Certainly, if the words in the Initial Notice on which Mrs Hall relied were intended to refer to ACT then, in my view, their meaning and significance was not made sufficiently clear.

173. In cross-examination, Mrs Green was asked why, in the Initial Notice, she had indicated HMRC's concern as being that BAT was unable to trace specific products from its production factories to its first customer outside the BAT group. Mrs Green replied that she had included that concern in the Initial Notice because:

> "… without BAT being able to trace to their first customer, they would never stand any opportunity to identify where the goods eventually became [sic] into the hands of smugglers and therefore their policy could not be effective because they could not see what might have gone wrong and what they had to improve on."

174. In other words, Mrs Green effectively repeated the views expressed in her letter of 19 December 2013.

175. Mrs Green accepted that, in including that concern in the Initial Notice, she wanted BAT to "put that right" i.e. she wanted BAT to be able to identify the first customer outside the BAT group and thus comply with the Schedule to TPR 2001. She also accepted that if BAT had remedied a concern expressed in the Initial Notice that would contribute to BAT avoiding a penalty when HMRC took into account all the factors at the end of the Warning Period. Mrs Green also acknowledged that she knew that BAT did not have ACT before she issued the Initial Notice. She maintained, however, that HMRC's expressions of concern in the Initial Notice about the inability of BAT to trace goods to their first external customer simply addressed BAT's failure to comply with its obligations under the TPR 2001. Finally, Mrs Green denied that her failure to include a warning in the Initial Notice about BAT's inability to track beyond the first external customer (i.e. a failure to warn about the lack of ACT) was "a trap" set for BAT.

176. In meetings between HMRC and BAT, in the Warning Period, HMRC did raise with BAT its concern that BAT was unable to pinpoint how its goods entered the illicit market i.e. a concern about the absence of ACT. BAT had first informed HMRC of its intention to pilot an ACT system called "Dispatcher" at a meeting between the parties on 15 January 2014. HMRC were told that BAT planned to pilot the system with a Belgian wholesaler and that BAT would be making the necessary arrangements with that customer with a view to undertaking a four week pilot with them in April/May 2014. BAT also explained that BAT's proposed system, using a 2-D code, would be superior to the linear barcode solution adopted by some of its competitors because it would provide tracking information at both the master case and carton level.[6]

177. In cross-examination, Mrs Green was asked about a letter from BAT (Mr Belhomme) to HMRC dated 14 May 2014. This was one of the last letters written by BAT to HMRC before the issue of the Penalty Notice. The letter listed the various actions taken by BAT in response to the Initial Notice and urged HMRC to conclude that these actions had addressed all the concerns raised in that Notice. Mrs Green was asked whether she understood that BAT, at that point, thought it had addressed all the concerns raised in the Initial Notice. Mrs Green replied:

> "All these things are future promises, and I am looking at a line in time, what was in place at that time, not what is going to happen going forward."

178. Mrs Green was subsequently forced to concede that not all of the actions taken by BAT were "future promises".

[6] One master case contains 12 cartons called "outers". Each "outer" contains ten 50 g pouches of HRT.

179. It seems to me that the failure by HMRC to address ACT in the Initial Notice, whilst attaching considerable importance to this topic in the Penalty Notice, was a significant mistake by HMRC and one to which I shall return later.

Seizures and SERP

5 180. As I have already explained, pursuant to TPR 2001, HMRC notified BAT of seizures of HRT, which HMRC believed had been manufactured by BAT, and which comprised at least 50 kg of HRT. The notification was accompanied with a sample of the seized HRT and BAT was given the opportunity, within a specified period, to inspect the remaining HRT at HMRC's warehouse.

10 181. BAT would then analyse the HRT sample in its laboratory to confirm whether the product was genuine or counterfeit.

182. The TPR 2001 provisions also required BAT to provide to HMRC the information set out in the Schedule to the TPR 2001. This information included the identity of the first purchaser of the HRT outside the BAT group.

15 183. As I have also explained, from May 2013, HMRC began to provide what were described as "new style" seizure reports. In sending the new style seizure reports to BAT, Mrs Green did not explain the purpose of the different format of these reports. The new style reports related to both notifiable and non-notifiable seizures (i.e. notifiable under the TPR 2001). One aspect of the notification of non-notifiable
20 seizures was that BAT was not provided with a sample and was generally not permitted by HMRC to inspect the products. It could not, therefore, determine whether the products were genuine or counterfeit. I accept Ms Udicki's evidence that some counterfeit products had been seized.

184. The first new style report was sent to BAT on 20 May 2013. The report
25 concerned a seizure of 96 kg of HRT but only 30 kg of which was manufactured by BAT (the product was CC). Ms Udicki's evidence, which I accept, was that in the light of the overall size of the seizure and the significant volume of CC comprised within it, BAT could not deduce from the report that smaller seizures ("little and often" smuggling) were an increasing problem. This point is linked to a conflict in
30 evidence between Ms Udicki and Mrs Green about whether and the extent to which Mrs Green had raised the problem of "little and often" smuggling with BAT prior to sending BAT the Project Falcon report in September 2013 (see below).

185. Mrs Green said that HMRC shared information with TMs about sub-50 kg seizures so that they could look back at their policy and see whether it was fit for
35 purpose. Moreover, Mrs Green said that it was not HMRC's intention to count those seizures within its calculations when looking at the volume of seizures. Its purpose was essentially informative and, according to Mrs Green, the information was not being shared "to hit them over the head with it." A review of the e-mail correspondence reveals a rather different picture.

186. In relation to this 30 kg seizure mentioned above, Ms Udicki stated in an e-mail to Mrs Green dated 21 May 2013:

> "…we wouldn't have a plan to inspect it as it is below the threshold set by both TPDA and EUCA which is 50 kg of HRT. In case you are in possession of any other valid information that would link this seizure to a matter of greater concern, please feel free to come back to us and we would be more than happy to look at it again."

187. One week later on 28 May 2013, Mrs Green replied by e-mail:

> "I am disappointed with your response to this seizure. Whilst I acknowledge that this does not exceed the notifiable seizure threshold it is clear from the information we have shared with you that this is a significant seizure and one that is born out of criminal activity.
>
> The TPDA requires you to avoid smuggling to those who may smuggle or resupply to someone who may smuggle. It has no minimum limit. I would have thought that you would have wished to find out how this product came into the hands of smugglers.
>
> I have noted your response and will consider it to fall within section 7 B(2)(h) should it come to us issuing an initial notice of a penalty."

188. It seemed to me that this was a somewhat harsh reply and that Mrs Green intended to take account of non-notifiable seizures for the purposes of section 7A-C TPDA. Moreover, it was difficult to understand Mrs Green's rather prickly response to Ms Udicki's comment that BAT did not plan to inspect a sub- 50 kg seizure. As I have said, the TPR 2001 did not give BAT the right to inspect such seizures and the evidence was that HMRC tended to refuse permission to inspect sub- 50 kg seizures (see paragraph 183 above and 191 below). Ms Udicki's statement seemed to me more a recognition of the status quo, bearing in mind that Mrs Green had not seen fit to share HMRC's purpose in sending "new style" seizure reports with BAT.

189. The next three new style seizure reports relating to CC all concerned large seizures but only one of the three seizures was a notifiable seizure for the purposes of TPR 2001. The first seizure report involved 440 kg of CC, Amber Leaf, and Golden Virginia (with no breakdown by volume according to brand) but because the HRT was seized by the French authorities it was not a notifiable seizure for the purposes of TPR 2001.

190. The second seizure report was dated 22 May 2013 and involved a seizure of 1584 kg of different HRT brands including 420 kg of CC (although the inspection reports indicated that there may only have been 300 kg of CC). The seizure took place on 19 May 2013 and the vehicle concerned was an HGV. BAT inspected a sample of the seized HRT and confirmed that it was genuine and not counterfeit product. This was a notifiable seizure for the purposes of TPR 2001.

191. The third new style seizure report was sent to BAT on 30 October 2013 i.e. a few days after the Initial Notice. The total quantity of CC involved was 50 kg. This seizure was made from two couples travelling together and was therefore treated by HMRC, in accordance with its practice, as a non-notifiable seizure. BAT asked to

inspect the HRT concerned, but its request was refused by HMRC because the seizure was non-notifiable and, therefore, BAT had no right to examine the seized product. Ms Udicki's evidence, which I accept, was that generally BAT was not permitted to inspect HRT seized in non-notifiable seizures.

192. Of the remaining 13 new style seizure reports in the period before the issue of the Penalty Notice, only one was notifiable (a seizure of 75 kg of CC notified on 15 January 2014, with a formal TPDA notification on 6 February 2014) and the remaining seizures were non-notifiable. The notifiable 75 kg seizure involved a Polish registered HGV driven by a Polish national.

193. None of the new style seizure reports involved seizures related to "baccy buses". I have reviewed the seizure reports and I accept Ms Udicki's comment that the reports provided before January 2014 did not give a clear picture of "little and often" smuggling. I also accept Ms Udicki's evidence that Mrs Green had not indicated that she expected reports in respect of non-notifiable seizures to be addressed in the same way that BAT dealt with notifications of notifiable seizures. If Mrs Green had indicated that she expected non-notifiable seizures to be treated in this way, this would have constituted a significant change in HMRC's previous approach which Ms Udicki would have discussed with colleagues and would have remembered.

194. I also accept Ms Udicki's evidence that neither Mrs Green nor her colleagues informed Ms Udicki that HMRC regarded non-notifiable seizures as significant for the purposes of BAT's compliance with TPDA.

195. Without the ability to inspect the HRT seized in respect of non-notifiable seizures and without Track and Trace (which was only implemented in April 2014) I further accept that there was relatively little that BAT could do in relation to the new style reports in respect of non-notifiable seizures.

196. Mrs Green sent two letters to Ms Udicki dated 19 February 2014 and 6 March 2014 (the latter was only e-mailed on 1 April 2014) giving further information about seizures below 50 kg.

197. In the letter of 19 February 2014, in respect of the months of April and August 2013, of the 24 seizures therein listed, only two involved a coach trip from Belgium. On one of these coach trips the amount seized was 15 kg and on the other the amount was 36 kg. Most of the seizures, however, involved passengers arriving at airports from different locations around the world, commercial vehicles from different countries and train passengers from various EU countries. The letter of 6 March 2014 concerned only cigarettes and did not relate to "baccy buses". As far as I could tell from the information about seizures to which I was referred, the letter of 19 February 2014 was the only evidence of seizures relating to "baccy buses", apart from the statements in the Project Falcon report.

198. On 3 July 2013, as I have already noted, Mrs Green met Ms Udicki and Mr Duncan of BAT. Mr Duncan gave a presentation about the role of the BAT's AITIU. Mrs Green gathered from Mr Duncan's presentation that his team did not investigate

the seizure of illicit products by HMRC that were found, on examination, to be genuine (i.e. non-counterfeit) branded products. Moreover, BAT's security team only investigated seizures where there had been a failure in BAT's own supply chain e.g. a theft from a factory or a stolen lorry. Mrs Green was concerned about the apparent lacuna in BAT's approach in relation to the smuggling of genuine product. Accordingly, she wrote to Ms Udicki on 10 July 2013 asking for clarification of BAT's position, noting that Mr Duncan did not regard the smuggling of genuine product to be within his remit and that this was also not the responsibility of BAT's Security team. Mrs Green asked who within BAT investigated seizures notified under section 7A(7) TPDA 1979. Mrs Green also asked whether her understanding that Miss Udicki had said that no investigations were carried out was correct.

199. On 18 July 2013 (see paragraph 66-67 above) Ms Udicki replied stating that BAT had plans to implement SERP and that, once this procedure was implemented, all seizures would be a matter for the AITIU working with the relevant end markets.

200. The purpose of SERP, according to Ms Udicki's evidence, was to establish a system relating to notified seizures that:

(1) formalised the process for review of seizure events and BAT's decisions on corrective actions; and

(2) captured and recorded key information and assumptions, decisions made on corrective measures, and details of actions taken.

201. The formulation of SERP had commenced before HMRC issued the Initial Notice but it had not been implemented by 23 October 2013. One of the first references to SERP was dated 13 March 2013 in the course of the audit conducted by Mr Fowler. At that meeting, Ms Udicki is recorded as having indicated that BAT had been working on a revised seizure "procedure" which was, at the time, in its draft stages but which she hoped to be able to share in draft form by the end of April 2013. The procedure would provide "recommended steps to follow up a notified seizure." Mr Fowler considered that BAT should have had a seizure procedure in place already, but in the context of an audit which began in January 2013 he agreed that BAT's proposal was "not a bad start." Mr Fowler's evidence, which I accept, was that BAT's response to notified seizures was significantly weaker than other manufacturers. Other manufacturers already had defined response procedures. In due course, SERP was piloted in the latter part of 2013 and was later implemented in markets in respect of which HMRC had identified concerns.

202. The SERP reports in November and December 2013 (relating to seizures many months before) indicated that BAT was unable to trace the origin of the products. Track and Trace had not, of course, been implemented by this stage. In a letter to HMRC dated 15 April 2014, Ms Udicki sent copies of BAT's SERP reports for Belgium and Luxembourg to Mrs Green. Ms Udicki noted that the SERP reports related to seizures made in early 2013 and the reports were initiated at a very early stage in the process for the phased implementation of SERP. The roll-out of SERP for Belux commenced on 14 November 2013, the day before the reports were initiated. Ms Udicki noted that some of the entries on the reports were: "not filled out as

comprehensively as BAT requires. This is the inevitable consequence of a pilot scheme, which Belux was part of." Ms Udicki accepted that SERP was still in pilot form in April 2014 and she agreed that in the absence of Track and Trace little further action could be taken in respect of seizures. It was clear to me that in the absence of Track and Trace the SERP report was of limited value. Nonetheless, BAT had, in my view, put into place a mechanism to review products seized by HMRC, albeit that it could not be truly effective without the implementation of Track and Trace.

203. At a meeting on 15 January 2014, BAT provided further information about the implementation and scope of SERP. BAT informed HMRC that SERP was being piloted among the EUCA countries – although Mrs Green pointed out that it had not been piloted in respect of Poland or Spain, two of the markets identified in HMRC's Initial Notice. BAT replied that, after the pilot phase, it would be possible to roll out SERP to all the markets that HMRC had identified as being of interest.

204. BAT sent HMRC a copy of its new "Seizure Event Review Process" on 6 February 2014. Mr Fowler reviewed the document and considered that SERP was a positive development because it recognised BAT's obligations not to facilitate smuggling. SERP also provided, in Mr Fowler's view, a structure for dealing with seizure notifications and, if properly implemented, ought to create a clear audit trail showing what steps BAT took in response to seizure notifications. In his letter of 11 February 2014, Mr Fowler suggested some improvements to SERP and noted that it would not be possible properly to judge whether SERP provided an effective method for dealing with seizure notifications until it had been in place for some time and used on a number of seizures. Mr Fowler agreed that the full effectiveness of SERP was only going to be evident once Track and Trace was in place.

205. Ms Udicki replied to Mr Fowler on 19 February 2014. She agreed with Mr Fowler's comment that the effectiveness of SERP would only be truly evident once it had been in place for a period of time. She replied to Mr Fowler's specific comments but Mr Fowler did not respond to her letter. In cross-examination, Mr Fowler accepted that BAT may reasonably have concluded that HMRC had no further complaints in relation to SERP, a view which I consider he was correct to express. Furthermore, Mr Fowler agreed that HMRC could have removed SERP from the penalty notice in order to give it a period of time to "bed in".

206. Ms Udicki and Mrs Green were cross-examined on SERP reports. In particular, there was a SERP report dated 17 December 2013 relating to the seizure of 80 kg of CC. The CC had been destined for the Belgian market and bore eight production codes. The SERP report recorded that no Track and Trace data was available.

207. The SERP report (compiled by a Mr Olive) also indicated that BAT could not determine whether "any quantity was (not) purchased for own consumption or as a gift." Mr Moser suggested to Mrs Green that it was unfair for HMRC to suggest in the Penalty Notice that this was an example of BAT's lack of commitment to the performance of its statutory duty (HMRC estimated that 80 kg would last one smoker

20 years[7]). Mr Moser argued that it was clear that BAT was under the misapprehension that in fact the seizure involved not one but multiple seizures. Mrs Green, however, pointed out (correctly in my view) that one of the seizure codes related to 37 kg which could only be a single seizure and was far in excess of what was required for personal consumption. In addition, Mrs Green pointed out that the next SERP report, also dated 17 December 2013, involved a seizure of 261 kg with only one production code. Nonetheless, in this second SERP report BAT stated that it was not possible for BAT to determine whether any of the quantities were purchased for own consumption or as a gift. The next sentence, however, seemed to contradict this by indicating that the quantity of one seizure was such that it was doubtful whether this quantity was purchased for own consumption and/or as a gift. Mr Olive's efforts did not inspire confidence in Mrs Green – reasonably enough, in my view. His comments appeared to indicate that BAT was not treating the seizure process seriously.

208. In a letter dated 15 April 2014, Ms Udicki said that her colleague, Mr Olive, (who completed the relevant section of the SERP form) had been told that he must better describe what he had done and use the intelligence derived.

209. It was clear that these early SERP reports were ineffective and that some of Mr Olive's observations were misguided. In the absence of Track and Trace, it seemed to me that there was very little information which would enable BAT to take effective action. I do not, however, accept that SERP would have been ineffective once Track and Trace had been introduced. It seemed to me that the procedure embodied in SERP was a sensible and workable one but one which could only produce useful results once Track and Trace had been introduced. I was, however, troubled by the comments of Mr Olive which indicated either a non-compliant attitude or one which treated the process with less than the requisite degree of seriousness.

210. In the preliminary results of Mr Fowler's supply chain audit, sent to BAT on 23 October 2013, HMRC indicated that they had real concerns about the follow up work undertaken on notified seizures involving genuine BAT products. Mr Fowler's concern involved the lack of Track and Trace capability in Belux and noted that this meant that BAT:

(1) could not provide the seizure information required by the Schedule to the TPR 2001;

(2) could not identify weaknesses in their own supply chain which may have led to a seizure; and

(3) had been unable to provide additional information about specific seizures when HMRC had requested it.

211. It is conspicuous, however, that Mr Fowler's criticisms related to the absence of Track and Trace, rather than the SERP process, and did not refer to ACT.

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[7] This would assume an average consumption of 4 kgs per annum, considerably greater than Mr Dickson's estimate.

212. In the Initial Notice, HMRC stated that BAT did not comply with its policy because it did not investigate or carry out any enquiries in relation to seizures of HRT. The weakness identified by Mrs Green was that no individual or team had overall responsibility to carry out enquiries into qualifying seizures and that "as such there is no process in place." Mrs Green considered that this view was supported by the fact that BAT "currently take no action in respect of genuine cigarette/HRT seizures, despite these seizures being notified to BAT by HMRC." Mrs Green referred to the meeting on 18 July 2013 (see paragraphs 65-67 above) where she was told that BAT's Anti-Illicit Team only dealt with counterfeit and illicit white cigarettes and that its Security Team only dealt with a breach of the policy, whilst the HRT/cigarettes were under BAT's control. Mrs Green concluded that BAT did not consider genuine products that are smuggled back into the UK as an area of legitimate concern. The letter noted BAT's plans to implement SERP but noted that there was no detailed timeframe for doing so. The Initial Notice stated that the SERP needed to be "implemented and proved effective as soon as possible."

213. In the Penalty Notice, HMRC noted, in relation to section 7C(2)(b), that BAT had introduced SERP but that the examples of investigations carried out under this process did not demonstrate any level of control of their supply chain and showed them to have no impact. The investigations did not take place until many months after the seizure and at the end of the process BAT was unable to establish to whom the product was supplied and where their product was supplied to smugglers. HMRC cited the example of the 80 kg HRT seizure, referred to above, noting that HMRC's reasonable estimation was that this amount of HRT would last a single smoker 20 years. Although noting Ms Udicki's letter of 15 April 2014 and her comments about Mr Olive, HMRC stated that they had seen no evidence of Mr Olive better describing what he had done and using the intelligence derived from HMRC. Therefore, HMRC had seen no evidence of a fully operable procedure in place for investigation of seizures or any corrective action identified or taken as a result of investigations made. Of the four notified seizures made during the Warning Period, HMRC noted that they had seen no successful investigation reports.

214. In relation to section 7C(2)(c) and (d), it remained HMRC's view that BAT's supply chain policy was fundamentally flawed as it did not contain any mechanism to identify and investigate where its products had entered the illicit market. HMRC noted that SERP was only a trial and they had not seen it produce any meaningful results. The initial results showed its ineffectiveness as all review examples shared concluded that BAT did not know to whom they sold the products and therefore could not identify the point of diversion into the illicit market. HMRC observed that BAT's Anti-Illicit Trade Team, unlike their counterparts in all their major competitors, were only concerned with counterfeit product.

Specification notices

215. As I have explained, under section 7A(4) TPDA HMRC may notify a TM that they think the risk of smuggling into the UK is particularly great in relation to:

(a) products marketed under a specific brand name;

(b) products supplied to persons carrying on business in or in relation to a specified country or place.

216. I shall refer to a notice under this provision as a "specification notice".

217. On 16 June 2010, HMRC (Ms James) sent BAT a specification notice ("the First Specification Notice") specifying CC (and the BAT variant of Golden Virginia HRT) as a brand and Belgium and Luxembourg (as well as Spain and duty-free markets) as markets in respect of which the risk of smuggling into the UK was considered to be particularly great. That notice stated that the specified brands had been identified as being "a substantial source of smuggled tobacco product into the UK" but did not provide any further details. The notice required BAT to supply HMRC with the information set out in the letter. This information included an overview of the structure of the marketing and distribution channels, the identity of the top five customers in Belgium and Luxembourg, total quantity supplied to those top five customers on a quarterly basis, any analysis undertaken by BAT of the smuggling risks in Belux and any analysis of legitimate demand for CC in Belux. BAT supplied the requested information on 17 September 2010.

218. Following the First Specification Notice, BAT introduced a maximum quota for supplies of CC in Belux, commensurate with BAT's assessment of legitimate demand for CC. In addition, BAT began to send HMRC monthly reports on volumes of the specified brands supplied in the specified markets and other European countries.

219. On 13 August 2012, HMRC issued a further specification notice (the "Second Specification Notice") to BAT in respect of CC and Golden Virginia (duty-free), both BAT brands of HRT. The specified markets were Belgium, Luxembourg, Spain and duty-free (as well as ferries and aircraft). The Specification Notice renewed and updated the First Specification Notice. The Notice required BAT to supply information to HMRC relating to the specification and asked BAT to review its supply chain policy in relation to the specified products.

220. Ms Udicki supplied Ms James with the requested information in a letter dated 21 December 2012. However, in response to HMRC's request for copies of "any analysis or evaluation undertaken by BAT of the smuggling risks" in Belgium, Ms Udicki noted that BAT had not conducted risk assessments regarding HRT (including CC) in Belgium due to the small quantities of that particular brand. In addition, Ms Udicki explained that BAT also did not undertake an analysis of the smuggling risks in Spain or in relation to duty-free markets. BAT, nonetheless, explained that its direct customers were legitimate wholesalers who supplied products to retailers. BAT's agreements with these wholesalers included stipulations that the HRT supplied by BAT was intended only for the legitimate retail trade in Belgium.

221. Ms Udicki's response also confirmed that the Belgian wholesalers were approved in accordance with BAT's KYC policy and it also referred to the unilateral quota that was based on BAT's evaluation of legitimate demand for CC.

222. A further specification notice was issued by HMRC on 6 November 2012 (the "Third Specification Notice"). The Notice maintained the specification for CC in the

Belgian, Spanish and Luxembourg markets and also specified four of BAT's main wholesale customers in Belgium (as well as three such customers in Luxembourg). BAT responded to this Notice on 13 February 2013. BAT requested a copy of the reports which led to the wholesalers being specified, but this was not supplied by HMRC.

223. After conducting an annual review, Mrs Green issued another Specification Notice (the "Fourth Specification Notice") on 9 December 2013. Mrs Green specified CC and another BAT brand of HRT. The specified markets were Belgium, Luxembourg, Spain as well as duty-free and mobile retail outlets, such as ferries. Seven wholesalers were specified. In addition Adinkerke in Belgium was added as a specified place. BAT responded to the Fourth Specification Notice in a letter dated 17 December 2013.

224. Mrs Green confirmed that she had had regard to BAT's response, in the letter from Miss Udicki to Ms James dated 21 December 2012, to HMRC's questions in relation to whether BAT had carried out analyses of the smuggling risks in the various markets before issuing the Penalty Notice. Mrs Green also confirmed in cross-examination that the specification notices were not limited to notifiable seizures or high-volume smuggling.

225. In the Initial Notice, with reference to section 7B (2)(c), HMRC stated that it had seen insufficient evidence that BAT had taken steps to address the issues raised in the specification notices. In relation to the quota introduced by BAT in response to the First Specification Notice, HMRC noted that the quota related to supplies that BAT had already made and that those supplies had increased between 2011 and 2013. Therefore, HMRC did not regard this as a targeted restriction of supply and the amount of the supply was, in HMRC's view, in excess of the legitimate demand for those products. HMRC also noted that (as it believed at the time) Track and Trace would only be introduced in 2016 which was too late for those high risk areas.

226. In relation to section 7C(2)(b) (action taken by BAT to secure its compliance with the duty under section 7A (1)), HMRC acknowledged that BAT had held a series of meetings with wholesalers and retailers to raise awareness of BAT's Anti-Illicit Trade messages. Nonetheless, HMRC considered that this was the first time BAT had undertaken such an activity even though the other major TMs had been carrying out retail engagement for many years. HMRC concluded that, although a step in the right direction, this activity fell short of what could reasonably be expected in relation to supply chain control. The Penalty Notice stated that the nature of fraud in HRT had been set out by HMRC in detail i.e. criminals purchasing large volumes of products through multiple purchases from retailers supplied by wholesalers in the markets concerned. The Penalty Notice stated that BAT did not dispute that but considered that there was no action they could legally take in relation to influencing the relationship between wholesaler and retailer.

227. In relation to section 7C(2)(e), HMRC stated that they were not aware of any specific actions BAT had taken in response to specification notices. The Notice stated that when this had been raised in discussions, BAT indicated that no additional action

was taken because they operate global policies and systems and would not vary them for one jurisdiction, a view which was not consistent or compliant with the obligations set out in the TPDA.

228. It seems to me that the statement that HMRC were not aware of any specific actions taken in response to the specification notices was a considerable overstatement. By the time the Penalty Notice was issued, HMRC were aware, for example, that BAT had accelerated the introduction of Track and Trace, was piloting ACT, had instituted the SERP procedure and had engaged with wholesalers and retailers. Whether this was directly in response to the specification notices, or partly in response to those notices and partly in response to the Initial Notice and the meetings BAT had held with HMRC, does not seem to me to be material because the general concern in relation to, for example, Belux in the specification notices was broadly the same as the concerns expressed in the Initial Notice and in the meetings. It is true that at an early meeting (13 March 2013) in the audit process, Ms Udicki confirmed that no further action was taken in relation to the specification notice of 13 August 2012, but this was before the steps referred to above were taken.

BAT's relationship with wholesalers and retailers

229. After receiving the Project Falcon Report, BAT took steps to raise awareness among retailers and consumers regarding their legal obligations. Where HMRC notified BAT of seizures of BAT products which could be identified to specific retailers, BAT notified the retailers of the seizures and initiated further discussions regarding measures which could be taken by retailers to avoid supplying smugglers.

230. Ms Borms, BAT's Legitimate Cross-Border Trade Manager for Belgium and Luxembourg, visited key retailers at least once every two months. In late 2013, BAT conducted site visits with the retailers identified by HMRC in its Project Falcon report to discuss the smuggling of HRT products from Belgium into the UK. Those visits involved discussions with the relevant retailer and providing training to raise retailers' awareness regarding illicit trade and anti-illicit trade measures. BAT representatives visited the retail stores to conduct the training and took the retail staff through a presentation on BAT's anti-illicit trade initiatives and the minimum indicative levels for tobacco applied by the UK government. BAT also supplied consumer information leaflets to the retailers, the wording of which was based on HMRC's website. The Belgian retailers were asked to display these leaflets in their retail outlets.

231. Ms Borms explained that Adinkerke was responsible for approximately 90% of all UK sales to cross-border shoppers. By speaking to the majority of retailers in Adinkerke she would have spoken to retailers responsible for 80% to 90% of the sales that went to the UK. Ms Borms believed that she had spoken to 10 to 15 of the retailers in Adinkerke.

232. In the first quarter of 2014, BAT undertook audits of the sales records of its Belgian wholesalers in order to confirm whether the wholesalers were selling through legitimate channels.

233. During the HMRC audit conducted by Mr Fowler, BAT exercised its rights pursuant to its contracts with its wholesalers to request a list of all retailers buying CC and the relevant volume data, as well as stock levels at the beginning and end of the year. BAT then compared this data against BAT's shipment data for each wholesaler. BAT concluded that CC was being sold within the legitimate supply chain in Belgium.

234. BAT encouraged wholesalers to adopt KYC principles with their retail customers by running KYC classes with wholesalers. BAT could either stop supplying or reduce supplies to a wholesaler but, as Ms Borms accepted, did not impose requirements on wholesalers as to how they constructed their contracts with retailers. This contrasted with the position of the other three major UK TMs, each of which had clauses in their contracts with wholesalers requiring them to require their retailers to agree to the KYC policy. Mrs Green accepted that she never suggested to BAT that similar clauses should be introduced into their contracts with wholesalers because, as she put it: "It is a commercial matter for the tobacco manufacturers to decide what is in their contracts."

235. There was a standard termination clause in BAT's contracts with its wholesalers. This clause allowed BAT to terminate its agreement with a wholesaler if the wholesaler did not comply with its contractual obligations or if BAT discovered that the wholesaler was guilty of or participating in activities that were linked to the smuggling and/or counterfeiting of tobacco products.

Memoranda of understanding ("MoUs")

236. As I have already explained, BAT and HMRC entered into three MoUs: in 2002, 2006 and, finally, in August 2013. None of the MoUs was legally binding.

237. The first MoU ("the 2002 MoU") was dated 30 October 2002. This was, therefore, the MoU in place between the parties at the date of the consultation process which ultimately resulted in the enactment of section 7A-D TPDA. Clause 2.3 concerned seizures of "a material quantity" of BAT product manufactured in the UK. It did not deal with BAT product manufactured outside the UK. BAT agreed to investigate "the original sale by BAT" and supply HMRC with export sales data relating to the products seized, "including details of the first customer." BAT also agreed that if the evidence indicated that the product had been smuggled into the UK "in commercial quantities by organised gangs for resale and BAT concludes that the first customer for such product is a smuggler of BAT product or is knowingly or recklessly supplying a smuggler with such product, then BAT will delist and refuse further supplies to that customer."

238. In Clause 3 HMRC agreed to advise BAT of any "significant seizures" of BAT product that had been smuggled into the UK and to provide BAT on request with samples of such seized stock and, where appropriate, an opportunity to examine the seizure to enable BAT to determine whether it was genuine product or counterfeit and "also to enable BAT to try to trace its first customer."

239. It will be observed, therefore, that the 2002 MoU envisaged that BAT's obligations in relation to tracing its products related only to its first customer (i.e. a wholesaler).

240. The 2006 MoU was intended (Clause 1.1) to "set out a framework of cooperation" between HMRC and BAT "in order to seek to limit the smuggling of both contraband and counterfeit BAT product into the UK."

241. BAT stated that it was committed "to take commercially reasonable steps… to promote the objectives that its tobacco products be sold, distributed, stored, and shipped in accordance with all applicable tax and duty laws in the intended retail market; and that volume is consistent with BAT's understanding of the domestic consumption in that market and the permissible requirements of the travelling consumer." (Clause 1.3)

242. By Clause 2.2, BAT undertook to provide HMRC with "source-market specific" sales data on request for UK-sensitive brands. BAT also undertook to share with HMRC "at least on an annual basis" its understanding of domestic and legitimate cross-border consumption for each such tobacco product and brand in the intended destination market of its international sales. In Clause 2.3 BAT agreed to keep under review its existing supply policy and procedures to ensure that controls, embedded in the Company's systems, "remain appropriate and reflect best practice in this area."

243. Next, in Clause 2.6, where HMRC had concerns about BAT's brands entering the UK from a specific market, BAT undertook to provide "source-market specific data related to current approved market distributors, proposed new market distributors…." BAT also agreed that it would "make all reasonable efforts to ensure that all its customers are similarly committed, through adoption of BAT's Tobacco Product Supply Policy, to taking action to prevent product being diverted by smugglers."

244. BAT also agreed (Clause 2.8) to support "all reasonable ways in which [it] can join with [HMRC] to maximise supply chain controls, disincentives and sanctions against those retailing EU duty-paid tobacco products in quantities that are not consistent with BAT's understanding of the domestic consumption in that market or the permissible requirements of the travelling consumer."

245. BAT also agreed (Clause 3.1) "to provide reasonable assistance to HMRC in its efforts to identify all smuggled product, and track down the smugglers with the overall objective of reducing further or eliminating this unlawful trade."

246. Clause 4 of the 2006 MoU dealt with seizures of tobacco products. Clause 4.1 stated:

> "For material seizures of tobacco products bearing BAT Trademarks by [HMRC]…, in circumstances where it is identified as destined to be smuggled into the UK without payment of UK duty, BAT and [HMRC] will apply the procedures set out in this clause. Seizures will

> be considered material if they are of at least… 50 kg of hand-rolling tobacco."

247. In Clause 4.2 HMRC agreed to notify BAT within 15 working days of any material seizures and, within 15 working days of the notification, to allow BAT access to inspect the seized product. HMRC was also permitted to select samples which BAT was required to examine for tracking and tracing.

248. BAT agreed (Clause 4.3) to provide HMRC with:

> "accurate and comprehensive responses to tracking and tracing requests and provide within 20 working days following the receipt of samples of these packs a written response stating whether the seized tobacco products are genuine or counterfeit. In the case of genuine BAT tobacco products the following information:
>
> (i) the place of manufacture of the seized product;
>
> (ii) the date of manufacture of the seized product;
>
> (iii) the country of intended destination for the seized product;
>
> (iv)…
>
> (v) the identity of the First Purchaser outside of the company, of the seized product, and related payment records. Where regular seizures are made where it is not possible to identify the First Purchaser outside of the company, BAT and [HMRC] will jointly identify alternative measures in order to identify the point of supply chain weakness;
>
> (vi) the identity of any known Subsequent Purchaser of the seized product; and
>
> (vii) information about codings and other pack markings."

249. Again, Clause 4.3 (v) focused upon the "First Purchaser" outside the BAT group. The identity of a Subsequent Purchaser (e.g. a retailer) was only required if it was known: Clause 4.3 (vi). HMRC agreed to make BAT aware of any concerns about specific traders, or destination markets from which "significant volumes" of tobacco products was seized being smuggled into the UK. "Significant", in this context, referred either to the volume of seizures or the proportion of seized product in relation to the total volume supplied to a particular market.

250. In Clause 4.6 BAT agreed that if the evidence indicated that the product had been smuggled into the UK in commercial quantities for re-sale and BAT concluded that the first customer could not demonstrate sufficient effective control of its products to prevent repetition "then BAT will take steps to restrict supply including if necessary de-listing and refusing further supplies to that customer."

251. Finally, in Clause 6 BAT and HMRC agreed to meet frequently to review progress. At those meetings, the parties agreed to consider the effectiveness of the arrangements set out in the MoU, "together with any further actions that may be necessary to ensure BAT brands continue to be driven out of the illicit market."

252. The third MoU ("the 2013 MoU") was dated 14 August 2013. This was just over two months before the issue of the Initial Notice. One of the curiosities of this appeal is that very little was said about this MoU in the evidence of HMRC's or BAT's witnesses. In particular, there was no explanation as to why, at this critical period (during the course of the supply chain audit of BAT and shortly before the issue of the Initial Notice), the MoU was updated at this time and the extent to which it reflected the current concerns of HMRC about BAT's supply chain policy.

253. In Clause 1.1 it was stated that the 2013 MOU "complements" the UK supply chain legislation and EUCA. By Clause 1.5, BAT recognised the need to assist HMRC in its efforts to combat all forms of the illicit trade in tobacco products and stated that, in conjunction with EUCA, this document set out BAT's continuing commitment to support UK government initiatives.

254. Next, in Clause 2.1, BAT agreed to make "all reasonable efforts to ensure that its customers are similarly committed, through the adoption of suitable policies to prevent, as far as reasonably practicable, its products from being diverted onto the UK illicit market…." BAT also agreed to make all reasonable efforts to contractually oblige its customers to implement effective controls to prevent its products being diverted onto any illicit market.

255. BAT also agreed (Clause 2.2) to provide HMRC, on request, with its understanding of the legitimate demand for specified products and brands in the intended market of retail sale.

256. In Clause 2.4, BAT agreed to consider all reasonable requests from HMRC to inspect and trace seizures of its tobacco products seized in the UK "that fall below the thresholds set out in the UK Supply Chain Legislation and the [EUCA], with the aim of sharing information about the supply of those products with HMRC."

257. Clause 2.5 provided that if HMRC believed that there was a serious problem concerning illicit trade in BAT's products entering into the UK, HMRC and BAT were to meet and discuss as soon as reasonably possible any appropriate measures, which may include having BAT reassess the demand for those products in the original intended market of retail sale as well as the trading relationship with its customers in those markets. In my view, Clause 2.5 envisaged a discussion between HMRC and BAT in relation to what BAT should consider doing in relation to "serious" problems identified by HMRC. In her evidence, however, Mrs Green consistently maintained the position that it was not for HMRC to advise BAT what to do – a position which to me seemed at odds with Clause 2.5 of the 2013 MoU.

258. In Clause 2.6, repeating the equivalent clause in the 2006 MoU (Clause 4.3), HMRC agreed to make BAT aware of any concerns about specific traders or destination markets from which "significant quantities" of tobacco products had been seized and "significant quantities" was defined in the same way as in the 2006 MoU.

259. Clause 2.7 provided that where HMRC's seizures indicated that "significant quantities" of BAT's products intended for retail sale in overseas markets had been

diverted onto the UK illicit market, BAT would, as far as reasonably practicable, investigate where and how the product was diverted.

260. Clause 2.8 contained a similar provision to Clause 4.6 in the 2006 MoU. Clause 2.8 provided that where BAT concluded that "any first customer" could not demonstrate sufficient effective control to prevent the diversion of its products onto the UK illicit market, BAT would review its business relationship with that customer and would take appropriate steps, which might include, "as far as permitted by law", terminating their relationship with that customer.

261. Clause 2.9 effectively repeated Clause 2.3 of the 2006 MoU.

262. In Clause 2.13, BAT agreed to "continually reassess" the risk of smuggling and diversion of its products onto the UK illicit market, "and consider with HMRC the appropriate actions to be taken if significant quantities are diverted onto the UK illicit market, or seized after being smuggled into the UK." The Clause continued with BAT agreeing "where the risks are considered significant", to take all reasonable steps (including the unique marking of specified products supplied to the specified markets) to assist in the identification of the point of diversion from the legitimate supply chain.

263. The 2013 MoU contained further provisions dealing with mutual assistance and intelligence collection.

264. It seemed curious to me that the 2013 MoU did not explicitly raise and deal with the type of concerns which HMRC raised (or considered had been raised) in the Initial Notice or the Penalty Notice. For example, there was no clear mention of any need by BAT to introduce Trace and Trace and SERP (points raised in the Initial Notice) or ACT (a point raised in the Penalty Notice).

265. I have already mentioned, in addition to the comments by the Financial Secretary to the Treasury, the descriptions given by HMRC to the TMA of the provisions of the TPDA introduced in 2006 as "complementing" or "mirroring" the MoUs. In addition, the Consultation Document of January 2006 stated that:

> "the legislation will complement the Memoranda of Understanding (MOUs) that [HMRC] have entered into with a number of tobacco manufacturers."

266. Section 18.1 of the Regulatory Impact Assessment ("RIA") submitted by HMRC stated:

> "The legislation is designed to complement the [MoUs] that HMRC has entered into with a number of leading UK tobacco manufacturers, and ensure that those manufacturers who support HMRC in their efforts to combat tobacco smuggling by doing so are not unfairly disadvantaged. Obligations will therefore be imposed on all tobacco manufacturers to control their supplies to non-UK markets, and ensure, as far as reasonably practicable that they do not facilitate smuggling.

> The [MoUs] are an important step towards dealing with the problem of tobacco smuggling and are representative of the co-operation of the manufacturers involved. However, the MoUs are voluntary agreements and only apply to the signatory manufacturers. By introducing legislation to complement and support the MoUs all tobacco manufacturers are placed under the same obligations…."

267. Under the headings, at paragraph 11.17 ('Options'), option 2 was to:

> "introduce legislation complementary to the existing MoUs" where "[t]he legislation is framed so as to mirror the main obligations of the MOUs and in doing so to extend those obligations to all manufacturers".

EUCA

268. BAT entered into EUCA on 15 July 2010.

269. EUCA required BAT to have in place policies and procedures in relation to the manufacture, sale, distribution and/or storage of its tobacco products.

270. EUCA provided that if there was a seizure by the authorities of any Member State of 50,000 or more cigarettes (0.92 g of HRT equalling one cigarette for these purposes) which the authorities believed to be BAT cigarettes, the seizing Member State was obliged to notify the Anti-Fraud Office of the European Commission ("OLAF"). OLAF would then notify BAT of the seizure and BAT would then consult with the seizing Member State in order to arrange an inspection and the taking of samples.

271. If the products were genuine BAT products, BAT was, *inter alia*, obliged to supply the identity of the First Purchaser of the seized tobacco products and, if known, the identity of any subsequent customer. The First Purchaser was the person which directly purchased the tobacco products from a BAT company. At the same time, BAT was required to make a payment to the European Commission in an amount equal to 100 % of the taxes and duties it would have been paid in the Member State of seizure. The amount of duty payable rose to 400% if the amount seized exceeded 150,000 cigarettes (or the equivalent of HRT). No payment was due, *inter alia*, if the total amount of cigarettes seized was less than 50,000. BAT undertook to comply with the principle set out in the periodically updated standards of business conduct. BAT also agreed to pay the European Commission $200 million in 20 yearly payments, to be used by the Commission in eliminating the illicit trade in tobacco products. As already described, BAT agreed to roll out Track and Trace in phases.

272. The Know Your Customer ("KYC") Framework Document ("the Framework Document") was executed in June 2011 pursuant to EUCA. This was a very lengthy document and it is beyond the scope of this decision to set out its terms in detail. However, a number of salient features of this document can be observed.

273. BAT was obliged to apply due diligence in respect of its current and prospective "Contractors" (which was defined, in effect, to mean BAT's wholesalers). As part of

the due diligence process, BAT was obliged to make commercially reasonable efforts to require a wholesaler to have a sales plan that specified the markets for distribution of BAT's tobacco products. The sales plan, where practical, would identify the intended or prospective customers of the wholesaler for BAT tobacco products. In a section headed "Controls on Sales", BAT undertook to ensure that its tobacco products were sold by BAT companies or their First Purchasers (i.e. the wholesalers) in quantities that were "commensurate with a legitimate demand in that country, which shall include local consumption and legitimate cross-border trade." BAT also agreed to take all reasonable steps to reduce or limit the volumes of tobacco products to a wholesaler which, in BAT's opinion, was not exercising sufficient control over its sale of BAT tobacco products or was purchasing brands/volumes of tobacco products inconsistent with those which BAT deemed reasonable for the wholesaler and markets in question.

274. The KYC Framework Document also required BAT to cooperate with OLAF and the participating Member State in any investigation or enforcement action regarding BAT's tobacco products. Moreover, BAT was obliged to require their wholesalers to cooperate "including… by the supply of relevant information". Information for this purpose included sales data and customer details. BAT was required to put in place a robust set of processes and procedures for due diligence on customers (i.e. purchasers from BAT in an amount greater than 20 million cigarettes or the HRT equivalent).

275. In relation to customer agreements procedure, the Framework Document referred to the fact that BAT had specific obligations relating to the control of its supply chain and relationships with customers such as distributors, all with the aim of ensuring BAT took reasonable precautions to combat illicit trade. BAT agreed to review its existing customer agreements in order to ensure that all the necessary KYC obligations were met. The document noted that BAT would want to ensure that equivalent obligations were reflected in the agreements between BAT and its immediate customers. The obligations were required to be inserted in BAT's distribution agreements where its customer purchased or was expected to purchase over 25 million cigarettes (or the equivalent amount of HRT).

276. The Framework Document also included specimen clauses to be included in BAT's agreements with its customers. One such clause entitled BAT to limit or cease the supply of products to a customer if it believed that the customer was not exercising sufficient control over its supply chain or where BAT believed that the brands/volumes purchased were inconsistent with BAT's market expectations. Another clause stated that BAT could request that the customer terminate any of its customer relationships where BAT had evidence that such person was involved in the illicit trade in tobacco. BAT was required to make reasonable commercial efforts to require its contractor to terminate the business relationship (including terminating its own relationship with its customer). Finally, the specimen clauses suggested, as a commercially reasonable provision, that BAT's customers should insert substantially equivalent provisions as the EUCA obligations in their non-final subsequent purchaser's contracts (and such persons should include such provisions in their terms of business with their non-final subsequent customers).

277. In relation to the terms of trade, the Framework Document suggested that BAT should be entitled to reduce or limit the volumes of supply of its tobacco products where BAT believed that the wholesaler was unreasonably failing to minimise the risk of the products being diverted into and resold to the illicit market. Also, the specimen clauses required the wholesaler to agree to incorporate substantially equivalent principles into its standard terms and conditions of business to be used with "non-final Subsequent Customers" which were substantially equivalent to the above terms. There was some discussion at the hearing as to the meaning of "subsequent Customers" and Mrs Hall accepted, according to the definition section of the KYC framework document, that a Subsequent Customer was an intermediate wholesaler rather than a retailer. There was, however, a definition of "subsequent customer" in the body of the Framework Document which simply defined "subsequent customer" (without initial capital letters) to mean "a subsequent customer of the Customer" (i.e. BAT's immediate customer) which, in my view, applied to the provisions summarised above.

278. The Framework Document also dealt with ACT. One of the suggested clauses stated that BAT may require the wholesaler to introduce a customer tracking information system to track information about subsequent customers and products to be stored in a database compatible with BAT's customer tracking database – this system was referred to as the "Additional Customer Tracking System". Plainly, however, ACT was regarded by EUCA as a measure which was optional.

279. The Framework Document also included standard terms which required the wholesaler, promptly on receipt of a notification from BAT, to terminate its commercial relationship with and cease supplying products to a retailer on the basis that:

(1) BAT had documentary or other substantive evidence that the wholesaler was involved in illicit trade; or

(2) BAT had received a written notification from a regulatory authority that the wholesaler should terminate its commercial relationship with and cease supplying products to the retailer.

280. The Framework Document also provided that BAT had the right to terminate its agreement with the wholesaler:

(1) if the wholesaler failed to satisfy its due diligence requirements;

(2) if BAT reasonably believed that the wholesaler was unreasonably failing to minimise the risk of the sale of its products being illicit trade;

(3) if the wholesaler did not comply with a request to terminate its commercial relationship with the retailer.

281. Mrs Green's evidence was that BAT had not drawn these provisions to her attention, although she accepted that HMRC had a copy of these agreements.

282. Nonetheless, when Mrs Green stated that BAT did not comply with the terms of its written supply chain policy, it was to this document and two other documents (the MoU and the Standards of Business Conduct) to which she was referring.

Standards of Business Conduct ("SBC")

5 283. The SBC were a set of global policies of BAT which, in its own words, expressed "the high standards of integrity we are committed to upholding." In the introductory message from the Chief Executive, it was stated that the SBC reflected "what the law requires of us and how much we value honesty, openness and integrity at [BAT]."

10 284. In relation to "illicit trade", the SBC stated that BAT must ensure that:

(1) it did not knowingly engage in unlawful trade in BAT's products;

(2) BAT's business practices only supported legitimate trade in its tobacco products;

(3) BAT collaborated pro-actively with authorities in any investigation of
15 illicit trade.

285. Accordingly, the SBC asserted that BAT must maintain controls to prevent its products been diverted into illicit channels. These controls would include:

(1) KYC procedures;

(2) measures to ensure supply to markets reflected legitimate demand;

20 (3) procedures for investigating, suspending and terminating dealings with customers or suppliers suspected of involvement in illicit trade; and making BAT's position on illicit trade clear to customers and suppliers. In this connection, the SBC stated that, wherever possible BAT should seek contractual rights to investigate, suspend and cease dealings with customers and/or
25 suppliers if they believed that they were involved, knowingly or recklessly, in illicit trade.

286. The SBC also stated that BAT's procedures required specific steps to be taken to assess the level and nature of illicit trade in a given market and to develop plans to address it.

30 *Contractual terms*

287. At the meeting between HMRC and BAT on 17 March 2014, the fourth question put by Mrs Green to BAT was:

> Is BAT intending to make any changes to the contracts that they hold with their first customers in respect of their contracts with their
35 retailers (for example, anti-smuggling clauses)?

288. Ms Udicki replied to this question in her letter of 4 April 2014 as follows:

(1) "4.1 We have been considering HMRC's recommendations in this regard with our lawyers. Without intending to waive legal professional privilege at this stage, we can tell you that they have raised concerns that there is a significant risk that such measures, if implemented in the EU, would infringe EU competition law, as well as, potentially, other EU laws governing the free movement of goods.

(2) 4.2 We would be happy for our lawyers to attend the meeting with HMRC's lawyers to discuss these concerns and consider whether there are lawful amendments to our contracts that we might be able to make."

289. On 15 April 2014 Miss Udicki wrote again to Mrs Green at HMRC. Ms Udicki repeated her suggestion of a meeting between lawyers. Her letter continued:

> "To amplify… the four types of contractual arrangements we previously discussed with our lawyers, and which formed the basis of our response to Question 4 in our 4 April 2014 letter, were contractual measures:
>
> (a) requiring first customers to cease supplying retailers they reasonably suspect of selling to customers who are likely to smuggle our products into the UK;
>
> (b) requiring first customers to cease supplying retailers which they know sell large amounts of products (i.e. amount significantly in excess of UK indicative limits) to individual customers;
>
> (c) requiring first customers to "blacklist" retailers BAT considers selling to customers who are likely to smuggle our products into the UK (the consequence of this would be that the retailer would then cease to be supplied); and
>
> (d) requiring first customers to require retailers to restrict sales to UK indicative limits.
>
> As we noted in our letter, the advice we received was that in relation to each of the measures described above, there was a significant risk that such measures, if implemented in the EU, would infringe EU competition law, as well as, potentially other EU laws governing the free movement of goods.
>
> [W]e,...in conjunction with our lawyers, have been considering whether there are any further steps which BAT could implement, through its contractual arrangements with its first customers, that might assist BAT's and HMRC's mutual objectives and which would not infringe relevant domestic or EU legislation. We are currently considering to specific initiatives that potentially meet these criteria:
>
> (a) requiring first customers to implement enhanced KYC provisions with their customers/retailers, possibly with the requirement that such further customer/retailer submits sales plans and confirms that those plans are commensurate with legitimate demand for our products; and
>
> (b) requiring first customers supplying the Belgian market to implement measures requiring (ultimately) retailers to notify them when such retailers have made sales that they consider to have been

> made for commercial purposes rather than for private consumption. We understand, based on Belgian legal advice…, that Belgian retailers are required to make such an assessment under Belgian VAT rules."

290. At a meeting between BAT and HMRC, which included legal representatives, on 8 May 2014, Mrs Green dismissed the two suggestions in Ms Udicki's letter of 15 April 2014 as a "waste of time", saying that the changes would not go far enough.

291. The meeting then explored the EU competition law concerns, particularly those arising under Article 101 TFEU. Mrs Green explained that HMRC had proposed that the contract should provide for BAT to issue a warning notice to its customer rather than an immediate right to terminate. It was also explained that HMRC envisaged that the contract would only be terminated where there were significant or repeated breaches and that this took into account the EU principle of proportionality. HMRC also suggested that the contract between the manufacturer and the wholesaler should set out the manufacturer's policy concerning illicit trade and that there should be a requirement for the wholesaler to take a similar approach with the retailer. Mrs Green said that what HMRC had in mind were contracts which contained high-level, non-specific clauses, rather than clauses that set out the precise actions a TM would take and in what circumstances it would take such action. Mrs Green said that she could not share specimen sample contractual terms but thought that the Anti-illicit Trade Working Group provided a forum in which the industry could explore such issues.

292. On 14 May 2014, Mr Belhomme (BAT's Regional General Counsel Western Europe) wrote to Mrs Green referring to the meeting on 8 May 2014 and to the prior correspondence. In his letter, Mr Belhomme noted that it was:

> "a significant feature of BAT's policies and procedures to take action against its contractors that it suspects of being involved with illicit trade. See, for example, paragraph 13 of Section A of our KYC Framework and Section B of the SERP Guidance Notes. Indeed, as I mentioned during the course of the meeting, for many years, predating even the TPDA, BAT group companies have terminated contractual relationships, across BAT's global operations, on this basis."

293. Mr Belhomme referred, for example, to the provision in the Framework Document summarised in the final sentence of paragraph 276 above.

294. After referring to the EU law concerns in relation to the four proposed contractual terms referred to in Ms Udicki's letter of 15 April 2014, Mr Belhomme continued:

> "However, from our meeting it is now clear that such provisions are not what HMRC was anticipating and those are not the type of provisions included in any other tobacco manufacturers' contracts.
>
> Instead, HMRC is recommending the inclusion of a broader commitment by customers to avoid the facilitation of smuggling and identifying that BAT group companies will take steps against entities in their supply chains that they reasonably suspect of engaging in such activity. You also confirmed that HMRC recognise that any punitive

action is likely only to be lawful if, in practice, there has been prior engagement with the relevant entity and warnings given in respect of the relevant issues, such that steps to cease or restrict supply can be justified as necessary and proportionate.

5 Now that we understand what you suggest, we are in a position to add some wording along these lines into our customer contracts and we will work with our lawyers to achieve this diligently. As we discussed at the meeting, you are unable to provide us with language apparently used by other tobacco manufacturers in their contracts, nor any 10 standard form wording that satisfies HMRC's concerns. Instead, we will produce our own draft wording and will discuss this matter with our competitors through the TMA's anti-illicit trade industry working group in order to confirm that our proposal accords with the equivalent approach used by our competitors, which HMRC has confirmed it is 15 happy with. We will implement the resulting clauses into our business contracts as soon as reasonably practicable."

295. I note that in HMRC's Amended Statement of Case, HMRC denied that section 7A TPDA required BAT to include any specific provisions in contracts between itself and purchasers of CC. HMRC observed that TMs have a choice as to what measures 20 to put in place to comply with that duty. Whilst this is true, there was clearly an expectation by HMRC that BAT would include contractual provisions which would allow BAT to limit or discontinue supplies of CC in certain circumstances. The meeting of 8 May 2014 made this expectation clear.

296. The position, therefore, appeared to be that BAT was under a misunderstanding 25 as to exactly what contractual provisions HMRC was suggesting and feared that HMRC required contractual provisions which may be in breach of EU competition law. In the event, it became apparent from the meeting on 8 May 2014, that HMRC were not requiring provisions that infringed competition law. I must say, however, that I had some difficulty with BAT's explanation of this misunderstanding because 30 what I understood HMRC to have in mind by way of the desired contractual provisions was essentially what was contained in the specimen EUCA clauses and, indeed, in the 2013 MoU.

297. Ms Borms's evidence contained a specimen clause that was contained in BAT's agreements with its wholesalers. Ms Borms confirmed that this clause would have 35 been contained in agreements with wholesalers between 2010 and 2016. The clause permitted BAT to terminate the agreement with immediate effect if, *inter alia*, BAT discovered that the wholesaler was guilty of or participating in activities that were linked to smuggling and/or counterfeiting of tobacco products. The clause also required the wholesaler to comply with the laws and regulations applicable to trade 40 and sale of goods, specifically those relating to smuggling and to seek to impose the same obligations on its counterparties. In the event of non-compliance by the wholesaler, the clause provided that BAT was entitled to terminate the agreement and suspend sales to the wholesaler if the wholesaler failed either to prove that there had been no non-compliance or to take steps to comply with the applicable laws and 45 regulations within a reasonable timeframe.

298. It was, perhaps, this clause to which Mr Moser was referring when he submitted that BAT's contracts already contained the sort of restrictions which HMRC was seeking. Mrs Green confirmed that she was unaware of the existence of this provision when she issued the Initial Notice.

299. Alternatively, Mr Moser may have been referring to the specimen clauses in the EUCA Framework Document.

300. On balance, it seems to me (based on Mr Belhomme's letter of 14 May 2014) that BAT's contracts with its wholesalers already contained the provisions set out in the EUCA Framework Document.

301. In any event, the Initial Notice did not refer to HMRC's concern about the absence of any specific contractual clauses (or indeed any clauses at all) in BAT's contracts with its wholesalers. That issue was, however, noted in the Penalty Notice under the heading "***Section 7C(2)(b) – action taken by BAT to secure compliance with the duty under section 7A(1)***" at paragraph C. Oddly, the Penalty Notice seems to have ignored Mr Belhomme's letter of 8 May 2014.

HMRC's Supply Chain Audit

302. From January to June 2013, the NAO carried out an audit of HMRC's Tobacco Strategy. At the same time, HMRC audited three of the four TM's tobacco supply chain policies from January to around October 2013. The manufacturers were BAT, and two other Manufacturers. The policies of a fourth Manufacturer were audited later in 2014. The rationale for the audit was set out in HMRC's letter of 29 January 2013 as follows:

> "You will be aware that the National Audit Office is conducting a review of HMRC's Tobacco Strategy and there is a strong possibility that the Parliamentary Public Accounts Committee may wish to ask questions about the detail and effectiveness of that strategy. I see the audit as an essential component in supporting HMRC's response to any such questions. I am sure you will agree that it is in both our interests to be able to present our findings and conclusions if that eventuality arises. I would, therefore, welcome your full co-operation in progressing this audit quickly."

303. Rather strangely, in cross-examination, Mr Fowler suggested that the reference to the NAO was "a lever to encourage cooperation from tobacco manufacturers in the audit." It seemed to me that Mr Fowler was suggesting that either the letter of 29 January misrepresented the position or did not tell the whole truth.

304. Ms Udicki's recollection (which was not challenged) was that, at the beginning of the audit process, HMRC committed itself to provide recommendations of best practice in relation to TMs' supply chain policies and practices, based on its audit of all the major UK-based tobacco companies. The best practice guidance was, however, produced only in April 2016.

305. Ms Udicki met Ms Green for the first time at a meeting with HMRC on 13 March 2013 to agree a plan for the audit. She was accompanied by Mr Fowler who took the lead on behalf of HMRC in the conduct of the audit. Mrs Green conducted the audit of two other Manufacturers. Mr Fowler accepted that those Manufacturers commanded a greater market share than BAT's CC brand in both the UK and in Belgium. Mr Fowler accepted that Mrs Green was content for Mr Fowler to conduct the BAT audit because she did not consider that BAT gave rise to the same concerns as the two other Manufacturers (whose brands had also been the subject of specification notices). BAT and HMRC agreed to have a number of audit meetings, which took place on 17 April 2013, 22 April 2013 and 28 June 2013.

306. At the meeting on 13 March 2013, Ms Udicki confirmed that EUCA was her remit and that the EUCA process had been "tweaked" to give one uniform process which BAT considered also covered the TPDA. Ms Udicki proposed to give a presentation on EUCA which would show how the TPDA obligations were met. Mr Fowler's evidence was that Ms Udicki explained that BAT's supply chain policy for the purposes of the TPDA was the same as the process for EUCA. It seems to me that Mr Fowler's evidence on this point was incorrect – Ms Udicki clearly explained that the EUCA process had been "tweaked" to take account of the TPDA obligations.

307. In the course of the audit, at a meeting on 17 April 2013, HMRC noted (there was no documentary evidence that HMRC raised this with BAT as a concern until September/October 2013) that Belgium was in Phase 3 for BAT's Track and Trace implementation. This meant BAT was unable to identify the first external customer for seized genuine product. As I have explained, BAT then took steps to accelerate the implementation of Track and Trace in Belgium, accelerating implementation by two years.

308. At a meeting on 22 April 2013, HMRC and BAT discussed BAT's "Standard of Business Conduct" ("SOBC") compliance program and its internal audit process. Mr Fowler considered that the SOBC was a good high level governance policy but was not a measure which he considered would make a major contribution to BAT's compliance with its statutory duty. He noted, however, that the internal audit process appeared to be independent and credible. Also, at that meeting, BAT gave a presentation on its global sales operational and planning process. Mr Fowler noted that the process appeared to be purely sales driven and did not consider legitimate demand in a market or the risks posed. Mr Fowler's concerns about the global sales operational and planning process were not raised in the Initial Notice.

309. At a further meeting on 28 June 2013, Mr Fowler discussed with Mr Doejaaren, (BAT's Head of Legal in the Belux region) BAT's assessment of legitimate demand in Belux, although Mr Fowler noted that the data was based on sales data (which might include sales to smugglers). During a discussion of the Belux sales policy for CC, BAT explained that CC was supplied to Belux and predominantly purchased by consumers who have travelled from the UK. HMRC asked to see a copy of the sales policy. Mr Doejaaren considered this to be a sensitive document and did not want it to leave BAT's premises but made it available for inspection by HMRC (and they reviewed it on 23 September 2013).

310. HMRC have criticised BAT for failing to send them a copy of the sales policy document. I have to say that I found the criticism over-stated. It is true that HMRC could have required BAT to produce the document. Nevertheless, the sales policy was made available for review by HMRC; there was no suggestion that BAT was withholding the information contained in the document and I do not think that BAT should be unduly criticised for their approach.

311. In any event, Mr Fowler found the sales policy to be potentially contradictory because it was not clear whether the aim was to increase sales or to reduce illicit trade and, in the case of a conflict, which aim was to be given priority.

312. Also, Mr Fowler said that he was disappointed in Ms Udicki's reply (dated 23 August 2013) to his e-mail of 2 August 2013, which contained further requests for information and clarification. In particular, Mr Fowler complained that Ms Udicki said that he would not be permitted to see the CC sales forecast or details of the CC quota for specific customers. In fact, as Mr Fowler accepted in cross-examination, in relation to sales forecasts, this information had already been provided.

313. Mr Fowler sent his initial supply chain governance audit findings to BAT on 23 October 2013 (the letter was dated 22 October 2013, but was clearly only sent on 23 October 2013). Although it was received by BAT on the same day as Mrs Green sent the Initial Notice, it clearly did not form part of the Initial Notice. As already noted, the letter explained that the findings were included in an appendix and were listed under various topics (see paragraphs 77-79 above). In respect of each topic Mr Fowler listed "positives", "concerns" and "recommendations". Mr Fowler also wrote:

> "Once you have considered all of the points raised you may wish to make further comments or provide additional explanation or information. If this is the case please could you do so by 22 November 2013."

314. In the appendix to his letter, Mr Fowler made a number of points and raised some concerns about BAT's supply chain policy. First, BAT's KYC process did not seem sufficiently robust. His review indicated that BAT did not properly consider or evaluate information on customers' affiliated businesses and on one occasion a customer refused to state whether it had a criminal conviction, with no follow-up action being taken. It was not clear how the information gathered during the KYC process was evaluated or used to inform BAT's thinking on illicit trade.

315. Secondly, in relation to EUCA, Mr Fowler noted that BAT took its EUCA obligations seriously. However, he was concerned that BAT's obligations under the TPDA were not given the same priority as EUCA.

316. Thirdly, in relation to SOBC, Mr Fowler expressed no concerns and noted that the SOBC were firmly embedded in the BAT business.

317. Fourthly, in relation to seizures, Mr Fowler noted that HMRC had concerns about the follow up work undertaken on notified seizures involving genuine BAT products. There was a lack of Track and Trace capability in Belux. This meant that

BAT could not provide the seizure information required by the TPR 2001, could not identify weaknesses in their own supply chain which may have led to a seizure and was unable to provide additional information about specific seizures when HMRC had requested it. Mr Fowler noted that BAT appeared to have recognised the need to do more to formalise the process and referred, in particular, to SERP (whilst noting that these measures were in their initial stages). He recommended an acceleration of the implementation of Track and Trace in Belux. He also recommended the establishment of an interim measure which would allow some level of tracing in this market.

318. Fifthly, in relation to CC Sales Plan, Mr Fowler expressed concern that BAT was reluctant to allow HMRC to have a copy of the document. He considered that the document was potentially contradictory because it was not clear where the priority lay in the objectives of avoiding loss sales and avoiding illicit trade. It was unclear who was responsible for this policy and the sanctions for failure to comply with it.

319. Sixthly, Mr Fowler expressed his concern about BAT's failure to share its sales forecast for CC in Belux. It is now acknowledged that this was a mistake and that BAT had indeed already provided this information.

320. Seventhly, Mr Fowler noted his concern that in relation to the Belux anti-illicit trade strategy, illicit trade was only mentioned in terms of inflow into the market and not the outflow of product to neighbouring markets.

321. Eighthly, in relation to the internal audit, Mr Fowler noted that the audit function appeared empowered and independent. The internal audit team, however, conducted its audit in line with the risks listed on the risk register for a market. The risk register for Belux did not include the outflow of product to neighbouring markets as a risk.

322. Finally, Mr Fowler noted that there was satisfactory evidence that "whistleblowing" in relation to illicit trade was handled effectively by BAT.

323. Pausing there, there was no indication that Mr Fowler was suggesting that BAT should introduce ACT in addition to Track and Trace. Apart from recommending the acceleration of Track and Trace in Belux (Mr Fowler was unaware that BAT was already planning to do this), Mr Fowler merely recommended the establishment of an "interim measure to allow some level of tracing in this market now." In context, in my view, this was simply a recommendation that BAT should introduce an interim form of Track and Trace i.e. an interim measure which would allow BAT to trace its products to the first external customer (i.e. the wholesaler).

324. In addition, I should note that the fourth and following concerns raised by Mr Fowler were expressed primarily in relation to Belux.

"Little and often" smuggling and Project Falcon

325. Mrs Green wrote to Ms Udicki in a letter dated 12 September 2013 (but sent on 17 September 2013) in relation to HMRC's Project Falcon report. Mrs Green said that the report demonstrated that HRT was being smuggled into the UK in significant quantities. She said that HMRC had identified a number of retailers which featured significantly in seizures and that their behaviours did not seem to fit with the standards BAT told HMRC they applied to BAT's wholesalers. Mrs Green suggested that HMRC meet BAT "in 8 weeks' time". I note that this date, of course, would fall after the issue of the Initial Notice.

326. In addition, in her letter, Mrs Green asked for information about how BAT's products reached the retailers in question. She said she wanted to know which wholesaler supplied them and whether that was a direct supply from the wholesaler or whether there was an intermediary wholesaler. Mrs Green specified that this information should be supplied by 25 October 2013 (a date which, in the event, fell two days after the issue of the Initial Notice).

327. The Project Falcon report was sent to BAT on 17 September 2013.

328. The report stated that it had been commissioned to develop a better understanding of the way in which HRT was being smuggled into the UK. The project also was designed to identify whether organised criminals were involved in the activity. The project was carried out in two phases – the first phase took place over 10 days in November and December 2012 and the second phase took place over eight days in April 2013. During phase 1, seizures amounting to 3536.5 kg were made which were believed to be of genuine HRT. During phase 2, seizures amounting to 1197 kg were made, which were also believed to be genuine HRT.

329. Phase 1, according to the report, identified that "baccy buses" appeared to be organised with the intention of allowing travellers to bring large quantities of tobacco into the UK. The report stated that HMRC believed that many of these buses were controlled by organised criminals. An analysis of the purchases made by travellers was undertaken and, according to HMRC, gave rise to concerns about the behaviour of some specific retailers. HMRC noticed multiple receipts being run up by certain retailers who sold more than the indicative limit (1 kg at that time) to individual travellers. The report stated:

> "HMRC have concerns about the amount of genuine UK produced HRT being supplied to the near continent. Our own analysis of demand in particular Belgium and Luxembourg shows that the UK brands are not as popular as home-grown brands. These concerns were also heightened by the amount of genuine HRT being seized at UK ports that did not fit the qualifying criteria (50 kg), which appears to be a small and often business. HMRC has concerns that this trade is being exploited by organised crime."

330. The report described "baccy buses". It noted that in some cases only one or two passengers on a bus had large quantities but said that in other instances everyone on the bus had at least 3 kg. HMRC believed that in these instances there was a third

party controlling the purchases, funding the trips, paying the traveller and collecting the goods prior to the bus "discharging". HMRC noted that in one instance it had found the goods and the receipts held by the passengers on the coach did not match, which led them to suspect that the goods were bulk purchased by one person and distributed on the bus. HMRC considered that the use of baccy buses was well organised. Most of the returning baccy bus traffic occurred later in the day on Thursday, Friday, Saturday and Sundays. The report noted that there were mass arrivals of the buses at customs controls. HMRC considered that there were clear indications that the buses would gather and nominate buses:

> "to absorb and diffuse the impact of any preventative resource, allowing subsequent buses a clear passage through border controls."

331. HMRC noted that they had identified and seized goods from numerous passengers who were already known to have smuggled goods in the past – this happened in both phases of the project. The report also observed that the minimum indicative limits were reduced to 1 kg just before phase 1 of Project Falcon, but in both phases HMRC encountered many cases where passengers had over the original limit of 3 kg.

332. In phase 2 HMRC observed an increase in cases where HRT was concealed, for example, in Thermos flasks, within food containers and stuffed into cushions. There was "clear evidence" of buses arriving and leaving during the hours of darkness when it was believed that border controls were at their lightest. In phase 2 there were many more HRT "couriers" who appeared to be travelling more frequently, but carrying less tobacco. The report noted that a kilo of HRT yielded a profit of approximately £100 when sold illicitly, thus making the journey potentially profitable.

333. The report identified three Adinkerke retailers who tended to supply "baccy buses".

334. Next, the report identified the phenomenon of "multi-receipts". This became evident in phase 2 of the project and HMRC indicated that there was "clear evidence" of multiple, pre-packaged bags of HRT that appeared to have been pre-ordered. HMRC considered that the use of multiple receipts (which was noted in both phases of the project) could only indicate an attempt by the retailer to disguise large quantities of tobacco which were being broken down to give the impression of multiple sales. HMRC also considered that this "may also suggest" that an organised criminal pre-orders for goods, collects and distributes them to paid couriers for the return journey. Examples of multi-receipt transactions were attached to the report.

335. The report concluded as follows:

> "- Baccy buses are being used by organised crime to facilitate tobacco smuggling.
>
> - We believe that the multi-receipt practice is geared specifically for tobacco smugglers.
>
> - Certain retailers are using this system to facilitate tobacco smuggling

> - The oversupply of genuine UK HRT is a credible risk to the UK exchequer and is being exploited by criminal groups based in the UK and overseas."

336. The report focused on a particular Belgian retailer ("the suspect retailer") which featured in more seizures than any other outlet. The suspect retailer was one which was supplied by BAT's wholesalers. HMRC considered that the practices used by the suspect retailer to sell to customers only assisted smugglers. The suspect retailer was prepared to sell customers in amounts well above the minimum indicative limit and also used a multi-receipt system to allow shoppers to buy much larger quantities even though the receipts showed smaller amounts. The report stated:

> "Receipts showed times down to the second, we have a variety of examples demonstrating this practice which also shows that more than one individual is buying well above the limit."

337. Ms Borms explained that some retailers had relationships with the operators of the "baccy buses". Some buses came specifically to the suspect retailer. The buses telephoned their orders "up front". She had been informed by the retailers that the purpose of doing this was to save time and to be as efficient as possible, because the "baccy buses" were on a very tight schedule. Once the HRT had been pre-ordered in this manner it was made available to passengers as soon as they arrived – the passengers then paid for it.

338. Ms Borms said that she had discussed with retailers the concerns expressed in the report to the effect that some "baccy buses" were arranged by organised criminals. Ms Borms did not accept that some of the people on "baccy buses" were involved in criminal activity and she described this as "a theory of HMRC in the report". She said that the retailers could not determine, from viewing the passengers, whether they were part of an organised criminal activity. She said, however, that BAT took the Project Falcon report seriously and that BAT had refreshed the training which BAT already had in place. Ms Borms did not accept that it was clear from the Project Falcon report that "baccy buses" were being orchestrated by organised criminal gangs – she regarded this as a possibility which the report raised but had not seen any evidence that it was organised. Ms Udicki also confirmed that she had not seen any evidence that "baccy buses" were controlled by criminal gangs.

339. Ms Udicki also adopted the same explanation of up-front orders put forward by Ms Borms.

340. I was also shown a note of a meeting between BAT and the suspect retailer dated 12 February 2014. The retailer was asked to explain, in one specific example, how 23 transactions could be done in 17 minutes for a total purchase of 48.1 kg of tobacco.

341. The retailer explained that a group of people would enter the store and one individual (the group representative) would ask to purchase goods for the group. Based on the list received from the group representative, the retailer selected the products requested and pre-packed them into different plastic bags. The seller then processed all the different transactions separately, "but in one go". The group

representative then paid the seller the total amount for all the transactions with money he received from the group. The group representative then split all the different orders within the group.

342. It seemed to me that the concept of pre-ordering explained by Ms Borms was somewhat different from that described by the suspect retailer. Ms Borms was suggesting a pre-ordering process which was completed before the "baccy buses" arrived in Adinkerke, whereas the suspect retailer was describing a process which started when the group representative appeared in the shop and then ordered on behalf of the passengers. On the whole, I was not satisfied that the somewhat inconsistent explanations of pre-ordering put forward by Ms Borms or by the suspect retailer were sufficiently persuasive to convince me that HMRC's suspicions (that at least some "baccy buses" were arranged by organised criminals) were unfounded. This was supported by reference to the suspect retailer in one seizure report where clearly multiple receipts had been prepared for one person (although this did not relate to a "baccy bus").

343. There was a conflict of evidence in relation to the question when the issue of "little and often" smuggling and HMRC's concerns about the issue (i.e. repeated smuggling of amounts less than 50 kg) were first mentioned to BAT. Mrs Green was insistent that she had mentioned the topic to BAT at a meeting in July 2013. The note of the meeting, however, contained no reference to this issue.

344. Ms Udicki, by contrast, maintained that BAT first became aware of the concern in relation to "little and often" smuggling at or around the time that BAT received the Project Falcon report in September 2013. Ms Udicki said that she was unaware of "baccy buses" before BAT received the Project Falcon report. She said that "little and often" smuggling had not been properly explained to BAT prior to the receipt of the report although she accepted that "little and often" smuggling may have been mentioned in her presence by HMRC. She was aware of Project Falcon but said she did not know what it was.

345. On 8 April 2013, Mrs Green sent Ms Udicki an e-mail:

> "You may recall when we met that I extended an invitation to join us at Dover during the second phase of Falcon. I can now confirm this invitation. It is suggested that you join the exercise during the afternoon/evening of Saturday 20 April. Can you let me know if you would still like to attend and I'll sort out the arrangements."

346. Ms Udicki replied on 12 April 2013 as follows:

> "I am sorry for late respond [sic], I was out of the office for a few days and back only now catching up with a lot of things. Please note that one of the AIT [Anti-Illicit Trade] Intelligence Unit members will attend as they are more qualify [sic] for this type of operations then [sic] me. Would you be so kind to let us know timing and venue and what will occur during this particular operation."

347. Mrs Green replied by e-mail on 15 April 2013:

> "This was a specific invitation for you so if you are not able to come (which I completely understand as it is us Saturday night!) then we will look to find something more suitable on another occasion."

348. Mrs Green said that when she had previously discussed "little and often" smuggling with Ms Udicki she gained the impression that Ms Udicki saw this phenomenon as legitimate cross-border shopping. Mrs Green said that she recalled a meeting with Ms Udicki and Toe Su Aung (another BAT employee) at which she said:

> " 'If you go into a shop and you are going to buy crisps for your lunch, what are you going to buy?' And we all came up with a different flavour. So, for me, it does not make sense for all these people [i.e. "baccy bus" passengers] to have bought exactly the same thing. That had been the nature of the conversations that had gone along."

349. Mrs Green said that, because she was concerned that Ms Udicki thought that "baccy buses" simply involved cross-border shopping, she had attempted to invite Ms Udicki to Dover to see what happened when "baccy buses" arrived.

350. The only previous meeting, on 13 March 2013, between Mrs Green and Ms Udicki (when Ms Udicki accompanied by Ms Toe Su Aung of BAT) was also the first meeting between Mrs Green and Miss Udicki and marked the start of the supply chain audit process. This meeting was less than a month before Mrs Green invited Miss Udicki to Dover. In the note of that meeting there is no record of the discussion of "little and often" smuggling or "baccy buses".

351. Mrs Green also specifically recollected discussing "little and often" smuggling with Ms Udicki at another meeting on 3 July 2013 (also attended by Mr Ewan Duncan of BAT) which was held to introduce the work of BAT's Anti-Illicit Trade Intelligence Unit. Mrs Green's note of that meeting makes no mention of either "baccy buses" or "little and often" smuggling.

352. I regarded both Ms Udicki and Mrs Green as truthful witnesses. In my view, the most likely explanation for this conflict of evidence – which was essentially a conflict of recollection – was that Mrs Green did mention "little and often" smuggling at the meetings to which she referred but that she did not give it the prominence or signify its importance in the way that, in retrospect, she now believes she did. This would explain why the subject was not mentioned in the notes of meetings. It would also explain Ms Udicki's comment that "little and often" smuggling may have been mentioned in her presence but was not fully explained. Furthermore, I do not consider that the e-mail exchange relating to the invitation to Ms Udicki to visit Dover sheds much light on this issue. Although Mrs Green's initial e-mail indicated that the proposed visit was the result of previous discussions, no detail was given and Miss Udicki was clearly uncertain about what was going to happen during the visit.

353. I therefore conclude that the first time that "little and often" smuggling in relation to "baccy buses" was brought fully to BAT's attention as a serious concern for HMRC was in September 2013, on or around the date that the Project Falcon report was transmitted. I have also reached the conclusion that this was the first time

that HMRC's concern about the operation of "baccy buses" and their possible manipulation by organised criminals was raised in any detail.

354. I should add that Mrs Green's evidence in relation to "little and often" smuggling was somewhat contradictory. At one point, in cross-examination, she said: "'Little and often' really is only talking about the baccy buses." Then, shortly afterwards, she suggested that "little and often" could include a seizure of below 50 kg concealed in a truck if the truck repeatedly crossed the border. Given this confusion, I have some sympathy with BAT if it was uncertain what Mrs Green meant when talking about "little and often" smuggling in conjunction with "baccy buses".

355. Furthermore, Mrs Green stated that the question of "baccy buses" had been discussed at a meeting of the Anti-Illicit Trade Working Group on 11 January 2013. The Working Group included representatives from HMRC, four TMs (including Ms Udicki from BAT) and the TMA. Mrs Green did not attend the meeting. Mrs Green claimed that the reference in the note of the meeting by an HMRC representative to "an increase in UK non-duty paid had been predicted due to a rise in travel numbers" was a reference to "baccy buses". If so, then, in my view, it was an extremely veiled reference which did not clearly explain the concerns relating to "baccy buses". In fact, the first explicit reference to "baccy buses" in the Working Group's minutes appears in the minutes of the meeting on 5 September 2013 i.e. shortly before the Project Falcon report was sent to BAT.

356. Finally, it was common ground that none of the notifications of seizures during the period between the Initial Notice and the Penalty Notice concerned "baccy buses". In fact, very few of the seizure notifications involved what could be described as "little and often" smuggling and, in my view, it would have been very difficult from these notifications for BAT to have established that "little and often" smuggling was an increasing problem.

Political pressure

357. At a case management hearing on 6 June 2016, the parties agreed that BAT's allegation that HMRC had been influenced by political pressure was limited as set out in its letter of 11 March 2016 as follows:

> "BAT contends that it did not act unreasonably, such that there was no power to impose the penalty, and HMRC thus acted unreasonably. That contention is in part evidenced by the fact that HMRC has exercised that power for improper purposes, something which, as Judge Berner [in *HT & Co (Drinks)Ltd* [2015] UKFTT 0663 (TC)] has rightly recognised, is plainly relevant to the statutory assessment of reasonableness, and which is plainly a matter for the Tribunal."

358. From January to June 2013, the NAO conducted a review of HMRC's strategy for tackling tobacco smuggling. As I have explained, the HMRC letter of 29 January 2013, which started the HMRC audit into BAT's supply chain policy, was prompted by the NAO review and by an awareness that the Public Accounts Committee ("PAC") may wish to consider the review's findings.

359. On 6 June 2013, the NAO published its report entitled "*Progress in tackling tobacco smuggling*" on HMRC's performance in relation to the Tobacco Strategy, concluding that HMRC had fallen short of its own internal targets. The report stated that HMRC was unlikely to achieve its target of achieving the prevention of a £1.4 billion revenue loss and that HMRC's performance fell short of internal targets in 2012-2013. It also noted that "*HMRC has not applied the full range of sanctions available under supply chain legislation. It has issued only one warning letter and no penalties in this period….*"

360. After the publication of the NAO's report, there were a number of parliamentary committee hearings in June and July 2013 and in 2014. At these hearings, HMRC were criticised for not making full use of their powers under the TPDA.

361. On 24 June 2013, Ms Lin Homer (Chief Executive and Permanent Secretary of HMRC) gave evidence to the PAC. In her evidence Ms Homer referred to perceived defects in the TPDA stating that:

> "There is nothing that a European body can do if our legislation is not effective. We did not design our legislation well enough. We have to accept that… We put into effect a piece of legislation that did not have the effect that we thought it would."

362. She further stated:

> "There is a legitimate criticism of us and the legislative fix we put in place to try to control the supply chain mechanisms better by undertaking test purchases…We have overcome the challenge we created for ourselves in the legislative fix we gave ourselves."

363. Mrs Green said she was not aware of the legislative defects referred to by Ms Homer and was surprised to read her comments. Whilst not doubting Mrs Green's evidence, I confess that I find it strange that HMRC's most senior official should express concerns about the TPDA provisions but the experienced HMRC officer charged with securing compliance with those provisions should be unaware of the nature of those concerns.

364. Ms Homer was challenged by the PAC with the fact that there had been no "prosecutions" (by which I take to mean the imposition of penalties) of TMs. Ms Homer replied that there had been one warning notice issued and continued:

> "The way we have put the proposals into effect brings deterrents in if manufacturers don't work cooperatively with us. Although it has taken a lot of combined effort from various people, the reality is that over this period the manufacturers have worked with us."

365. In addition, Ms Homer referred to the cooperative work which HMRC had done with TMs and described their response, in most areas, as "very good."

366. On 23 July 2013, the Home Affairs Select Committee announced that it was commencing a new inquiry into tobacco smuggling. HMRC and Border Force representatives were called to give evidence before the Committee. Mr Jim Harra,

Director General for Business Tax at HMRC was asked why no penalties had been imposed under the TPDA even though the legislation had been introduced in 2006 in circumstances where HMRC believed there to be an oversupply of tobacco products. Mr Harra replied that the purpose of the legislation (and, thus, the purpose of the threat of a penalty) was to incentivise TMs to improve their supply chain management.

367. It was clear, therefore, that a range of Parliamentary and public bodies responsible for reviewing HMRC's performance in relation to its Tobacco Strategy, were, from the middle of 2013, raising questions with (and making some criticism of) HMRC regarding its use of its enforcement powers under the TPDA.

368. On 10 October 2013, less than two weeks before the Initial Notice, the PAC published its report "*HMRC: Progress in tackling tobacco smuggling*". The PAC criticised HMRC for not challenging UK tobacco manufacturers sufficiently**:**

> "HMRC estimated that the supply of some brands of hand-rolling tobacco to some countries exceeded legitimate demand by 240% in 2011. But HMRC has not fined any UK tobacco manufacturer for over-supplying products and failing to control its supply-chain and has issued only one letter of warning. HMRC is focussing on improving cooperation with manufacturers but it must also become more assertive in using its powers where necessary and consider whether it has the full range of powers and tools at its disposal to take action."

369. The PAC's recommendation was:

> "HMRC should apply the supply chain legislation to its full extent. It needs to identify and seek to correct any shortcomings in the legislation to put a stop to the abuse of exports by tobacco manufacturers. It should consider naming and shaming those manufacturers who fail to co-operate fully with the department."

370. Mrs Green denied that Mr Forrester had instructed Mrs Green to be "tough" on TMs when she took over her post as Tobacco Supply Chain Manager. She said that that was not the way in which "Mr Forrester would ever address anything."

371. There was a meeting with another Manufacturer on 21 November 2013. The meeting was attended by HMRC representatives including Mrs Green and her immediate superior, Mr Forrester. HMRC opened the meeting by referring to the criticisms made of HMRC in the PAC's report of 10 October 2013. The note of the meeting records Mr Forrester explaining that "HMRC needed to be 'tough' on tobacco companies because the media had been suggesting that HMRC was 'too cosy' with tobacco companies." Mr Forrester also stated that HMRC had been criticised for seeming to be failing to enforce the TPDA and the note records him saying that HMRC "intended to ensure that they are seen as properly enforcing the [TPDA] going forward."

372. Mrs Green denied that Mr Forrester had told her to "get tough" on tobacco manufacturers and queried whether the note of the 21 November 2013 meeting

accurately recorded his comments (even though the note had been put forward by HMRC and had not previously been questioned). In my view, there was no basis to doubt that the note was an accurate contemporary record of Mr Forrester's remarks.

373. On 11 March 2014 Mr Jim Harra, Director General for Business Tax at HMRC, gave evidence before the Home Affairs Select Committee. HMRC was heavily criticised for its failure to penalise a single manufacturer.

374. That Mrs Green was aware that political pressure was being applied to HMRC was evident from the note of her meeting of 17 March 2014 (i.e. towards the end of the Warning Period) where Mrs Green is recorded as having said:

> "SG [Mrs Green] confirmed that BAT were previously behind their competitors in adopting such measures but that the measures BAT is taking in response to the Warning Notice puts BAT on par with its competitors. JU[Ms Udicki] asked whether unilateral measures would be enough to prevent illicit trade. SG commented that it was unlikely that such actions would be enough to respond to the challenges posed but measures had to be taken to respond to the on-going political pressure. SG said that such pressure may result in Warning Notices or penalties being issued to all of the big tobacco companies."

375. Ms Udicki asked Mrs Green whether HMRC believed that smuggling into the UK would be reduced by BAT reducing supply of HRT. The note of the meeting records:

> "SG said that, in her opinion, it was unlikely as other tobacco manufacturers would fill in the gap but that there is a significant political pressure on HMRC to exercise their rights under the TPDA and it may be the case that HMRC will need to issue penalty notices on the tobacco manufacturers to satisfy those applying the pressure. Ultimately, the issuance of penalty notices might highlight the inadequacy of the TPDA to address the problem of smuggling into the UK."

376. In my view, HMRC was plainly under and was conscious of political pressure to apply the penalty provisions of the TPDA more rigorously. However, I accept the evidence of Mrs Green that the issue of the Penalty Notice was not politically motivated. Mrs Green noted that the NAO and the PAC generally paid a great deal of attention to the activities of the Large Business Service of HMRC (within which Mrs Green worked). That level of scrutiny was therefore, as Mrs Green described it, something of "a constant". Furthermore, from reviewing the correspondence and meeting notes between the parties, it seemed to me that Mrs Green adopted a professional, forthright and critical approach to BAT's compliance with the provisions of the TPDA from the outset i.e. before the publication of the NAO report and before the criticism voiced by the PAC. As Mrs Green put it, and I accept, she was not unduly bothered by the criticism of HMRC from these bodies because they were recommending something that Mrs Green thought HMRC already should be, and in her view were doing.

377. That said, it does seem to me that the process leading up to the issue of the Initial Notice did accelerate in the second half of 2013. I consider that the coincidence in timing and the issue of the Initial Notice at the same time as the interim results of Mr Fowler's supply chain audit did suggest a degree of haste. This haste may have contributed to some of the deficiencies in the Initial Notice (i.e. failure to mention issues which were later picked up in the Penalty Notice) to which I shall refer later in this decision, but I do not think that matters of substance were affected by "political" considerations. In particular, I do not think that the decision to issue either the Initial Notice or the Penalty Notice was made for political reasons or because of Parliamentary criticisms of HMRC (i.e. for reasons which were irrelevant in a *Wednesbury* sense). I, therefore, reject BAT's submissions on this point.

Competitors

378. Mrs Green gave evidence concerning the practices of other TMs in relation to the TPDA. As already indicated, I shall refer to these other TMs as the "Manufacturer" or the "Manufacturers", as the case may be. These Manufacturers' supply chain policies were audited by HMRC in 2013 in parallel with BAT. A fourth Manufacturer was audited by HMRC in 2014. Consequently, when Mrs Green issued the Initial Notice and the Penalty Notice she had seen and considered in detail the supply chain policies of two of the other TMs.

379. Mrs Green formed the opinion shortly after taking up her post in 2013 that other TMs were taking their obligations under the TPDA more seriously than BAT. She formed his view for two main reasons. First, the representatives of other TMs were directly concerned with investigating how their products had come to be smuggled and were able to influence supplies through an internal governance process. A number of those individuals had investigative experience and, in her view, could interact with customers who posed a smuggling risk. In the case of BAT, however, Ms Udicki was not involved in investigating seizures. In Mrs Green's view, Ms Udicki's role related primarily to EUCA and not the TPDA.

380. Secondly, two other Manufacturers focused specifically on their obligations under the TPDA in addition to EUCA. For example, one Manufacturer's manual explained the process of investigation after the seizure and differentiated between response to seizures notified at the EU level and seizures identified by HMRC under the TPDA. The procedure manuals of two Manufacturers demonstrated that all seizures notified to them would be investigated. This contrasted with BAT's approach where, according to Mrs Green, BAT would investigate only notifiable seizures.

381. In relation to the ability of the Manufacturers to trace their products through wholesalers to retailers, two Manufacturers had a process to examine the seized tobacco during which they gathered information that allowed them to trace the forward supply chain of their product. Two Manufacturers had introduced their own tracking systems before the introduction of the system used by EUCA i.e. "Track and Trace". These other systems were not as effective as Track and Trace but they allowed the Manufacturers concerned to respond effectively to HMRC seizure

notifications (including, in particular, the specific statutory obligation to provide information about a manufacturer's first customer).

382. One Manufacturer began to put coding on some of its HRT products in order to track its products as early as 2010. It also had the specific EUCA Track and Trace system in place in Belgium and Luxembourg in January 2013 for tracing to the first customer.

383. In addition, a Manufacturer was also able to trace products sold in Belux to the retail level early in 2013 and provided this information to HMRC in response to seizure notifications.

384. The same Manufacturer implemented Track and Trace (i.e. the EUCA version of Track and Trace) by June 2013. In fact, this Manufacturer was obliged by EUCA to implement Track and Trace by 30 June 2014 i.e. almost 2 years before the date on which BAT was obliged to introduce Track and Trace in those markets. This difference was presumably due to the fact that this Manufacturer supplied a greater quantity of HRT in Belux. This advance in the implementation of Track and Trace by the Manufacturer concerned was notified to HMRC on 24 October 2012 following a meeting between HMRC (whose participants included Ms James and Mr Fowler) and the Manufacturer in September 2012 at which the topic was evidently discussed.

385. Mrs Green accepted that it appeared from notes of meetings between Mr James and the Manufacturer concerned in 2012 that HMRC had indicated that the implementation of Track and Trace should be brought forward and that the Manufacturer had done so. There was no documented record of HMRC applying similar pressure to BAT at this earlier stage.

386. In addition, the same Manufacturer indicated (in April 2013) that it planned, during 2013, to track its products to the retail level as regards 98% of its products sold in Belgium and 100% in Luxembourg. The first seizure report included in the evidence which demonstrated this capability to track to the retail level was, however, dated 5 September 2014. It was, therefore, unclear exactly when this particular Manufacturer was able to track its products to the retail level but it appeared to be some time from the end of 2013 to September 2014.

387. In the light of the above evidence, I accept that it would, in theory, have been possible for BAT to have had some form of Track and Trace system in place earlier than April 2014 which would have allowed BAT to trace its products at least to its first external customer. There was, however, no technical evidence to the effect that these alternative (i.e. temporary) methods would in fact have been feasible for BAT in the light of its products and packaging. Equally, it appears that in the case of one Manufacturer, Track and Trace was brought in at an earlier stage because of HMRC pressure in 2012 and, therefore, the comparison between that Manufacturer and BAT in this regard was not an entirely fair one.

388. Two Manufacturers also had provisions in their contracts with their wholesalers which enabled them to take steps against those wholesalers where necessary. In one

specimen clause, the wholesaler agreed to discontinue sales to specific customers where the Manufacturer could show that the customer was involved in illegal trading.

389. In another clause, two Manufacturers, in summary, agreed with their wholesalers that the Manufacturer could terminate the agreement with the wholesaler if: (a) the Manufacturer believed the wholesaler was involved in illicit trade in the Manufacturer's tobacco products or (b) did not take reasonable measures to combat illicit trade in the Manufacturer's tobacco products. The wholesaler agreed to seek to impose the same obligations on its counterparties.

390. There was an example of one Manufacturer, at a meeting with HMRC in November 2012, confirming that it used a range of measures to address supply chain issues with its customers, including restricting and blocking supply in some cases. At a meeting in November 2013, The Manufacturer informed HMRC that as a result of seizure investigations its management had terminated a number of retailers.

391. The Manufacturer concerned informed HMRC in November 2012 that it always aimed to discuss seizure investigations with customers "in face-to-face meetings".

392. In relation to Project Falcon, another Manufacturer confirmed that it had sent a letter to all retailers identified by Project Falcon explaining the findings of the project and that this had been followed up by a visit by the Manufacturer's anti-illicit compliance manager to each retailer.

393. In addition, a Manufacturer carried out "covert shopper" exercises and showed Mrs Green pictures of test purchases they had made in which they obtained illicit product.

HMRC Notice 477

394. Notice 477 "Tobacco Products Duty: Control of Supply Chains" was originally issued by HMRC in 2006 and updated subsequently but was not, for present purposes, materially amended. Notice 477 provides HMRC's public guidance on the TPDA supply chain provisions and was referred to frequently by the parties throughout the hearing.

395. Paragraph 4.11 of Notice 477 provided:

> "**Can I appeal against a notified seizure?**
>
> No. The notification of the seizure is not a matter for appeal. However, where a notified seizure can be shown to our satisfaction to fall within one of the categories described below, we will disregard the seizure for the purposes of any subsequent action we may take regarding your duty not to facilitate smuggling:
>
> - the notified seizure does not meet the volume criteria as set out in section 4.1 [i.e. i.e. the volume of product in the seizure is equal to or exceeds 50 kg of HRT]; or
>
> - …

- for any other reason deemed to be relevant by us.

> It is recognised that seizures may be disputed by you on grounds other than those set out above. Therefore, in the event that we issue you with a penalty for failing in your duty not to facilitate smuggling, and you wish to dispute the penalty, you may bring the matter of any seizures that you wish to dispute on other grounds to the attention of the reviewing officer or tribunal…."

396. Mrs Green said that she had not taken non-notifiable seizures (e.g. many of the seizures referred to in the new-style seizure reports) into account as regards those criteria that looked at notifiable seizures. However, she said that she had consulted the authors of Notice 477 who confirmed that the wording of paragraph 4.11 allowed her to take account of non-notifiable seizures in respect of other aspects of the section 7A statutory duty. She had only looked at "little and often" seizures in relation to issues such as whether BAT's supply chain policy was "agile" enough to cope with changes in the pattern of smuggling activity.

397. Mrs Green noted that paragraph 3.4 of the Notice stated that TMs should keep their supply chain policy under regular review "as the content of the policy may need to adapt to address any changes in the market, and the activity of smugglers." Mrs Green said that HMRC were sharing information with TMs about non-notifiable seizures so that they could consider whether their policy was fit for purpose.

398. In my view, paragraph 4.11 clearly states that HMRC would disregard a non-notifiable seizure for the purposes of "*any* subsequent action we may take regarding your duty not to facilitate smuggling." It seems to me that a TM could reasonably have understood this assurance to mean that seizures of amounts below 50 kg would be disregarded for all purposes in relation to the issue of either an Initial Notice or a Penalty Notice. The fact that Mrs Green found it necessary to consult with the authors of Notice 477 to my mind reinforces this point. If, as Mrs Green (and the authors of Notice 477) considered, paragraph 4.11 meant that non-notifiable seizures would not be taken into account only in relation to those matters that considered notifiable seizures, this seems to me to be a subtlety which would have escaped the average reader and should have been publicly clarified; not to have done so was, in my view, misleading. I also consider that HMRC did not follow their publicly stated policy, as it would be fairly understood, by taking account of sub-50 kg seizures in the Penalty Notice.

399. As we have seen, however, (paragraphs 185 – 188 above) Mrs Green took a rather confrontational view of BAT's failure to investigate a sub-50 kg seizure, making no allowance for the unfortunate wording of paragraph 4.11 of Notice 477.

400. Paragraph 6.1 of Notice 477 described HMRC's view of the purpose of an Initial Notice:

> "**What is an initial notice?**
>
> An initial notice is a letter from us, advising you that we have concerns regarding the level of your compliance with your legal duty not to facilitate the smuggling of tobacco products, as set out in section 2.1.

The initial notice acts as a warning, *and provides you with an opportunity to take corrective action* regarding the level of your compliance, and in so doing avoid being issued with a financial penalty." (Emphasis added)

5 401. It seems to me that the second paragraph of paragraph 6.1 accurately describes the function and purpose of an initial notice. I also note that paragraph 6.6 reinforced the point about "corrective action" made in paragraph 6.1. The first paragraph of paragraph 6.6 provides:

"**What should I do upon receipt of an initial notice?**

10 *You should take appropriate action to address any specific matters raised in the initial notice*, and thoroughly review your supply chain policy to ensure that you have included any reasonably practicable measures to improve your supply chain controls." (Emphasis added)

402. Paragraph 7.3 of Notice 477 addresses the factors which HMRC would consider
15 before issuing a penalty notice and provides:

"In deciding whether or not to issue a penalty notice we will consider:

- any action you have taken during this period [i.e. the six-month period between the Initial Notice and the Penalty Notice] to ensure that you comply with your legal duties; and

20
- any representations made by you since the initial notice was issued.

In particular we will review whether or not you have satisfactorily addressed the reasons for the issuing of the initial notice, and any seizures notified to you in the six month period following the issue of the initial notice. These matters will be considered in the context of
25 your duty not to facilitate smuggling, along with any other matters we believe to be relevant." (Emphasis added)

403. I have also noted the contents of Appendix A to Notice 477 "Content of a supply chain policy". Under the heading "Know your customers" the list of checks recommended includes:

30 "-Actions to be considered/taken where a problem with a customer is identified e.g. restriction of supply or termination of supply.

- Procedures for the reporting to us of suspected wrongdoing by your customers in relation to supplies of tobacco products."

404. The next section deals with "Know your markets" and states:

35 "- Monitor the overall mix and volume of tobacco products supplied to individual markets to ensure your supplies are consistent with your understanding of the legitimate demand in those markets.

- To undertake a risk assessment when… changing the level of supply to, or in, a specified country."

40 405. Finally, in relation to "Internal governance" the Appendix states:

> “Internal measures to ensure that your supplies of tobacco products *can be tracked to the first customer outside your own business/group* where appropriate.” (Emphasis added)

406. Mrs Green accepted that she was familiar with the Appendix and accepted that
5 the reference under “Internal governance” was to the “first customer” outside the TM’s group and not to the second or third customer.

Discussion and submissions

407. Extensive submissions on the law and evidence were made by counsel in the course of the hearing – the written closing submissions alone ran to over 230 pages. I
10 have carefully considered all of these submissions. It would be impossible to deal with every point made in those submissions and I have therefore addressed those which seemed to me to be the most material.

Scope of the section 7A(1) duty

408. Section 7A(1)(b) requires BAT to avoid “so far as it is reasonably practicable”,
15 supplying HRT “where the nature or circumstances of the supply makes it likely that [it] will be resupplied to persons who are likely to smuggle [it] into the UK”.

409. HMRC accepted that “likely” meant “more likely than not” i.e. the balance of probabilities. This was in accordance with statements made by the Financial Secretary to the Treasury recorded in *Hansard*.

20 410. Mr Moser submitted that section 7A(1)(b) applied only to an initial “*supply*” and a further, single “*resupply*”, and therefore imposed no obligations on TMs in relation to any additional supplies (i.e. by retailers to consumers) beyond any supply. Mrs Hall submitted that such a narrow reading of “*resupplied*” in section 7A(1)(b) was at odds with its natural and ordinary meaning and also was plainly contrary to the
25 clear purpose of the section.

411. I reject Mr Moser’s submission. The ordinary meaning of “resupplied” in the context of section 7A(1)(b) means, in my view, simply “supplied again”. I agree with Mrs Hall’s submission that the wording of the provision does not contain nor does it imply any inherent limit as to the number of times that its object (in this case HRT)
30 may be resupplied.

412. Nor do I find merit in Mr Moser’s related submission that construing “resupplied” to supplies beyond that made by the wholesaler to the retailer involves considering supplies that were too “remote”. This submission fails to take account of the true meaning of section 7A(1)(b) which, in my judgment, focuses upon the
35 “nature and circumstances” of the original supply rather than the remoteness or otherwise of the resupply. There is, therefore, no justification for reading into the language of the provision a “remoteness” limitation.

413. I also accept Mrs Hall’s submission that the restrictive meaning of “resupplied” contended for by Mr Moser would defeat the purpose of the provisions. Mr Moser’s

narrow interpretation would, as Mrs Hall submitted, allow a manufacturer to supply HRT to a wholesaler even where the manufacturer knew that there were those, further along that wholesaler's supply chain (but who were not the immediate purchasers from the TM), who were likely to smuggle the HRT supplied into the UK.

5 414. I therefore conclude that the duty to avoid the risk of facilitating smuggling contained in section 7A(1)(b) is wide enough to apply to a resupply of HRT from a retailer to a consumer.

415. For completeness, I should add that I consider BAT's reliance on the decision of the CJEU in Joined Cases C-354/03, C-355/03 and C-484/03 *Optigen Ltd, Fulcrum*
10 *Electronics Ltd and Bond House Systems Ltd v Commissioners for Customs & Excise* ECLI:EU:C:2006:16 *('Optigen')*, as support for its argument that 'resupplied' in s7A(1)(b) should be limited to only the second stage of any supply, to be misplaced. That case involved alleged MTIC fraud. HMRC had argued that the transactions in question were not "supplies" for VAT purposes because of the fraudulent nature of
15 the transactions. The CJEU rejected that argument and reaffirmed the principle that the transactions had to be analysed for VAT purposes in accordance with their objective characteristics rather than by reference to the subjective motives of the parties. It seems to me that this decision, and the line of authority related to it (e.g. *Kittel*) is irrelevant to the present case.

20 416. Finally, I also reject BAT's submission that "little and often" smuggling was outside the scope of the statutory duty contained in section 7A(1). I accept that Regulation 29(2)(a) TPR 2001 establishes a threshold for notification of supplies above 50 kg. There may be many reasons why Parliament imposed a 50 kg limit. For example, Parliament may have considered that a lower limit may have placed too
25 onerous a burden upon TMs, who would be required to analyse every small seizure. Whatever the reason for the 50 kg threshold may be, it is not expressed as a limitation upon the statutory duty contained in section 7A(1). To interpret the statutory duty in the way suggested by Mr Moser would involve rectification rather than construction of the legislation and I decline to interpret it in this manner.

30 *EU law arguments*

417. I turn now to deal with arguments raised by BAT relating to EU law.

418. BAT argued that Article 30 Treaty for the Functioning of the EU ("TFEU") and Articles 34-35 TFEU were engaged in the present appeal.

419. Article 30 TFEU imposes an absolute prohibition on customs duties or charges
35 having equivalent effect to customs duties ("CEEs"). Articles 34 and 35 TFEU prohibit quantitative restrictions or measures having equivalent effect to such restrictions ("MEEs").

420. BAT submitted that the penalty imposed by HMRC was a CEE that violated Article 30 in so far as it was a charge that was imposed on BAT as a result of BAT's
40 products crossing a border from one Member State to another.

421. Secondly, BAT submitted that in so far as HMRC had calculated the legitimate demand for BAT's products in Belgium substantially below the actual level of legitimate demand, the requirement that BAT supplied no more than HMRC's incorrect calculation of legitimate demand was to impose a quantitative restriction or an MEE that violated Articles 34-35 and could not be justified.

422. BAT's third argument was that the Penalty Notice violates its right to conduct a business and its right to good administration under Articles 16 and 41 of the EU Charter of Fundamental Rights ("the Charter").

423. Although both parties submitted lengthy written submissions on these issues, I can deal with them quite briefly. In my view, none of these three issues requires me to make a reference to the Court of Justice of the European Union. The first issue seems to me to be clear ("acte clair"), the second issue is not necessary for a resolution of the issues in this appeal and, as regards the third issue, BAT's rights under the Charter are simply not engaged.

424. As regards the Article 30 argument, this bold submission, which amounts to a fundamental attack on sections 7A-7C, suffers from the flaw that the penalty imposed under section 7B (4) is not a penalty imposed on goods.

425. BAT sought to make good their submission by relying on Case 24/68 *Commission v Italy* [1969] ECR 193 at [9] where the Court described a custom duty or MEE as:

> "[a]ny pecuniary charge, however small and whatever its designation and mode of application which is imposed unilaterally on domestic or foreign goods by reason of the fact that they cross the frontier."

426. The Italian government imposed a small levy on goods exported to other Member States, arguing that the levy was imposed for the purpose of collecting statistical data for use in the analysis of trade patterns, which was argued to be of benefit to the traders.

427. The levy was held to be a MEE. This was the case even though:

(1) it was not imposed for the benefit of the Member State;

(2) it was not discriminatory in effect;

(3) it did not have a protectionist effect; and

(4) the product on which the charge was imposed was not in competition with any domestic product.

428. In this case, the section 7B(4) penalty was not a charge imposed on tobacco goods crossing a border. Instead, the penalty was imposed on BAT, in broad terms, for breaching its statutory duty not to facilitate smuggling. As I conclude below, there is no need to demonstrate that BAT's goods were smuggled or to prove a particular act of smuggling in order to establish a breach of the section 7A(1) duty. The penalty

arises because of BAT's conduct and the circumstances of its supplies rather than being specifically related to any actual movement of goods into the UK.

429. In any event, I accept HMRC's argument that a penalty under the TPDA is governed not by Article 30 but rather by Article 110-113 as pertaining to excise duties rather than customs duties. I acknowledge that Article 110 TFEU prohibits the imposition "directly or indirectly on the products of other Member States of any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products." In my view, the penalty levied under section 7B(4) is not, even indirectly, a form of taxation on products but is rather a punishment for, in broad terms, supplying tobacco in circumstances where it is likely to be smuggled by third parties. BAT introduced an argument based on Article 110 in its closing submissions which, in my view, was unfair because HMRC had no opportunity to call evidence in relation to the argument or adequately respond to it.

430. BAT's reliance on the second issue – the legitimate demand restriction – was puzzling. At no point was HMRC seeking to contend that BAT should restrict its supply of HRT below the amount of legitimate demand. HMRC's complaint was that BAT was supplying an amount in excess of legitimate demand.

431. As I have already discussed, there was a dispute between the parties about the approximate quantum of legitimate demand for HRT in the Belux market.

432. BAT's argument that HMRC's alleged underestimate of legitimate demand constituted an unjustified quantitative restriction in violation of Articles 34-35 seemed to me unnecessary. To the extent that HMRC assessed the penalty on BAT wholly or partly on the basis of an incorrect underestimate of legitimate demand, it is clear that I would be entitled as a matter of domestic law to quash HMRC's decision and substitute my own decision. As we shall see, that is exactly what I shall do later in this decision. It is, therefore, entirely unnecessary to rely on Articles 34-35.

433. On that basis, it seems to me fruitless to consider the Articles 34-35 arguments further.

434. Finally, BAT contends that its rights under the Charter are engaged by Regulations 29 to 31 TPR 2001 on the basis that these provisions implement the UK's obligations under EU law.

435. In my view, BAT's argument is misguided. Regulations 29 to 31 TPR 2001 were introduced in 2006 by the Tobacco Products (Amendment) Regulations 2006 (SI 2006/2368). Unlike the original provisions of the TPR 2001, Regulations 29 to 31 do not implement any obligation under EU law. Therefore, BAT's rights under the Charter cannot be engaged.

The imposition of a penalty under section 7B TPDA

436. The scheme of the TPDA provisions relevant to this appeal is, on its face, relatively simple. Nonetheless, with respect, the drafting of the statutory provisions leaves much to be desired and creates considerable scope for uncertainty.

437. First, section 7A(1) sets out the statutory duty, which I have already discussed.

438. Secondly, section 7B(1) deals with the Initial Notice and is entitled "Penalty for facilitating smuggling: initial notice." In fact, section 7B is not confined to the Initial Notice: it also deals with the issue of the Penalty Notice. Section 7B(1) provides:

> "Where the Commissioners think that a manufacturer has without reasonable excuse failed to comply with the duty under section 7A(1) they may give him written notice that they are considering requiring him to pay a penalty."

439. It is clear from the statutory wording that HMRC have a discretion whether to issue an Initial Notice. The condition for exercising this discretion is that HMRC must "think" that a TM has failed to comply with the statutory duty in section 7A(1). It is also clear that in exercising that discretion HMRC must consider whether the manufacturer has a reasonable excuse for failing to comply with its duty. This was a point which was only considered in outline at the hearing, although it did feature in closing submissions. I shall return to this point later, but for the moment, I observe that it is not enough for HMRC to conclude that the TM is in breach of its statutory duty, it must also consider whether the TM has a reasonable excuse for its failure to comply.

440. The concept of "reasonable excuse" is a familiar one in the context of tax penalties. Many statutory duties imposed on taxpayers (e.g. the obligations to file tax returns or make tax payments on time) are backed up by penalties if there is a breach of the duty. Usually, however, it will be a defence against the imposition of a penalty if the taxpayer can prove (the burden is usually on the taxpayer to establish the defence) that there was a reasonable excuse for the default. Section 7B(1) is, however, rather different. "Reasonable excuse" is not a defence which the taxpayer can or must establish but is, rather, a matter which HMRC must consider in reaching the conclusion that the TM has failed to comply with its section 7A(1) duty.

441. Parliament has not defined what constitutes a "reasonable excuse", leaving it to HMRC to assess the issue in the light of the facts and circumstances of each case. This Tribunal has considered the concept of "reasonable excuse" in many cases and has concluded that it involves an objective test of reasonableness applied to the individual circumstances of the appellant in question (see, for example, the much-cited decision of HH Judge Medd OBE QC in *The Clean Car Company Limited v C & E Commissioners* [1991] VATTR 239).

442. As we have seen, section 7B(2) indicates the matters which HMRC "shall have regard to" in issuing an Initial Notice and section 7B(3) states that the Initial Notice "must specify the matters to which the Commissioners have had regard in determining to give it." In other words, it is not enough that HMRC have had regard to relevant

and appropriate matters, HMRC must inform the manufacturer of the matters which they have taken into account. I think this is a relevant point when we come to consider the relationship between the Initial Notice and the Penalty Notice because, in my judgment, it supports the view that the purpose of the Initial Notice is to act as a warning to a TM in order to allow it to take corrective action in the Warning Period.

443. Thirdly, section 7B(4) deals with the issue of the Penalty Notice and provides:

> "(4) After the end of the period of six months beginning with the date on which a notice is given to a manufacturer, the Commissioners shall give him notice in writing either—
>
> (a) that they require payment of a penalty, or
>
> (b) that they do not require payment of a penalty."

444. A notable feature of section 7B(4) is that it does not expressly state the grounds on which a Penalty Notice is to be issued (in contrast to section 7B(2)-(3) in respect of the Initial Notice). I shall return to this point shortly. Secondly, it is clear from the alternatives contained in section 7B(4) that HMRC have a discretion whether to impose a penalty by issuing a Penalty Notice. They can either issue a Penalty Notice or notify the manufacturer that they do not require the payment of a penalty, but they must do one or the other.

445. Section 7B(5) requires HMRC when issuing a Penalty Notice under subsection (4) to consider:

> "(a) any representations made by the manufacturer during that period in such form and manner as the Commissioners may direct, and
>
> (b) action taken by the manufacturer during that period."

446. It is worth noting that these are the only specific matters which the statute identifies as matters to which HMRC must have regard in issuing a Penalty Notice under section 7B(4).

447. Plainly the representations and actions referred to in section 7B(5) are those representations made and actions taken in response to the Initial Notice. Again, I think this is a statutory recognition of the fact that there is a close link between the Initial Notice and the Penalty Notice.

448. Section 7C(1) provides that the Penalty Notice must specify the amount of the penalty and state the grounds on which HMRC "think that the manufacturer has failed to comply with the duty under section 7A(1)". The reference to "think" (which echoes the use of the same word in section 7B(1) in relation to the Initial Notice) is, in my view, an acknowledgement that HMRC can issue a Penalty Notice if they have formed the view that the manufacturer has failed to discharge the statutory duty under section 7A(1).

449. Next, section 7C(2) states that the amount of the penalty, not exceeding £5 million, must be specified in the Penalty Notice and then continues:

> "and in determining the amount to specify the Commissioners shall have regard to…."

450. The factors to which HMRC must have regard relate, on the plain words of the statute, to the quantum of the penalty rather than the incidence of liability. I shall examine the matters listed in section 7B(2) and (5) and section 7C(2) later when I consider the relationship between the Initial Notice and the Penalty Notice.

451. The meaning of sections 7B and 7C occasioned much debate before me.

452. Mr Moser submitted that it was necessary, before imposing a penalty under section 7B, that HMRC must prove that:

(1) BAT's products (and not counterfeit products) had actually been smuggled;

(2) BAT was in breach of its section 7A(1) duty; and

(3) HMRC had satisfied the procedural conditions regarding what HMRC must have had regard to before issuing either the Initial Notice or the Penalty Notice.

453. These were, Mr Moser argued, jurisdictional conditions to the exercise of the power to issue a penalty. Both parties referred to the following passage from the judgment of Lord Hope in *R(A) v LB Croydon* [2009] UKSC 8 at [52]:

> "In the Court of Appeal and in the argument before us, reference was made to the rule that where the exercise of executive power depends upon the precedent establishment of an objective fact, the courts will, if called upon to do so in a case of dispute, decide whether the requirement has been satisfied: *R v Secretary of State for the Home Department, Ex p Khawaja* [1984] AC 74, 110, per Lord Scarman. On the other hand, as Sir Thomas Bingham MR observed in *R v Secretary of State for the Home Department, ex p Onibiyo* [1996] QB 768, 785, where the question is one that is to be determined by the executive itself, its determinations will be susceptible to challenge only on *Wednesbury* principles: *R v Secretary of State for the Home Department, Ex p Bugdaycay* [1987] AC 514. In order to decide into which class of judgment the case falls one must, of course, first construe the statutory language used and the scheme of the legislation."

454. Mr Moser considered that the present case was much closer to the *Khawaja* end of the spectrum, whereas Mrs Hall argued that it was much closer to *Bugdaycay*.

455. The language of section 7B(1) (read together with section 7C(1)(b)) requires only that HMRC should "think" that BAT has, without reasonable excuse, been in breach of its section 7A(1) duty. There is no requirement, in my judgment, that HMRC should prove that BAT products had actually been smuggled in breach of its duty. It is enough for it to be shown (in relation to section 7A(1)(b)) that BAT was supplying HRT – which was not denied – and that the "nature or circumstances" of that supply "makes it likely that they will be resupplied to persons who are likely to smuggle them". I think that the wording of the provision is clear and it is not

appropriate to add an unnecessary gloss to the statutory language. Therefore, contrary to BAT's submissions, there is no need to prove that BAT's products have been smuggled.

456. I asked Mrs Hall for examples of penalties which could be imposed on the basis that HMRC or any other Government Department "thinks" that the jurisdictional conditions for the imposition of a penalty have been satisfied. I did this because I was not aware of other examples in the UK tax code where this was so. Usually, in relation to penalties imposed in respect of direct and indirect tax matters, HMRC must prove that the conditions for the imposition of a penalty have been satisfied and, if applicable, the taxpayer must prove that any statutory defence (often a "reasonable excuse" for the default) has been made out.

457. In written closing submissions, Mrs Hall referred to a number of different statutory provisions which, she argued, gave HMRC a wide discretion in imposing penalties. In my view, the examples provided (regulation 42 Money Laundering Regulations 2007 (2007/2157), paragraph 4 Schedule 46 Finance Act 2009, paragraph 1 Schedule 24 Finance Act 2007 and the Warehousekeepers and Owners of Warehoused Goods Regulations 1999/1278) supplied no parallel to the breadth of the power for which Mrs Hall argued under section 7B(1).

458. For example, regulation 4(1) Money Laundering Regulations 2007, provided that a designated authority "may impose a penalty of such amount as it considers appropriate on a person…who fails to comply with any requirement" in certain regulations. Regulation 42 (2) provided that the designated authority "must not impose a penalty on a person under paragraph (1)… where there are reasonable grounds for it to be satisfied that the person took all reasonable steps and exercised all due diligence to ensure that the requirement would be complied with." As I pointed out to Mrs Hall, regulation 42(1) did not allow the designated authority to impose a penalty because it "thinks" a person was in breach of certain regulations. It is true that regulation 42(2) confers a discretion on the authority, but it limits its power to impose a penalty in the first place.

459. Nonetheless, I accept that HMRC can issue an Initial Notice and a Penalty Notice on the grounds that HMRC thinks a TM is in breach of its section 7A(1) statutory duty. I consider that HMRC must prove the grounds which have led them to their belief that there has been a breach of the section 7A(1) duty. It seems inconceivable to me that Parliament would enact a provision enabling HMRC to impose a penalty of up to £5 million unless HMRC puts forward *prima facie* grounds to justify its belief that a TM had breached its statutory duty.

460. I should add that my analysis (later in this decision) of the effect of Article 6 of the Convention, when read with section 16(5) Finance Act 1994 construed to give effect to BAT's Convention rights, has the result that this Tribunal has full jurisdiction to undertake a merits review of HMRC's decision under section 7B to impose a penalty and is not confined to a *Wednesbury* jurisdiction. In my view, this removes many of the concerns expressed by BAT in relation to the existence of precedent or jurisdictional facts. If, for example, I disagreed with HMRC's opinion

that BAT had been in breach of its section 7A(1) duty, I would simply quash HMRC's decision and substitute my own view.

461. In relation to the question whether any of BAT's products had been smuggled, I would have concluded, in any event, that HMRC had proved that this had occurred. Eleven notifiable seizures were notified to BAT in the period from 16 June 2010 until immediately prior to the issue of the Initial Notice. In respect of a number of the seizures, there was evidence that the seized tobacco was genuine BAT product. There is no doubt in my mind that the circumstances described in those notices indicated that genuine BAT product had been smuggled.

462. I also reject Mr Moser's submission, as I understood it, that absent evidence of a conviction for smuggling HMRC could not argue that BAT's products had been smuggled. In my view, it is simply necessary for HMRC to demonstrate that it was more likely than not that BAT's products had been smuggled. It is not necessary to demonstrate that a smuggler had been convicted. There may be many reasons why HMRC or the Border Force may take the decision not to prosecute in particular cases and a failure to prosecute would not convince me that smuggling (or attempted smuggling) had not taken place. Had it been necessary to reach a view on this point, I would have concluded, as I have indicated, that there was sufficient evidence to conclude that BAT's products had been smuggled.

463. Furthermore, section 7A(1) imposes a duty on a manufacturer to take steps, in broad terms, to avoid supplying tobacco in circumstances likely to facilitate smuggling. Contrary to Mr Moser's argument, it seems to me that it is perfectly possible, at least in theory, to be in breach of that duty even if no tobacco is smuggled or proven to have been smuggled. Thus, by analogy, it may be possible for an employer to be in breach of its duty to ensure the health, safety and welfare at work of all its employees even though no employee is, in fact, injured as a result of the breach of duty. As Mrs Hall observed, a bank which leaves its doors unlocked overnight may be in breach of its duty to safeguard its customers' money even if no money is actually stolen. In other words, a duty may be breached even though the harm which the duty is intended to prevent does not materialise.

Article 6 – whether TPDA penalty a "criminal charge" for Convention purposes?

464. BAT argued that the penalty imposed under section 7B TPDA was a "criminal charge" and, therefore, brought into play the protections afforded by Article 6 of the European Convention on Human Rights ("the Convention").

465. Article 6 of the Convention has effect for domestic law purposes in accordance with the Human Rights Act 1998 ("HRA"). It was common ground that, by virtue of section 3 HRA, the domestic legislation with which we are here concerned must be construed in a way which is compatible with that Article. Section 3 HRA provides that:

> "So far as it is possible to do so, primary legislation and subordinate legislation must be read and given effect in a way which is compatible with the Convention rights."

466. Although the application of section 3 HRA was common ground, Mrs Hall observed that a number of BAT's arguments based on Article 6 had not been developed either fully or at all in its pleadings. Whilst I have some sympathy with her comments, it is plain that it is the duty of the Tribunal, as far as possible, to construe and apply the provisions of the TPDA, the Finance Act 1994 and the TPR in a manner consistent with Convention rights. If I decide that BAT's Convention rights have been infringed then I am required to apply, to the extent it is possible to do so, a conforming construction to the relevant domestic provision (see *Ghadian v Ghodin-Mendoza* (FC) [2004] UKHL 30, per Lord Nicholls at [30] - [33]); that is so regardless of the parties' pleadings.

467. Essentially, the dispute before me resolved into a question whether the section 7 B penalty imposed on BAT was a "criminal charge" for the purposes of Article 6. If Article 6 was so engaged, then two main issues arose. The first issue was the effect on the jurisdiction of this Tribunal and whether, on the basis of the arguments advanced by HMRC, it is a court or tribunal of "full jurisdiction". The second issue related to the burden of proof, on which point BAT's position changed in the course of the hearing.

468. Article 6 provides:

> "(1) In the determination of his civil rights and obligations or of any criminal charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law. Judgment shall be pronounced publicly but the press and public may be excluded from all or part of the trial in the interest of morals, public order or national security in a democratic society, where the interests of juveniles or the protection of the private life of the parties so require, or to the extent strictly necessary in the opinion of the court in special circumstances where publicity would prejudice the interests of justice.
>
> (2) Everyone charged with a criminal offence shall be presumed innocent until proved guilty according to law.
>
> (3) Everyone charged with a criminal offence has the following minimum rights—
>
> (a) to be informed promptly, in a language which he understands and in detail, of the nature and cause of the accusation against him;
>
> (b) to have adequate time and facilities for the preparation of his defence;
>
> (c) to defend himself in person or through legal assistance of his own choosing or, if he has not sufficient means to pay for legal assistance, to be given it free when the interests of justice so require;

> (d) to examine or have examined witnesses against him and to obtain the attendance and examination of witnesses on his behalf under the same conditions as witnesses against him;

469. In *Ferrazini v Italy (Application no 44759/98)* [2001] STC 1314 the European Court of Human Rights ("ECtHR") held that tax disputes fall outside the scope of civil rights and obligations within Article 6. *Ferrazini*, however, was confined to such rights and obligations and did not consider the question of tax penalties and whether these could constitute a "criminal charge".

470. Tax penalties, although not within the scope of civil rights and obligations within Article 6, can nonetheless fall within the scope of Article 6 if the assessment of such a penalty could be regarded as a "criminal charge" for Convention purposes (*Jussila v Finland 73053/01* [2006] ECHR 996 and *Customs and Excise Commissioners v Han and another* [2001] STC 1188).

471. The concept of a "criminal charge" has an autonomous meaning. The ECtHR's established case-law sets out three criteria to be considered in the assessment of the applicability of the criminal aspect. These criteria are sometimes referred to as the "*Engel* criteria" following the decision of the Court in *Engel and others v The Netherlands (No 1)* (1976) 1 EHRR 647 (see also *Ezeh and Connors v. the United Kingdom* [2003] ECHR 485).

472. The *Engel* criteria, in summary, require that the following must be taken into account: (a) the classification of the penalty in domestic law; (b) the nature of the offence; and (c) the nature and degree of severity of the penalty that the person concerned had risked incurring. The domestic classification of the penalty is only one of the factors, and is not decisive. Not only was the domestic law classification not decisive, it carried relatively less weight than the other factors of the nature of the offence and the nature and degree of severity of the penalty (see for example, *Yau and Ors v Customs & Excise* [2001] EWCA Civ 1048 per Mummery LJ at [26]). These latter two criteria were alternative, and not cumulative; it was sufficient if the offence in question was by its nature criminal from the point of view of the Convention or that the nature and degree of severity of the penalty placed the sanction in general in the criminal sphere. However, a cumulative approach is equally permitted if it was not possible to reach a conclusion by reference to the individual criteria (see the helpful summary of the relevant ECtHR case-law in the recent decision of the Upper Tribunal (Birss J and Judge Berner) in *Euro Wines (C&C) Ltd v Revenue and Customs Commissioners* [2016] UKUT 359 (TCC) at [15] – [21] ("*Euro Wines"*)).

473. I also note the observations of the Upper Tribunal (Morgan J and Judge Herrington) in *Wood v Revenue And Customs* [2016] UKUT 346 (TCC) at [58], which were based on [38] of *Jussila*, in relation to the second *Engel* criterion:

> "In our view the authorities demonstrate that it is the character or nature of the legislative provision that is said to be of a penal nature, which is the key determining factor. The key issue is whether the provision can be regarded as imposing a punishment to deter offending by those to whom it is directed."

474. In the present case, it was common ground that the penalty imposed under section 7B TPDA was a civil penalty as a matter of domestic UK law.

475. Mrs Hall argued that legislation which embodied measures adopted for the prevention of crime could not be treated as falling under Article 6. In *Raimondo v Italy* no. 12954/87, 22 February 1994 at [43] the ECtHR found that:

> "special supervision [restrictions involving a form of police parole] is not comparable to a criminal sanction because it is designed to prevent the commission of offences. It follows that proceedings concerning it did not involve … the determination of a criminal charge."

476. In addition, Mrs Hall referred to the decision of the Divisional Court in *Gough v Chief Constable of Derbyshire* [2001] EWHC 554 (Admin), in which it was held that the power of a magistrate to issue a football banning order was not a "criminal charge" under Article 6. Laws LJ held at [37]:

> "It follows that a punitive or attributive purpose no more marks an order as a penalty than a protective order serves to take it out of such a category. That being so the court is, as it seems to me, likely to be assisted by considering whether, in the statutory scheme before it, the predominant purpose of the measure under scrutiny is punitive, or for the protection of the public at large or a section of it."

477. In the Court of Appeal, Laws LJ's reasoning was approved ([2002] EWCA Civ 351 at [89]):

> "Laws L.J. held that banning orders were not penalties. We endorse his conclusion for the reasons that he gave. We also reject the submission that section 14B proceedings are criminal. They neither require proof that a criminal offence has been committed, nor involve the imposition of a penalty. We find that the proceedings that led to the imposition of banning orders were civil in character."

478. A banning order preventing someone attending a football match is, of course, very different from a penalty in the maximum amount of £5 million. Also, the reference to a banning order not being "a penalty" suggests to me that the Court of Appeal would have reached a rather different conclusion if a penalty had been involved.

479. In the present case, the penalty was imposed essentially for the breach of duty not to facilitate a criminal activity i.e. smuggling. The imposition of the *penalty* was not, in my view, merely a preventative or regulatory measure and it seems to me that the very structure of the legislation (i.e. an Initial Notice followed by a Penalty Notice) is fatal to Mrs Hall's argument. The Initial Notice was, indeed, a measure which was intended to prevent a breach of the section 7A statutory duty by giving its recipient a "warning shot" and the opportunity to put matters right. The Penalty Notice, however, was undoubtedly intended to punish such a breach in cases where the Initial Notice had not produced the desired effect. I also note, and respectfully agree with, the comments of the Upper Tribunal in *Euro Wines* at [23] which support this analysis:

"[W]e can see no principled distinction between mere encouragement towards compliance and deterrence from non-compliance. They are essentially two sides of the same coin. Any difference depends on the process adopted to encourage or deter; a warning or guidance might be regarded as falling on the side of encouragement, whereas in our judgment a penalty is clearly on the side of deterrence."

480. I also reject Mrs Hall's submission, based on *Bendenoun v France* - 12547/86 [1994] ECHR 7 at [47] (a decision cited with approval in *Engel*), to the effect that the penalty in that case was applicable to all taxpayers and "not a given group with a particular status". In this case, Mrs Hall argues that the section 7B penalty was applicable to a "handful" of TMs (although I note that the actual number of TMs throughout the world to which the TPDA was introduced to apply was never actually established, I understood it to be considerably more than the four UK-based TMs). In my view, this consideration cannot outweigh the more general characteristics of the section 7B penalty to which I have referred. Furthermore, there are many penal provisions which apply to specific categories of persons and which have been held to constitute criminal charges for the purposes of Article 6 (e.g. discipline of military personnel (*Engel*) and discipline of prison inmates (*Campbell and Fell v UK* 7819/77; 7878/77 [1984] ECHR 8)).

481. I, therefore, considered the second *Engel* criterion to be satisfied in this case and the penalty to constitute a criminal charge for the purposes of Article 6.

482. As regards the nature and severity of the penalty (the third *Engel* criterion), as the case-law of the ECtHR makes clear, this must be judged in relation to the penalty to which the person is *a priori* liable and not merely by reference to the actual penalty imposed (see *Grande Stevens v Italy* 18640/10 - Chamber Judgment [2014] ECHR 230 at [98]).

483. In this case, the maximum penalty which could have been imposed was £5 million. This was a substantial penalty by any standards and indicates to me that it was intended to be severe. I therefore consider that the third *Engel* criterion to be satisfied.

484. In this regard, I reject Mrs Hall's submission that the severity of the penalty should be judged by the financial ability of the person on whom the penalty is imposed to pay and that a penalty imposed on a multi-national company such as BAT was, therefore, insufficiently "severe" for the purposes of the *Engel* criteria to constitute a "criminal charge". I see no justification for adding any such gloss, for which there is no authority, on the *Engel* criteria. I do not think protections afforded by Article 6 depend on the depth of the pocket of the defendant – those protections apply to rich and poor alike. Moreover, I observe that in the *Grande Stevens* case (considered later in this decision), the ECtHR did not adopt (and, indeed, did not even consider adopting) this approach in relation to penalties of an equivalent severity charged upon applicants of substantial means.

485. Thus, in relation to both the nature of the penalty (the second *Engel* criterion) and the severity of the penalty (the third *Engel* criterion) I have concluded that a

penalty under section 7 B is a "criminal charge" for the purposes of Article 6 of the Convention.

Article 6 – right to a fair trial

486. Mrs Hall submitted that it was clear from the statutory scheme that the evaluation of whether a Penalty Notice should be issued under section 7B had been entrusted by Parliament to HMRC and not to this Tribunal. The Tribunal could only quash HMRC's decision if it was satisfied that it was made unlawfully. It followed, Mrs Hall said, that HMRC's decision to issue the Penalty Notice was susceptible to challenge only on *Wednesbury* principles. HMRC relied heavily on the word "think" in section 7B(1). It was, therefore, only necessary for HMRC to show that its decision to issue the Penalty Notice was *Wednesbury* unreasonable; this Tribunal could only interfere with HMRC's decision, therefore, if it concluded that HMRC took into account irrelevant matters, failed to take account of relevant matters, had reached a conclusion that could not reasonably have been arrived at or otherwise had made an error of law (e.g. as to the scope of the statutory duty in section 7A(1)). Thus, according to Mrs Hall's argument, the Tribunal's power, under section 16 (5) Finance Act 1994), to quash or vary a section 7B penalty decision was limited to *Wednesbury* grounds.

487. Mr Moser, however, argued that HMRC had to prove that BAT had, without a reasonable excuse, failed to comply with the duty under section 7A (1): section 7B (1). This was, he said, a "jurisdictional condition" to the exercise of the discretions (i.e. the decision to issue an Initial Notice and a Penalty Notice). Moreover, this Tribunal had full appellate jurisdiction under section 16(5) Finance Act 1994 to conduct a full merits-based review to determine whether a penalty should be imposed. Section 16 (5) gives this Tribunal the power to quash or vary HMRC's decision and to substitute its own decision.

488. In the course of opening submissions, I raised with the parties the requirement that, if the penalty imposed under section 7B was held to be a "criminal charge" for the purposes of Article 6 of the Convention, the case-law of the ECtHR made it clear that HMRC's decision had to be capable of review by a court of "full jurisdiction." I enquired whether a *Wednesbury*-type jurisdiction would satisfy the requirement of "full jurisdiction". This was not, as far as I could see, a point which had been addressed in the opening submissions of either party but was, in my opinion, plainly raised by HMRC's submission that this Tribunal had only a *Wednesbury* jurisdiction to review HMRC's Penalty Notice.

489. The requirement for a review of an administrative decision by a court of "full jurisdiction" has been considered in many ECtHR decisions. For example, in *Umlauft v Austria* [1995] ECHR 41, the ECHR stated at [37]:

> "…decisions taken by administrative authorities which do not themselves satisfy the requirements of Article 6.1 of the Convention… *must be subject to control by a 'judicial body that has full jurisdiction'*."(emphasis added)

490. I invited Mrs Hall and Mr Moser to make submissions on the question, if this Tribunal's jurisdiction was limited to that of a *Wednesbury* review, whether that would satisfy the requirement of "full jurisdiction". For convenience, I referred to my decision in *Linda Jarvis v HMRC* [2012] FTT 483 (TC), where a number of the relevant authorities (one of which is only available in French) were summarised. I should note that *Linda Jarvis* was a decision taken on the papers and without the benefit of argument and, as a decision of this Tribunal, is not binding upon me. Although *Linda Jarvis* concerned a tax penalty, the facts were very different and involved the imposition of a penalty from which there was, by express statutory provision, no right of appeal.

491. Counsel for both parties helpfully furnished written submissions on the "full jurisdiction" issue and also addressed it in closing submissions. Those submissions considered both the question whether a penalty imposed under section 7B was a "criminal charge" for the purposes of Article 6 (with which I have already dealt) and, if so, whether this Tribunal was a court of "full jurisdiction".

492. Mrs Hall submitted that "full jurisdiction" under Article 6 did not require a full merits review in all cases and referred to the speech of Lord Hoffmann in *R v (Alconbury Developments Ltd) v Secretary of State for the Environment, Transport and the Regions* [2001] UKHL 23 at [87]:

> "The reference to "full jurisdiction" has been frequently cited in subsequent cases and sometimes relied upon in argument as if it were authority for saying that a policy decision affecting civil rights by an administrator who does not comply with article 6(1) has to be reviewable on its merits by an independent and impartial tribunal. It was certainly so relied upon by counsel for the respondents in these appeals. But subsequent European authority shows that "full jurisdiction" does not mean full decision-making power. It means full jurisdiction to deal with the case as the nature of the decision requires."

493. It is noteworthy that Lord Hoffmann expressly addressed only the issue in relation to "policy decisions affecting civil rights". I would certainly not describe the decision to issue either an Initial Notice or a Penalty Notice in these terms.

494. It is also worth observing that immediately after the passage that I have quoted from Lord Hoffmann's speech in *Alconbury*, Lord Hoffmann referred to the ECtHR decision in *Zumtobel v Austria* (1993) 17 EHRR 116 noting that it was not necessary to have a merits review of a policy decision. The *Zumtobel* case concerned an objection to a compulsory purchase order in respect of farming land required for building a highway. A Government committee heard the applicant's objections but confirmed the order. The applicant appealed to an administrative court which held that the Government had taken proper matters into account and that it was not entitled to substitute its decision for that of the administrative authority. The ECtHR held at [32] held that its jurisdiction was sufficient in the circumstances of the case:

> "[r]egard being had to the respect which must be accorded to decisions taken by the administrative authorities on *grounds of expediency* and to

> the nature of the complaints made by the Zumtobel partnership [the applicant]".

495. Thus, in determining the appropriate level of judicial jurisdiction, Lord Hoffmann had in mind, at least in that case, decisions relating to policy matters. Once again, this seems to me to be far removed from a public authority taking a decision to impose a substantial financial penalty.

496. In addition, in *Bryan v UK* [1995] ECHR 50 the ECtHR considered whether judicial review by the High Court was insufficient to meet the requirements of "full jurisdiction" in respect of decisions of a planning inspector; again, an issue involving civil rights. The court held that [45]:

> "…in assessing the sufficiency of the review available to Mr Bryan on appeal to the High Court, it is necessary to have regard to matters such as the subject-matter of the decision appealed against, the manner in which that decision was arrived at, and the content of the dispute, including the desired and actual grounds of appeal."

497. The Court concluded at [47] that judicial review was sufficient in the circumstances to satisfy the requirements of Article 6:

> "Such an approach by an appeal tribunal on questions of fact can reasonably be expected in specialised areas of the law such as the one at issue, particularly where the facts have already been established in the course of a quasi-judicial procedure governed by many of the safeguards required by Article 6 para. 1 (art. 6-1). It is also frequently a feature in the systems of judicial control of administrative decisions found throughout the Council of Europe member States. Indeed, in the instant case, the subject-matter of the contested decision by the inspector was a typical example of the exercise of discretionary judgment in the regulation of citizens' conduct in the sphere of town and country planning."

498. In *Begum v Tower Hamlets* [2003] UKHL 5, Lord Hoffmann again considered the requirement of "full jurisdiction" under Article 6 (1) but, this time, in the context of a right of appeal against the decision of a housing officer. This was also, plainly, a case involving civil rights. Lord Hoffmann said:

> "52. In this case the subject matter of the decision was the suitability of accommodation for occupation by Runa Begum; the kind of decision which the Strasbourg court has on several occasions called a "classic exercise of an administrative discretion". The manner in which the decision was arrived at was by the review process, at a senior level in the authority's administration and subject to rules designed to promote fair decision-making. The content of the dispute is that the authority made its decision on the basis of findings of fact which Runa Begum says were mistaken.
>
> 53. In my opinion the Strasbourg court has accepted, on the basis of general state practice and for the reasons of good administration which I have discussed, that in such cases a limited right of review on questions of fact is sufficient."

499. Mrs Hall, in her submissions, also relied on *Fazia Ali v. the United Kingdom* [2015] ECHR 924. In this case, which involved the provision of priority need for accommodation of a homeless person, the ECtHR held:

> "75. The Court recalls that even where an adjudicatory body determining disputes over "civil rights and obligations" does not comply with Article 6 § 1 in some respect, no violation of the Convention can be found if the proceedings before that body are subject to subsequent control by a judicial body that has "full jurisdiction" and does provide the guarantees of Article 6 § 1 (*Albert and Le Compte v. Belgium*, 10 February 1983, § 29, Series A no. 58 and *Sigma Radio Television Ltd*, cited above, § 151).
>
> 76. Both the Commission and the Court have acknowledged in their case-law that the requirement that a court or tribunal should have "full jurisdiction" ("pleine juridiction" in French) will be satisfied where it is found that the judicial body in question has exercised "sufficient jurisdiction" or provided "sufficient review" in the proceedings before it (see, amongst many authorities, *Zumtobel v. Austria*, 21 September 1993, §§ 31-32, Series A no. 268-A; *Bryan*, cited above, §§ 43-47; *Müller and others v. Austria* (dec.), no. 26507/95, 23 November 1999; and *Crompton v. the United Kingdom*, no. 42509/05, §§ 71 and 79, 27 October 2009).
>
> 77. In adopting this approach the Convention organs have had regard to the fact that in administrative-law appeals in the Member States of the Council of Europe it is often the case that the scope of judicial review over the facts of a case is limited and that it is the nature of review proceedings that the reviewing authority reviews the previous proceedings rather than taking factual decisions. It can be derived from the relevant case-law that it is not the role of Article 6 of the Convention to give access to a level of jurisdiction which can substitute its opinion for that of the administrative authorities. In this regard, particular emphasis has been placed on the respect which must be accorded to decisions taken by the administrative authorities on grounds of "expediency" and which often involve specialised areas of law (for example, planning - *Zumtobel*, §§ 31 and 32, and *Bryan*, § 47, both cited above; environmental protection - *Alatulkkila and Others v. Finland*, no. 33538/96, § 52, 28 July 2005; regulation of gaming - *Kingsley v. the United Kingdom* [GC], no. 35605/97, § 32, ECHR 2002-IV).
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> 78. As has been explained in previous case-law (for example, *Sigma Radio Television Ltd*, cited above, § 154), in assessing the sufficiency of a judicial review available to an applicant, the Court will have regard to the powers of the judicial body in question (see for example, *Gradinger v. Austria*, 23 October 1995, § 44, Series A no. 328-C; *Bryan*, §§ 44-45, cited above; *Potocka and Others v. Poland*, no. 33776/96, § 55, ECHR 2001-X; *and Kingsley*, § 32, cited above), and to such factors as (a) the subject-matter of the decision appealed against, in particular, whether or not it concerned a specialised issue requiring professional knowledge or experience and whether it involved the exercise of administrative discretion and if so, to what

> extent; (b) the manner in which that decision was arrived at, in particular, the procedural guarantees available in the proceedings before the adjudicatory body; and (c) the content of the dispute, including the desired and actual grounds of appeal (see, inter alia, *Bryan*, §§ 44, 45 and 47, and *Crompton* §§ 71 - 73 and 77, both cited above)."

500. Again, this case plainly involved civil rights rather than a "criminal charge".

501. I note, however, as Mr Moser submitted, that all the above authorities cited by Mrs Hall related to civil rights. None of these cases is authority for the proposition that in relation to a criminal charge for the purposes of Article 6, a *Wednesbury* judicial review jurisdiction is sufficient to satisfy the requirements of "full jurisdiction".

502. Mrs Hall did, however, cite one ECtHR decision concerning the question of "full jurisdiction" which did involve a criminal charge. In *Malige v France* 27812/95 [1998] ECHR 91 a French motorist was caught speeding and suffered a points deduction from his driving licence. The motorist had declined to pay the fine and elected to stand trial before the Police Court. At the trial, the motorist argued that the evidence produced by the police did not establish his guilt (on the basis that the speed-gun used was inaccurate) and also raised matters of law. The Police Court convicted him and imposed a fine and a 15 day driving disqualification. The Police Court held that it did not have jurisdiction to consider the question of the lawfulness of the statute ("the 1989 law") providing for the deduction of points from the motorist's driving licence. The 1989 law provided that each driving licence had an initial allocation of twelve points. Points were then automatically deducted if the licence-holder committed one of the criminal offences listed in the French Road Traffic Code, this being established by the payment of a standard fine or by a conviction which had become final. The Police Court's conviction satisfied this requirement with the result that the points deduction followed automatically.

503. The case then came before the Versailles Court of Appeal. The motorist argued that the 1989 law was incompatible with Article 6 (1) of the Convention in so far as provisions of that Law excluded any possibility of judicial review of a measure which was recorded on the national register of driving licences (i.e. the points deduction). The Court of Appeal dismissed the appeal. The motorist later appealed to the Court of Cassation which also dismissed his appeal.

504. The key part of the ECtHR's judgment was as follows:

> "46. [The Court] notes that points are deducted when it has been established that one of the offences listed in Article L. 11-1 of the Road Traffic Code … has been committed, by means of either a final conviction or payment of a fixed fine by the offender, which implies admission of the offence and tacit acceptance of the deduction of points.
>
> 47. At the time when the details of an offence are recorded, the driver is informed by the administrative authority that he is liable to lose points on account of the offence he has committed and that there is an

automatic system for the deduction and restoration of points …. He is thus given the opportunity to contest the constituent elements of the offence which might be used as the basis for a deduction of points.

48. The Court observes that the applicant did not pay the fixed fine and that the partial loss of points thus depended on the criminal courts finding him guilty. *As the Commission pointed out, in the Versailles Police Court and the Versailles Court of Appeal, criminal courts which satisfy the requirements of Article 6 § 1, the applicant was able to deny that he had committed the criminal offence of exceeding the speed limit and to submit all the factual and legal arguments which he considered helpful to his case, knowing that his conviction would in addition entail the docking of a number of points.*

…

50. Like the Commission, *the Court accordingly considers that a review sufficient to satisfy the requirements of Article 6 § 1 of the Convention was incorporated in the criminal decision convicting [the motorist],* and that it is not necessary to have a separate, additional review by a court having full jurisdiction concerning the deduction of points. Moreover, it is open to the applicant to seek judicial review in the administrative courts, in order to ascertain whether the administrative authority acted after following a lawful procedure.

51. The Court concludes, like the Commission, that domestic law afforded the applicant a review by the courts of the measure in issue which was sufficient for the purposes of Article 6 § 1." (Emphasis added)

505. In other words, the Police Court and the Versailles Court of Appeal were courts of "full jurisdiction" for the purposes of Article 6 because the motorist was able to present all the relevant factual and legal arguments relating to his case - the points deduction followed from his criminal conviction. It was, therefore, unnecessary to have a *further* hearing in respect of the points deduction, which the ECtHR plainly considered flowed from the conviction, before a court of "full jurisdiction" because all relevant factual and legal matters had already been determined before the Police Court and the Versailles Court of Appeal. It was only in that context that, in relation to the points deduction, the ECtHR found that a judicial review was sufficient .

506. In my judgment, *Malige* provides no support for Mrs Hall's submission. At no point in the decision is it suggested that the motorist could have been convicted on the *ipse dixit* of the police authorities simply because they "thought" the motorist had been speeding and that a judicial review hearing to consider whether the motorist should be convicted would be sufficient to constitute a review by a court of "full jurisdiction". The requirement for a review by a court of "full jurisdiction" was satisfied by hearings before two courts which were able to determine all the factual and legal arguments before deciding to convict the motorist; the conviction, resulting from these hearings, gave rise automatically to the penalty points deduction. Indeed, far from supporting Mrs Hall's submission, *Malige* undermines it. It is an example of the ECtHR requiring that a criminal charge be determined by a court of "full

jurisdiction" viz a court that can determine the relevant facts and law. It is not an authority for the proposition that, in relation to a criminal charge, the requirement of a review by a court of "full jurisdiction" can be satisfied by judicial review alone.

507. The case-law of the ECtHR in relation to penalties and Article 6 has developed since the decisions of the House of Lords in *Alconbury* and *Begum*. I shall quote from the decision in *Linda Jarvis* simply for convenience because one of the key relevant decisions is published only in French:

> "42. The decision in *Umlauft* was cited by the Court in the subsequent case *Silvester's Horeca Service v Belgium* 47650/99 [2004] ECHR 97. This decision and the subsequent recent decision in *Segame SA v France* (see below) have not, as far as I am aware, been considered by this Tribunal. For this reason and because the *Silvester's Horeca* and *Segame SA* decisions are available only in French[8], I shall consider them in some detail.
>
> 43. The *Silvester's Horeca* decision involved a tax fine of approximately 2,000,000 Belgian Francs. The taxpayer company had failed to establish certain deliveries or invoices existed, had prepared invoices that did not correspond to reality and had failed to keep certain evidence and documents required by the Belgian VAT Code. The taxpayer appealed. The jurisdiction of the tribunal was limited to checking the existence of violations of the VAT code and the legality of tax penalties, but the tribunal had no jurisdiction to judge the appropriateness of the fine or grant a partial or total remission. The Court held that there was a breach of Article 6.1 because the applicant had not had access to a tribunal with full jurisdiction. The Court said:
>
> "27. Parmi les caractéristiques d'un organe judiciaire de pleine juridiction figure le pouvoir de réformer en tous points, en fait comme en droit, la décision entreprise, rendue par l'organe inférieur. Il doit notamment avoir compétence pour se pencher sur toutes les questions de fait et de droit pertinentes pour le litige dont il se trouve saisi (*Chevrol* v *France*, arrêt du 13 février 2003, § 77)."
>
> 44. Thus, the Court is saying that a court of full jurisdiction must have the authority to correct or reverse ("le pouvoir de reformer") on all questions of fact and law. In addition, in deciding that the Belgian tribunal was not a court of full jurisdiction the Court observed [28] that the tribunal had jurisdiction only to consider the reality and legality of the fines:
>
> "La Cour doit constater qu'en l'espèce, la société requérante n'eut pas la possibilité de soumettre la décision prise à son encontre à un tel contrôle de pleine juridiction. Dans son arrêt rendu le 3 octobre 1996 suite à l'opposition à contrainte formée par la société requérante, la cour d'appel de Bruxelles estima en effet qu'elle était uniquement appelée à examiner la réalité des infractions au code de la TVA et à contrôler la légalité des amendes fiscales réclamées *sans être compétente pour apprécier l'opportunité ou accorder une remise complète ou partielle de celles-ci*." (emphasis added)

[8] The *Segame* decision has subsequently been made available in English and I quote from the English version below.

> 45. The Court concluded, therefore, that the Belgian tribunal was not a court of full jurisdiction because it did not have the authority either to evaluate the appropriateness ("apprécier l'opportunité") or to grant a partial or total reduction ("accorder une remise complète ou partielle") in the tax fine."

508. In *Silvester's Horeca* the Belgian authorities accepted that the fine was a penal imposition i.e. a criminal charge.

509. The *Silvester's Horeca* decision was considered by the ECtHR in *Segame SA v France* 4837/06 in a decision delivered on 7 June 2012. In this case, following a tax audit by the French tax authorities, Segame received tax adjustments for certain prior years, including a penalty of 100% of the understated tax (in respect of works of art and antiques), although this penalty was subsequently reduced by French law to 25% during the course of the proceedings. The taxpayer company challenged the tax liability and the penalty before the Administrative Tribunal, Court of Appeal and Supreme Administrative Court (Conseil d'Etat) but its appeals were dismissed. Segame then appealed to the ECtHR, arguing it had been denied the right to a fair trial because there was no court with full jurisdiction to adjudicate on the amount of the penalty (effectively an argument on proportionality). I note that it was accepted by the French Revenue that the penalty fell within the criminal head of article 6. The Court dismissed Segame's argument, holding as follows:

> "54. The Court reiterates that a system of administrative fines, such as the tax penalties in the present case, is not incompatible with Article 6 § 1 of the Convention so long as the taxpayer can bring any such decision affecting him before a court that affords the safeguards of that provision (see *Bendenoun v. France*, 24 February 1994, § 46, Series A no. 284, and *Silvester's Horeca Service v. Belgium*, no. 47650/99, § 25, 4 March 2004).
>
> 55. Respect for Article 6 § 1 of the Convention means that decisions taken by administrative authorities which do not themselves satisfy the requirements of Article 6 § 1 of the Convention must be subject to subsequent control by a judicial body that has full jurisdiction (see *Schmautzer*, cited above, § 34; *Umlauft v. Austria*, 23 October 1995, § 37, Series A no. 328-B; *Gradinger v. Austria*, 23 October 1995, § 42, Series A no. 328-C; *Pramstaller v. Austria*, 23 October 1995, § 39, Series A no. 329-A; *Palaoro v. Austria*, 23 October 1995, § 41, Series A no. 329-B; and *Pfarrmeier v. Austria*, 23 October 1995, § 38, Series A no. 329-C). *The characteristics of a judicial body with full jurisdiction include the power to quash in all respects, on questions of fact and law, the decision of the body below. It must have jurisdiction to examine all questions of fact and law relevant to the dispute before it* (see *Chevrol v. France*, no. 49636/99, § 77, ECHR 2003-III; *Silvester's Horeca Service*, cited above, § 27; and *A. Menarini Diagnostics S.R.L. v. Italy*, no. 43509/08, § 59, 27 September 2011).
>
> 56. The Court notes that in the present case the applicant company was able to lodge an application with the Administrative Court to be exempted from paying the additional tax and the fines, and then an appeal with the Administrative Court of Appeal and an appeal for

> judicial review with the Conseil d'Etat. *The Administrative Court concerned had broad powers and full jurisdiction in this case to assess all the elements of fact and law and could not only quash or uphold an administrative decision, but also change it or replace it with its own decision and rule on the rights of the interested party; in fiscal matters it could exempt the taxpayer from the disputed taxes and penalties or modify the amount thereof within the limits prescribed by law, and where penalties were concerned, it could lower the rate within the limits of the applicable legal provisions* (see paragraphs 29-30 above; and contrast *Silvester's Horeca Service,* cited above, § 28).
>
> 57. Thus, the applicant company was able to submit to the Administrative Court and the Administrative Court of Appeal – both of which courts met the requirements of Article 6 § 1 – all the factual and legal arguments which it considered helpful to its application for exemption from the revised tax assessment and the related penalties (see, *mutatis mutandis*, *Malige*, cited above, § 48), including challenging the compatibility of the tax with Community law and discussing the base used to calculate the tax, which it persuaded the Administrative Court of Appeal to reduce (see paragraph 17 above)."(emphasis added)

510. The Court applied the same principles in *A Menarini Diagnostics s.r.l. v Italy* 43509/0843509/08 - Decision of 27 September 2011 (fines in respect of infringements of competition law) at [59] and in *Valico srl v. Italy* [2012] ECHR 1167 (fines in respect of infringements of planning law which were considered to be criminal charges) where the Court said:

> "Therefore, in administrative proceedings, the obligation to comply with Article 6 of the Convention does not preclude a "penalty" being imposed by an administrative authority in the first instance. For this to be possible, however, decisions taken by administrative authorities which do not themselves satisfy the requirements of Article 6 § 1 of the Convention must be subject to subsequent control by a judicial body that has full jurisdiction (see *Schmautzer, Umlauft, Gradinger, Pramstaller, Palaoro and Pfarrmeier v. Austria*, 23 October 1995, §§ 34, 37, 42, 39, 41 and 38 respectively, Series A nos. 328 A-C and 329 A-C). The characteristics of a judicial body with full jurisdiction include the power to quash in all respects, on questions of fact and law, the decision of the body below. It must in particular have jurisdiction to examine all questions of fact and law relevant to the dispute before it (see *Chevrol v. France*, no. 49636/99, § 77, ECHR 2003-III, and *Silvester's Horeca Service v. Belgium*, no. 47650/99, § 27, 4 March 2004)."

511. The ECtHR again considered the question of "full jurisdiction" in *Grande Stevens and others v. Italy* - 18640/10 - [2014] ECHR 230. The reasoning and findings of the Court are instructive and, in my judgment, are clearly applicable in the present appeal. In that case, a penalty was imposed on the applicant by a body called CONSOB (the Italian National Companies and Stock Exchange Commission) in respect of alleged market abuse (making a false and misleading statement to the market). The Court concluded that the severity of the penalties (up to €5 million, with penalties ranging between €500,000 and €3 million actually imposed) was such that they were criminal in nature. Taking account of the deterrent purpose of the penalties, the Court held that the penalties fell under the "criminal charge" heading of Article 6.

512. One of the questions considered by the Court was whether the applicant had recourse to a tribunal of "full jurisdiction" in respect of CONSOB's penalty decision. The Court held that the Turin Court of Appeal, which heard the applicant's initial appeal from the CONSOB decision, was a court of "full jurisdiction" because it had a full merits jurisdiction. The Court said at [149]:

> "The Court further observes that the [Turin] court of appeal had jurisdiction to rule, in respect of both law and fact, on whether the offence set out in Article 187 *ter* of Legislative Decree no. 58 of 1998 had been committed, and was authorised to set aside the decision taken by the CONSOB. It was also called upon to assess the proportionality of the imposed penalties to the seriousness of the alleged conduct. In fact, it reduced the amount of the fines and the length of the ban on exercising their profession imposed on certain of the applicants (see paragraphs 30 and 31 above) and examined their various factual or legal allegations (see paragraphs 32-36 above). Thus, its jurisdiction was not merely confined to reviewing lawfulness."

513. In relation to the Court of Cassation (which heard a subsequent appeal by the applicant), however, the ECtHR concluded at [155] that it was not a court of "full jurisdiction" for the following reasons:

> "It is true that a public hearing was held before the Court of Cassation. However, the latter did not have jurisdiction to examine the merits of the case, to establish the facts and to assess the evidence; indeed, the Government do no contest this. It could not therefore be considered as a court with full jurisdiction within the meaning of the Court's case-law."

514. I think it is conspicuous that, in relation to a "criminal charge", the ECtHR did not refer to its jurisprudence in relation to "sufficient jurisdiction" applied in cases falling within the civil head of Article 6 (e.g. *Fazi Ali*). I do not think that this was an oversight. In my view, where Article 6 is engaged in relation to a "criminal charge" any decision of an administrative body, such as HMRC, must be subject full judicial control. Full judicial control in this context means a full merits-based jurisdiction i.e. "jurisdiction to examine the merits of the case, to establish the facts and to assess the evidence…."(*Grande Stevens*, above at [155]) as well as to ensure that the decision was correct in law.

515. This Tribunal must take account of relevant decisions of the ECHR: Section 2 Human Rights Act 1998. As the Court of Appeal stated in *Han v C& E Commissioners* [2001] EWCA Civ 1048 at [25]:

> "Since s.2(1) of the HRA requires the court or tribunal to take into account the Strasbourg case law of the European Court of Human Rights ("Strasbourg") when determining a question which has arisen in connection with a Convention right, that case law provides the starting point for the domestic court or tribunal's deliberations and the court or tribunal has a duty to consider such case law for the purposes of making its adjudication. It is not bound to follow such case law (which itself has no doctrine of precedent) but, if study reveals some clear

> principle, test or autonomous meaning consistently applied by Strasbourg and applicable to a Convention question arising before the English courts, then the court should not depart from it without strong reason."

5 516. In my view the ECtHR has evolved a clear principle relating to the meaning of a court of "full jurisdiction" in relation to a "criminal charge" for the purposes of Article 6. On factual and legal matters, a decision of an administrative body such as HMRC, which does not fulfil the requirements of Article 6, must be subject to review by a court or tribunal which is able to determine all factual and legal matters and is
10 not merely confined to a *Wednesbury* judicial review jurisdiction.

517. I therefore reject HMRC's argument that a judicial review jurisdiction exercised by this Tribunal under section 16(5) Finance Act 1994 over the decision embodied in the Penalty Notice (as upheld on review) would be a "full jurisdiction" for the purposes of Article 6 in the context of the present appeal.

15 *Jurisdiction of the Tribunal – section 16(5) Finance Act 1994*

518. As I have said, it is common ground that the jurisdiction of this Tribunal in the present appeal is conferred by section 16(5) Finance Act 1994. It will be seen from the use of the word "also" in section 16(5) that this provision confers jurisdiction which is additional to that found in section 16(4). I therefore have jurisdiction to
20 quash or vary the decision of HMRC and to substitute my own decision.

519. Having concluded that the exercise of a judicial review jurisdiction would not satisfy the Article 6 requirement of recourse to a tribunal of "full jurisdiction" in the present case, I have decided that, construing section 16(5) to give effect to BAT's Convention rights in accordance with section 3 HRA, I can quash or vary HMRC's
25 decision and substitute my own decision if I disagree with HMRC's decision, regardless of whether my grounds for disagreement fall within *Wednesbury* principles. I therefore conclude that I have a full merits-based jurisdiction to determine the issues before me.

520. Before leaving the subject of this Tribunal's jurisdiction, I should comment on
30 Mrs Hall's argument that the scheme of the legislation was such that Parliament had entrusted an evaluative decision (on whether to issue a Penalty Notice) to HMRC, in the light of its considerable expertise in relation to smuggling, and not to the Tribunal. It seems to me, leaving aside the issues discussed above in relation to the Convention, that Mrs Hall's argument loses much of its force when one considers the specialist
35 nature of this Tribunal. The First-tier Tribunal has significant experience (particularly by virtue of what are called "restoration cases", dealing with seizure of vehicles etc used in smuggling) of smuggling various types of contraband.

Article 6 – burden of proof

521. Proceeding on the basis that the penalty assessed on BAT is a "criminal charge"
40 for the purposes of Article 6 of the Convention, it is now necessary to consider the burden of proof.

522. Article 6 (2) provides:

> "Everyone charged with a criminal offence shall be presumed innocent until proved guilty according to law."

5 523. Section 16(6) Finance Act 1994, however, provides:

> "…it shall … be for the appellant to show that the grounds on which any such appeal is brought have been established."

524. Effectively, therefore, section 16 (6) reverses the burden of proof by placing it on BAT to establish its grounds of appeal.

10 525. It is common ground that this Tribunal is not a "court" for the purposes of section 4(5) HRA with the result that I have no jurisdiction to make a declaration of incompatibility even if I were to reach the conclusion that the two provisions were incompatible. Instead, I must first determine whether section 16(6) infringes the presumption of innocence provided for in Article 6(2). If so, it would then be 15 necessary to determine whether, pursuant to section 3 HRA, I could read section 16 (6) and give effect to its provisions, "so far as it is possible to do so", in a way which is compatible with Convention rights.

526. The leading relevant ECtHR decision is *Salabiaku v France* [1988] ECHR 10589/83. In that case, the Court made it clear that the Convention did not prohibit 20 presumptions of law or fact, noting that these operated in every legal system. The Court noted, however, at [28] that:

> "Article 6(2) does not … regard presumptions of fact or of law provided for in the criminal law with indifference. It requires States to confine them within reasonable limits which take into account the 25 importance of what is at stake and maintain the rights of the defence."

527. *Salabiaku* was considered by the House of Lords in *Sheldrake v Director of Public Prosecutions* [2005] 1 AC 264 where Lord Bingham said at [12]:

> "… the question in any case must be whether, on the facts, the reasonable limits to which a presumption must be subject have been 30 exceeded."

528. These authorities, and the ECtHR decision in *Janosevic v. Sweden* - 34619/97 [2002] ECHR 618, were recently reviewed by the Upper Tribunal (Birss J and Judge Berner) in *Euro Wines (C&C) Ltd v Revenue And Customs* [2016] UKUT 359 (TCC) ("*Euro Wines*") where the Tribunal said:

> 35 "36. The commentary offered by Lord Bingham in *Sheldrake* on the decision of the ECtHR in *Janosevic* is particularly illuminating. At [20], Lord Bingham noted that in *Janosevic* the Court had rejected a complaint that the imposition of the surcharges in that case was incompatible with Article 6(2) because "an almost insurmountable 40 burden of proof" was imposed on the taxpayer (*Janosevic*, at [99]). The surcharges in that case were, as we have noted earlier, imposed on

5 objective grounds, in other words without any requirement of intent or negligence on the part of the taxpayer. The starting point for the tax authorities and the courts was that the inaccuracies found during the tax assessment were due to an inexcusable act attributable to the taxpayer and that it was not manifestly unreasonable to impose a tax surcharge as a penalty for that act. The Swedish tax system thus operated with a presumption, which it was up to the taxpayer to rebut (*Janosevic*, at [100]).

10 15 37. As Lord Bingham observed, the Court in *Janosevic* acknowledged that it was difficult for the taxpayer to rebut the presumption in question, but he was not without means of defence (*Janosevic*, at [102]). The ECtHR had regard to the financial interests of the state in tax matters and its dependence on the provision of correct and complete information by taxpayers ([103]). On that basis, the Court had concluded, at [104], that the presumption was confined within reasonable limits.

38. At [21], Lord Bingham summarised the principles to be derived from the case law of the ECtHR. He said:

20 25 30 35 "From this body of authority certain principles may be derived. The overriding concern is that a trial should be fair, and the presumption of innocence is a fundamental right directed to that end. The Convention does not outlaw presumptions of fact or law but requires that these should be kept within reasonable limits and should not be arbitrary. It is open to states to define the constituent elements of a criminal offence, excluding the requirement of *mens rea*. But the substance and effect of any presumption adverse to a defendant must be examined, and must be reasonable. Relevant to any judgment on reasonableness or proportionality will be the opportunity given to the defendant to rebut the presumption, maintenance of the rights of the defence, flexibility in application of the presumption, retention by the court of a power to assess the evidence, the importance of what is at stake and the difficulty which a prosecutor may face in the absence of a presumption. Security concerns do not absolve member states from their duty to observe basic standards of fairness. The justifiability of any infringement of the presumption of innocence cannot be resolved by any rule of thumb, but on examination of all the facts and circumstances of the particular provision as applied in the particular case.""

40 45 529. The appeal in *Euro Wines* concerned a penalty for handling goods subject to unpaid excise duty under paragraph 4(1) Schedule 41 Finance Act 2008. The Upper Tribunal, overturning the decision of the First-tier Tribunal, held that the penalty assessed at 20% of the 'potential lost revenue' of £159,322, namely £31,864.41 was a "criminal charge" for the purposes of Article 6. Section 154 of the Customs and Excise Management Act 1979 ("CEMA") made provision for the burden of proof in cases which included appeals against penalty assessment under Schedule 41 and provided that in such cases the burden of proof would be upon the other party to the proceedings and not on HMRC. The Tribunal noted:

> "39. In this case…there is… an effective requirement, having regard to the sanction of the penalty, for the recipient of goods to take reasonable steps to check that those goods are duty paid. That is reinforced by the defence of reasonable excuse. As well as that defence, there is an opportunity, according to the express terms of s 154 CEMA, for the person concerned to rebut the presumption that duty has not been paid. The penalty is also subject to reasonable mitigation, reflecting the "quality of the disclosure", namely whether the disclosure was prompted or unprompted, and the timing, nature and extent of the disclosure (see FA 2008, Sch 41, paras 12 and 13)."

530. Noting that in *Janosevic* at [20] the difficulty involved in discharging a reverse burden of proof was not necessarily decisive of the question of incompatibility with Article 6 (2), the Upper Tribunal stated [40] that that difficulty had to be considered in the context of the scheme of the penalty provisions as a whole. The Tribunal continued:

> "41. Mr Bedenham [counsel for Euro Wines] sought to contrast the facts of this case with those in *Sheldrake*, where the question was as to the absence of likelihood of the defendant driving a vehicle whilst over the alcohol limit. There, as Lord Bingham described it at [41], the House of Lords found that it was not objectionable to criminalise a defendant's conduct without requiring a prosecutor to prove criminal intent. The likelihood of the defendant driving was "a matter so closely conditioned by his own knowledge and state of mind at the material time as to make it much more appropriate for him to prove on the balance of probabilities that he would not have been likely to drive than for the prosecutor to prove, beyond reasonable doubt, that he would."
>
> 42. It is not in every case that the question resolves itself into which of the parties is best placed to prove a particular fact. The whole scheme of the relevant provisions must be considered. It is not possible, in our judgment, to conclude with the clarity that was available in *Sheldrake*, which out of HMRC or a trader in the position of Euro Wines, would be the appropriate party to prove the question of duty payment. It might in some cases be HMRC, and in others the trader. Nevertheless, it is the trader who is in the best position, when carrying out its own trade, to know the circumstances of that trade. In every case a trader who is at the point of acquiring dutiable goods has the opportunity to take steps in order to satisfy itself about whether duty has been paid before going ahead. A trader who goes ahead without being satisfied knows or ought to know it is at risk. A trader in that situation can avoid the risk entirely by refusing to take such goods.
>
> 43. Parliament has determined that in all cases the burden should be on the relevant person and not on HMRC. It has done so whilst at the same time enabling the relevant person to rebut the presumption of non-payment of duty, and to raise defences of reasonable excuse, in particular, and special circumstances. This, we consider, strikes an appropriate balance in the circumstances. In our judgment, the penalty provisions as a whole represent a proportionate scheme and accordingly the imposition in that context of the burden of proof on the

> relevant person as to payment of duty does not go beyond what is necessary for the protection of the revenue. We find accordingly that the reverse burden of proof in s 154 CEMA is not incompatible with Article 6 of the Convention. There is accordingly no need for a conforming construction of s 154."

531. Consistent with its submission that the Tribunal could only quash HMRC's Penalty Notice on *Wednesbury* grounds, HMRC accepted that it bore the evidential burden of demonstrating that HMRC:

(a) had reasonable grounds for concluding that BAT had breached its statutory duty;

(b) had properly understood the scope of the statutory duty; and

(c) did not have regard to extraneous considerations.

532. BAT accepted in its opening submissions and in its written closing submissions that it bore the burden of proof under section 16(6). It stated, however, that it reserved its position on the compatibility of section 16(6) with Article 6(2) in the event of an appeal. In its oral closing submissions, however, Mr Moser reversed the position and withdrew what he described as a "concession" that BAT bore the burden of proof. Mr Moser invited the Tribunal to find that section 16(6) was wide enough to embrace the burden of proof being on HMRC. Mr Moser noted that section 16(6) provided that "it shall otherwise be for the appellant to show that the grounds on which any such appeal is brought have been established." Mr Moser noted that the grounds of appeal included, at paragraph 57 of BAT's Grounds of Appeal, the argument that HMRC had not discharged the burden of proof on the following four matters, namely that the HRT seized was:

(1) BAT's CC (as opposed to some other brand or counterfeit); and

(2) That the product was being smuggled; and

(3) That: (a) the smuggler was the person to whom the product was supplied or resupplied and that this could have been avoided if BAT had taken certain reasonably practicable steps that it failed to take; and (b) the smuggling was otherwise facilitated by BAT and that BAT failed to take reasonably practicable measures to avoid providing that facilitation; and

(4) That BAT had no reasonable excuse for failing to comply with the section 7 A(1) duty.

533. In relation to those four matters, I have already held that it is not necessary for HMRC to prove that BAT's product was, in fact, smuggled. I do, however, consider that it is necessary for HMRC to establish the grounds for its opinion that there was a breach of the section 7A(1) duty.

534. Mrs Hall objected that HMRC would suffer significant prejudice if, having presented opening submissions, examined and cross-examined witnesses on the basis that BAT accepted that the burden of proof lay upon it, BAT was now allowed to change its position. I must say I have considerable sympathy for that point of view.

535. Nonetheless, the question on whom the burden of proof lies is one for the Tribunal and not for the parties to either agree or concede. I must determine whether section 16(6) infringes Article 6(2) in the sense that the reversal of the burden of proof is unreasonable or disproportionate, examining the whole scheme of the legislation.

536. In this case, HMRC must prove the grounds giving rise to its opinion that there has been a breach of the section 7A(1) duty. BAT is given the opportunity to rebut HMRC's case. Secondly, in accordance with my decision that section 16(5) must be interpreted to allow a full merits-based review in order for the Tribunal to be a court of "full jurisdiction"; thus, the Tribunal, in the words of Lord Bingham, retains the power to assess the evidence. Thirdly, the scheme of the legislation, requiring written grounds to be given for both the Initial and Penalty Notice ensures that the TM is aware of the issues with which HMRC are concerned, i.e. the case made against it, and also allows the TM to take corrective action before a penalty is finally assessed. Finally, BAT as a major tobacco manufacturer, with considerable experience of dealing with illicit trade, is well placed to understand the circumstances and risks involved in that trade.

537. I accept that, unlike *Euro Wines*, there is no conventional "reasonable excuse" defence to a penalty assessed under section 7B (4), although the question of "reasonable excuse" is a matter which must be considered by HMRC in deciding to issue the Penalty Notice. I do not, however, consider this to be determinative.

538. Looking at the whole scheme of the legislation and its application to BAT, I consider that the penalty provisions in sections 7A-7C TPDA are proportionate and go no further than is necessary for the protection of excise duty revenue. I therefore conclude that the reverse burden of proof in section 16(6) requiring BAT to prove its grounds of appeal does not go beyond reasonable limits and therefore does not infringe Article 6(2).

Reasonable excuse

539. One curious feature of both the Initial Notice and the Penalty Notice was that neither mentioned the issue of "reasonable excuse". This is a matter which HMRC is required to take into account when exercising its discretion under section 7B(1).

540. There was, however, no indication that HMRC had considered this issue when issuing the Initial Notice. Moreover, in the light of my conclusion (below) that the grounds for the issue of the Penalty Notice are implicitly the same as those for the issue of the Initial Notice, it seems to me that in deciding to issue a Penalty Notice HMRC must also consider whether BAT had a reasonable excuse for its breach of duty at the end of the Warning Period. Again, there is no indication in the Penalty Notice that HMRC considered whether BAT had a reasonable excuse.

541. In my view, that would, of itself, permit me to set aside HMRC's decision. In the light of my conclusions on other matters, it is perhaps not necessary for me to decide whether BAT could be regarded as having a reasonable excuse for its failure to

comply with its duty. Nonetheless, were it necessary to decide this point, I would be minded to consider it relevant that BAT could have reasonably assumed, both from the terms of the Initial Notice and Notice 477 (as well as statements made by Mrs Green at the meeting on 18 December 2013 and her letter of 18 December 2013), that if it rectified the matters raised in the Initial Notice it would not be subject to a penalty. BAT would then understandably focus its attention on dealing with matters raised in the Initial Notice. In my view, it would at least be arguable that this would give BAT a reasonable excuse in relation to those matters specified in the Penalty Notice but which were not raised in the Initial Notice.

Relationship between Initial Notice and Penalty Notice

542. Mr Moser submitted that, even if BAT had been in breach of its section 7A(1) duty, the only grounds on which HMRC could issue a Penalty Notice were those identified in the Initial Notice and having regard to the matters specified in section 7B(5) (i.e. BAT's actions taken during the six month Warning Period and representations made by BAT). HMRC could not, he argued, set a "trap" for a TM by warning it of certain concerns in the Initial Notice and then impose a penalty on different grounds in the Penalty Notice. In particular, Mr Moser noted that the Initial Notice did not refer to concerns about the absence of ACT, focusing instead on the inability of BAT to identify its first customer outside its group, or on the absence of specific contractual terms in its contracts with wholesalers.

543. Mrs Hall denied that there was any such limitation on HMRC's power to issue a Penalty Notice under section 7B(4); HMRC's power to issue a Penalty Notice was not constrained by the matters raised in the Initial Notice. It was not possible to read in such a constraint from the words used by Parliament. Mrs Hall posed a hypothetical example of an Initial Notice served on a TM which identified six matters of concern which the TM successfully addressed during the Warning Period. During the Warning Period, however, the TM engaged in flagrant breaches of the statutory duty to the extent that HMRC could reasonably conclude that a Penalty Notice should be issued. In such a case, Mrs Hall argued that it could not have been Parliament's intention to deny HMRC the power to penalise a TM for a manifest breach of the statutory duty.

544. In my judgment, the matters to which HMRC can have regard to in issuing a Penalty Notice under section 7B(4) are limited to those matters directly related to the issues clearly identified in the Initial Notice and to the matters referred to under section 7B(5). It seems to me that the whole thrust of the statutory scheme is that an Initial Notice is issued in order to warn a TM and to give it the opportunity to address the concerns therein raised thereby enabling it to avoid the issue of a Penalty Notice. The issue of a Penalty Notice on grounds not specified in the Initial Notice thwarts this statutory purpose.

545. In the Consultative Document dated January 2006, which preceded the amendments to the TPDA eventually enacted by the Finance Act 2006, various paragraphs refer to the purpose of the Initial Notice (referred to in the Consultative Document as the "Warning Notice"). Thus, paragraph 2.16 states:

> "The Warning Notice will state the grounds for believing that the manufacturer has failed to exercise adequate control over his supply chains. *Failure to take reasonable and effective steps to improve his control over those supply chains could lead to the issuing of a Penalty Notice*." (Emphasis added)

546. In addition, paragraph 2.26 of the Consultative Document provided:

> "The Commissioners would cancel the Warning Notice *if they were convinced that it should not have been issued or if they were satisfied that the manufacturer had adequately addressed the problem*. The decision not to issue a Penalty Notice would be the Commissioners' final judgement. *Any subsequent concerns would be expressed in a subsequent Warning Notice*."(Emphasis added)

547. The statements contained in the Consultative Document (which are aids to determining the mischief of the legislation) make it clear that it was intended that a TM should address the matters raised in the Initial Notice and that the issue of a Penalty Notice would be dependent on how successfully the TM took corrective action.

548. HMRC's Notice 477 stated in paragraph 6.1:

> "An initial notice is a letter from us, advising you that we have concerns regarding the level of your compliance with your legal duty not to facilitate the smuggling of tobacco products…
>
> *The initial notice acts as a warning, and provides you with an opportunity to take corrective action regarding the level of your compliance, and in so doing avoid being issued with a financial penalty*." (Emphasis added)

549. In addition, Notice 477 indicated that the purpose of an Initial Notice was to enable a TM (paragraph 6.6) to "take appropriate action to address any specific matters raised in the Initial Notice, and thoroughly review your supply chain policy to ensure that you have included any reasonably practicable measures to improve your supply chain controls". Furthermore, in paragraph 7.3 ("What factors will you consider before issuing a penalty notice?"), Notice 477 states that HMRC would consider any action taken by the TM during the six month Warning Period to ensure that the TM complied with its legal duties. Paragraph 7.3 continued:

> "In particular we will review whether or not you have satisfactorily addressed the reasons for the issuing of the initial notice, and any seizures notified to you in the six month period following the issue of the initial notice."

550. It is clear from the Consultative Document and Notice 477 that it was intended that the purpose of the Initial Notice was to enable a TM, about whose level of compliance with the section 7A(1) statutory duty HMRC had concerns, to take corrective action in order to avoid incurring a financial penalty.

551. That understanding of the very close link between the Initial Notice and the Penalty Notice is, in my view, strongly supported by the statutory language. As I have

already pointed out, it is noteworthy that section 7B(4) does not specifically state the grounds on which HMRC may issue a Penalty Notice. Instead, I think it is implicit that those grounds are the same as those listed in respect of the issue of the Initial Notice in section 7B(2), with the addition of those matters expressly referred to in section 7B(5).

552. Both Mr Moser (in argument) and Mrs Green (in the drafting of the Penalty Notice) respectively contended or assumed that section 7C listed the factors that HMRC could take into account in deciding whether to issue a Penalty Notice. That, however, ignores the clear wording of section 7C(2) which states that the factors listed are to be taken into account "in determining the amount" of the penalty which HMRC specify pursuant to section 7C(1)(a). As I have said, this wording makes it clear that those factors go to the quantification of the penalty and not to the incidence of liability.

553. Of course, there is a close relationship between the factors set out in section 7C (2) and those listed in section 7B(2). Section 7C(2)(c) – (g) and (i) are identical to the corresponding grounds in section 7B(2). Section 7C(2)(h) has no counterpart in section 7B(2) and is obviously a factor relevant to "quantum" rather than to liability. Section 7C(2)(a) corresponds broadly to the assessment which HMRC must make under section 7B(1). Section 7C(2)(b) also corresponds broadly to section 7B(5)(b), although it is not limited to action taken in the Warning Period. Section 7C(2) does not contain an equivalent provision to that of section 7B(5)(a).

554. Section 7C(2)(i) allows HMRC to have regard to "any other matter that they think relevant". As I have just indicated this corresponds to section 7B(2)(h). In my view this allows HMRC in assessing the amount of the penalty to take account of the matters related to those considered under that heading in the Initial Notice.

555. The scheme of the legislation, therefore, is that the statutory duty is expressed in very general terms in section 7A(1). The Initial Notice draws a TM's attention to specific issues in respect of which HMRC consider that the TM is failing to discharge its statutory duty – it gives specificity to the alleged breach of the general duty. Section 7B(4) then allows a six month Warning Period. It is evident that the purpose of this period is, as Notice 477 correctly describes, to allow the TM to take appropriate corrective action in order to avoid the issue of a Penalty Notice. The remaining provisions of section 7B(4) then allow HMRC either to indicate that they do or do not require the payment of a penalty. Save for section 7B (5), the statute contains no further information as regards the matters to which HMRC must have regard in issuing a Penalty Notice.

556. If HMRC, in issuing a Penalty Notice, were not limited to the issues raised in the Initial Notice (and supplemented by the matters referred to in section 7B(5)) the statutory scheme would, in my view, be undermined. Parliament's evident intention was to allow a TM an opportunity in the six month Warning Period to take action in order to comply with its statutory duty. Allowing HMRC to issue a Penalty Notice on grounds which were different from those raised in the Initial Notice deprives a TM of that opportunity and thereby frustrates Parliament's intention. Taken to its logical

limits, HMRC's interpretation of section 7B would allow HMRC to raise a fresh matter on the last day of the Warning Period giving the TM little or no time in which to take corrective action or, indeed, to make representations as envisaged by section 7B(5). That is plainly not what Parliament intended.

5 557. Furthermore, that does not appear to be what Mrs Green intended when she issued the Initial Notice or, at least, it was not the impression that she conveyed on any fair reading of the Initial Notice. That was clear from the last paragraph of page 5 of the Initial Notice which stated:

> "This initial notice gives warning that in six months from the date of
10 this notice, HMRC will review the actions BAT has taken following the issue of this notice and make its decision whether or not to issue a penalty notice under section 7C…"

558. The final paragraph of the letter ("next steps") equally stated:

15 > "I have no doubt that you will wish to reflect on the contents of this initial notice and implement the points that have been outlined."

559. In addition, the notes of the meeting of 18 December 2013 between BAT and HMRC record Mrs Green noting the six month deadline in the "Warning Notice", following which HMRC would have 40 days[9] in which to make a decision in respect
20 of whether to issue BAT with a penalty. Mrs Green noted the tight timetable for the inspection of BAT's introduction of Track and Trace at its Belgian warehouse. She then noted that it was for BAT to satisfy HMRC that the matters that had been identified in the Warning Notice were being properly addressed, and not *vice versa*. Clearly, the implication of this warning was that BAT needed to address the matters
25 in the Initial Notice in order to avoid a penalty.

560. Mrs Green made the same point in a letter to Hogan Lovells dated 19 December 2013. In the final paragraph of that letter Mrs Green stated:

> "Whilst I am happy to have been able to provide answers to your questions, I would respectfully remind you that the purpose of the
30 Initial Notice is to give BAT adequate time to make improvements to their processes in order to meet the requirements of the TPDA and to avert the necessity of issuing a penalty. The six month period for these improvements ends on 22 April 2014."

561. Again, I think the implication of that final paragraph is that BAT had a six
35 month period in which to address the issues raised in the Initial Notice in order to avoid a penalty. There is no suggestion that at the end of the six month Warning Period HMRC might impose a penalty on new grounds i.e. grounds which were not stated in the Initial Notice.

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[9] In fact, section 7B(5) provides that HMRC has 45 days to give the manufacturer notice either that they require payment of a penalty or do not require payment of the penalty.

562. In my view, BAT could reasonably have assumed from this correspondence and the comments made by Mrs Green at the meeting on 18 December 2013 that it should address the matters raised in the Initial Notice if it wished to avoid a penalty.

563. In the course of argument, I asked Mrs Hall to explain the purpose of the Initial Notice because, on her submission, it seemed to me that the Initial Notice was, at least in legal effect, largely pointless. She replied that the purpose of the Initial Notice was to provide TMs with the opportunity to address the matters which HMRC had listed in the Initial Notice – effectively a repetition of the words of Notice 477. I agree, but it seems to me that Mrs Hall's main submission deprived the TM of its right to a six month period in which it could take action in response to the matters raised in the Initial Notice.

564. Mrs Hall referred on a number of occasions to matters which emerged in the Warning Period, which had not been dealt with in the Initial Notice, and which might justify the issue of a Penalty Notice. She did so in order to support her view that the Penalty Notice was not limited to matters raised in the Initial Notice. That argument, in my view, betrays a misunderstanding of section 7B. If, in the course of the Warning Period, further matters emerged which indicated that a TM was in breach of its statutory duty under section 7A, there would be, in my judgment, no prohibition on HMRC issuing a further Initial Notice covering all the matters of which they were now aware. It is true that that would set the six-month Warning Period running again, but that is a statutory scheme which Parliament has ordained.

565. In the course of cross-examination, Mrs Green said that she believed that a further Initial Notice could only be issued in what she described as "catastrophically very different circumstances". Section 7B contains no such "catastrophe" test and it was plain to me that Mrs Green had misdirected herself.

566. Mrs Green indicated that opinions were divided within HMRC on the question whether a second Initial Notice could be issued during the Warning Period. However, when it issued the Initial Notice, HMRC clearly envisaged that if fresh matters emerged another Initial Notice may be issued. The Initial Notice stated:

> "There are currently no additional matters HMRC consider relevant. If other matters do arise, HMRC will write to BAT and set these out in detail and, if necessary, issue another initial notice under section 7B (1)."

567. The Initial Notice, as I have already concluded, made no mention or complaint about the failure of BAT to introduce ACT i.e. tracking HRT products to the level of the retailer. That complaint was only raised explicitly by HMRC in December 2013, after the issue of the Initial Notice. I note that when Mrs Green refers to ACT (usually by referring to the point at which BAT's HRT enters the illicit market) in the Penalty Notice, as she does repeatedly, her meaning is unmistakable. The Initial Notice focused on BAT's inability to identify its first customer outside the BAT group – a shortcoming which was remedied by the introduction of Track and Trace.

568. Secondly, the Initial Notice did not refer to the phenomenon of "little and often" smuggling or the issues raised in the Project Falcon report. Whilst HMRC noted that the Initial Notice referred to earlier correspondence and meetings between HMRC and BAT, I do not think that this can sensibly be regarded as an explicit expression of concern regarding "little and often" smuggling in the Initial Notice. Moreover, the reference in the introductory paragraphs of the Initial Notice to the fact that the TPDA was introduced to prevent organised criminal gangs from exploiting weaknesses in the TM's supply chain controls was similarly unspecific and cannot be taken as a clear reference to "little and often" smuggling.

569. Furthermore, the Initial Notice did not refer explicitly to issues arising from new-style seizure notifications of amounts below 50 kg. I note, however, that on page 5 of the Initial Notice, in relation to legitimate demand, the Initial Notice required that BAT undertake a robust examination of its calculation of legitimate demand, "in particular taking notice of the seizures both notified to BAT under this legislation *and of others shared with BAT to demonstrate the interdictions carried out."* This was, in my view, a reference to seizure notifications in quantities of less than 50 kg but did not refer to other issues relating to non-notifiable seizures.

570. Thirdly, there was no reference in the Initial Notice to the failure by BAT to include "anti-smuggling" clauses in its contracts with wholesalers. Again, this concern was only raised after the Initial Notice had been issued.

571. In my view, HMRC were aware or should have been aware of all of these issues prior to the issue of the Initial Notice.

572. Therefore, HMRC's failure to raise these matters in the Initial Notice means that they cannot be relied upon as grounds upon which to issue a Penalty Notice nor, of course, can they be used in the quantification of the penalty. Indeed, that is all the more so where, as in this case, the Initial Notice invited BAT to address the issues raised in the Initial Notice and indicated that, if other matters arose, a further Initial Notice would be issued.

573. I have therefore concluded that the failure of HMRC to mention in the Initial Notice the lack of ACT, "little and often" smuggling (and issues relating to seizure notifications of amounts of HRT below 50 kg) and its concerns regarding contractual clauses in BAT's contracts with its wholesalers, whilst relying on these matters in the Penalty Notice, requires me to set aside the Penalty Notice and I therefore do so.

574. Accordingly, I shall substitute my own decision for that of HMRC.

Decision – penalty grounds

575. I shall consider the matters raised in the Initial Notice in some detail. Before doing that, I find that BAT was aware of the risk that at least some of its supplies of HRT to Belgium and Luxembourg were likely to be smuggled. Certainly, BAT was aware that HMRC had concerns that some of BAT's products were being smuggled from Belgium and Luxembourg into the UK. Notices had been served on BAT under

section 7A(4) and (5). BAT had also received numerous seizure notifications, both statutory and informal (i.e. under 50 kg).

576. I have considered the matters raised by the Initial Notice and I have also taken account of actions taken and representations made by BAT, as required by section 7B(5). As regards those matters, the position at the end of the Warning Period was as follows:

> "**Section 7B(2) (a) & (b) – content of, and compliance with, BAT's written policy of steps taken to ensure compliance with section 7A (1)**
>
> **…**
>
> (i) BAT is unable to tell HMRC who the name and address of the first customer to whom it has supplied the cigarettes/HRT that have been manufactured by BAT."

577. In my view, this concern was addressed by the introduction of Track and Trace by April 2014. Because corrective action had been taken during the Warning Period there was no justification for issuing a penalty in relation to this concern.

> "(ii) BAT does not provide the information about the seized product(s) in accordance with the Schedule of the TPR 2001"

578. Again, this complaint was remedied by the introduction of Track and Trace which, in my view, was capable of supplying the information required by the TPR 2001.

> "(iii) BAT does not comply with its policy as it does not investigate or carry out any enquiries in relation to the seizure of HRT/cigarettes."

579. I have concluded that this issue had not been fully addressed by BAT in the course of the Warning Period. BAT had introduced SERP, but its performance was defective. In part this was because, in the absence of Track and Trace, SERP could not be effective in relation to the identification of the relevant wholesaler. I accept that the implementation of Track and Trace in April 2014 would rectify this problem at least to the extent of allowing BAT to identify its first purchaser outside the group. Secondly, however, the comments made by BAT on the SERP reports in relation to the seizures notified during the Warning Period (particularly those made by Mr Olive) indicated that BAT was not taking the notified seizures seriously. I accept Ms Udicki's evidence that Mr Olive had been spoken to and told better to describe what BAT had done.

580. I have also taken account of Ms Udicki's letters of 4 and 15 April 2014 in response to the four questions posed by HMRC to BAT. BAT indicated that they would investigate seizures where their products had been found on the illicit market in quantities greater than BAT expected. I found this a surprising reply. I would have expected BAT to investigate, as far as possible, all notified seizures. I consider this to be further evidence that BAT adopted a somewhat half-hearted approach to investigation of seizures of genuine product.

581. Nevertheless, I consider that BAT were in breach of their section 7A(1) duty. Even though they had established SERP, it was clear that BAT was less than fully committed to investigating genuine HRT which had been seized. As I have already observed, BAT were aware of the risk that some of its supplies of HRT to Belgium and Luxembourg were likely to be smuggled. Failing to act assiduously in relation to seizure notifications made it more likely, in my view, that BAT's products would be resupplied to persons who are likely to smuggle. BAT's inadequate implementation of SERP – effectively, a failure adequately to investigate seizures – inevitably compromised its and HMRC's efforts to prevent supplies being made to persons who were likely to smuggle. In addition, there was nothing to suggest that it was not "reasonably practicable" to investigate seizures in a whole-hearted fashion.

582. I should add that I have considered whether BAT had a "reasonable excuse" for this aspect of their breach of the statutory duty, applying an objective analysis to BAT's particular circumstances which I have described earlier in this decision. In my view they did not have such an excuse. I could see no reasonable excuse for BAT's flawed implementation of SERP. Mr Olive's and Ms Udicki's comments did not seem justifiable on any objective basis and betrayed a failure to implement SERP in a diligent manner.

"Section 7B(2)(c) – action taken by BAT in relation to information supplied by HMRC under section 7A(4)"

583. The first point under this heading was a complaint by HMRC that it had seen insufficient evidence that BAT had taken steps to address the issues in relation to notifications to BAT under section 7A(4). HMRC noted that BAT had introduced a quota for supplies, but the quota had been based on the supplies BAT had already made and had increased between 2011 and 2013. HMRC did not consider this to be a targeted restriction of supply and, in HMRC's view, the amount supplied exceeded legitimate demand.

584. Effectively, this was a complaint that the amount of HRT supplied by BAT exceeded legitimate demand. As I have explained, I consider that HMRC underestimated legitimate demand, but BAT also overestimated legitimate demand.

585. In my view, therefore, a penalty based on this ground can only be partially justified.

586. The second point made by HMRC in the Initial Notice under this heading was that BAT's first tranche implementation of Track and Trace failed to take account of those countries identified by HMRC as high risk in relation to smuggling. HMRC understood that Track and Trace would not be implemented for those countries until 2016. Of course, when it issued the Initial Notice, HMRC had not been informed by BAT that it had decided in August 2013 to accelerate the implementation of Track and Trace in 2014. Consequently, because BAT introduced Track and Trace in April 2014, before the end of the Warning Period, no penalty would be justified on this ground.

"Section 7B(2)(d) – compliance by BAT with any notices supplied under section 7A(5)"

587. In the Penalty Notice, HMRC accepted that it did not have significant concerns under this heading and no penalty was assessed on this ground.

5 **"Section 7B(2) (e) – the number, size and nature of seizures of BAT products where HMRC has provided information about those seizures to BAT"**

588. Under this heading, HMRC took account of the notifiable seizures of HRT reported to BAT in the period 2011 to 2013. The number of seizures led HMRC to 10 conclude that BAT was not applying sufficient controls to deter smuggling of HRT in the Belux market. HMRC urged BAT to consider urgently bringing forward the introduction of Track and Trace to those countries specified by HMRC as being of concern (effectively Belux) so that BAT were able to provide the information required.

15 589. In my view, BAT had effectively addressed this concern by introducing Track and Trace by April 2014 and, thus, taking the corrective action proposed by HMRC. On this basis, I have concluded that no penalty should be imposed on this ground.

"Section 7B(2)(f) – compliance by BAT in relation to supplying information and documents to HMRC about seizures as set out in 20 the TPR 2001"

590. HMRC noted "serious failings" in BAT's compliance with the requirements set out in the TPR 2001. Specifically, HMRC noted that the information required to be furnished in respect of seizures of HRT in accordance with regulation 31 and the Schedule to the TPR 2001 was inadequate. HMRC summarised the failures.

25 591. In the Penalty Notice, HMRC noted that this failure had continued throughout the Warning Period but acknowledged that the introduction of Track and Trace technology should mean that the inability to identify the first wholesaler should be corrected for the future. HMRC criticised BAT's audit of its supplies to wholesalers in the Belux area stating that it was "beside the point." I think that BAT's focus on 30 supplies to its wholesalers was most likely the result of HMRC's own emphasis in the Initial Notice on BAT's failure to identify its first customer. In any event, whatever the reason may be, I have concluded that no penalty should be imposed on BAT on this ground on the basis that BAT had taken the necessary corrective action during the Warning Period.

35 **"Section 7B(2)(g) – demand for BAT's products for consumption outside the United Kingdom"**

592. HMRC considered that BAT was supplying HRT in amounts in excess of legitimate demand in the Belux market. HMRC's estimate of legitimate demand was 34 tonnes per annum but BAT's supplies amounted to several times in the year to 30 40 June 2013. HMRC noted that BAT had not supplied a detailed analysis of legitimate demand. Accordingly, HMRC was required to undertake "a robust examination of its calculation of legitimate demand, in particular taking notice of the seizures both

notified to BAT under this legislation and of others shared with BAT to demonstrate the interdictions carried out." HMRC required that the source of the calculation should be supported by independent evidence and not based on the supplies in previous periods.

593. This is, again, another concern regarding legitimate demand. BAT produced a detailed calculation of legitimate demand but HMRC were unable to agree with the assumptions made by BAT in the calculation.

594. BAT's detailed analysis of legitimate demand produced during the Warning Period was discussed at a meeting on 17 March 2014 attended by Mr Fehrensen and Mr Dickson. The parties failed to reach agreement on the underlying assumptions on which each other's estimate of legitimate demand was based.

595. As I have already concluded, BAT overstated legitimate demand and HMRC, in its calculation, under-estimated the legitimate demand.

596. I have already decided that one of Mr Fehrensen's key assumptions was not soundly based on independent evidence. I have therefore decided because BAT unjustifiably over-estimated legitimate demand a penalty for the breach of the section 7A(1) duty is justifiable on this ground, but in a lower amount than that assessed by HMRC. By supplying HRT into the Belux market in an amount in excess of legitimate demand, it was, in my view, more likely that BAT's products would be resupplied to persons who were likely to smuggle.

597. I should add that I have considered whether BAT had a "reasonable excuse" for this aspect of their breach of the statutory duty, applying an objective analysis to BAT's particular circumstances which I have described earlier in this decision. In my view they did not. BAT was aware that they were being asked to produce an analysis of legitimate demand based on independent evidence. One of Mr Fehrensen's key assumptions was not so based and seemed to me to be flawed. I could see no reasonable excuse for this error.

598. Finally, in my view, there was nothing to suggest that it was not reasonably practicable to calculate legitimate demand correctly, recognising that any such calculation would be imprecise.

"Section 7B(2)(h) – any other matters HMRC consider relevant for the issue of the initial notice under section 7B(1)"

599. HMRC noted that there were "currently no additional matters HMRC consider relevant." HMRC noted that if other matters did arise, HMRC would write to BAT and set these out in detail and, if necessary, issue another initial notice under section 7 B(1). Plainly, therefore, no penalty could be based on this ground.

600. Next, as I have indicated, I have taken into account actions taken by BAT in the Warning Period as required by section 7B(5). In particular, I have noted that BAT implemented Track and Trace (allowing it to trace its HRT products to the first customer), introduced SERP (albeit with defects noted above), made site visits to the

retailers identified in HMRC's Project Falcon report, undertook an audit of its Belgian wholesalers, produced a detailed analysis (albeit flawed) of legitimate demand, confirmed that it intended to ensure that anti-smuggling clauses were (and possibly were already) included in its contracts with wholesalers and indicated that it would shortly begin to pilot ACT with a Belgian wholesaler.

601. Save for the last point (the piloting of ACT and the more effective implementation of SERP), these were not, as Mrs Green stated in her oral evidence, "future promises" – a statement which she was later forced to retract. In my judgment, these are matters for which BAT should be given credit in assessing the amount of the penalty.

602. I have already discussed BAT's defective implementation of SERP during the Warning Period and see no reason to add to my comments.

603. Finally, I have taken into account the various representations made by BAT during the Warning Period and, in particular, the letter from Mr Belhomme dated 14 May 2014.

Decision – quantification of penalty

604. I have decided that BAT was in breach of its section 7A(1) duty in respect of two matters identified in the Initial Notice i.e. its failure to establish a fully effective SERP process which took the seizures notified to it sufficiently seriously and, secondly, over-estimating legitimate demand based on assumptions which were not independently verifiable.

605. Appendix B to the Penalty Notice set out the scoring criteria used for the issue of the penalty and explained the basis of calculation. HMRC's "scoring criteria" were based on section 7C(2). Appendix B listed nine factors each of which, in accordance with HMRC's guidance (it was unclear whether this guidance was published or was simply internal to HMRC), was allocated a maximum score depending on the perceived gravity of BAT's conduct. The maximum scores totalled 100 and the actual scores awarded to BAT were then totalled to produce a percentage which was then applied to the maximum permitted penalty of £5 million to produce the actual penalty amount.

606. I have considered Appendix B in detail. I have found Appendix B a confusing document. As well as setting out the scoring criteria, Appendix B also sets out what appear to be additional reasons justifying the imposition of the penalty. Some of those reasons are different from those set out in Appendix A which is supposed to be a statement, pursuant to section 7C(1)(b), of the grounds on which HMRC think that BAT has failed to comply with its statutory duty. For example, under Factor 1, HMRC stated that they "have seen minimal engagement of Senior Executives in this issue throughout the Warning Period." That was not a matter raised in Appendix A.

607. Appendix B referred to Appendix A to the Penalty Notice. Appendix A set out the grounds which HMRC took into account under section 7C in deciding to issue the

penalty. These factors used in Appendix B, as I have said, did not seem to me to be entirely consistent with the grounds for the penalty given in Appendix A with the result that it was not entirely clear the extent to which the grounds for the penalty translated into its quantification.

608. Mrs Hall argued that the same conduct could be taken into account under different headings of section 7C and that there was, therefore, no prohibition on double counting. Mrs Hall referred to the practice of criminal sentencing where the consideration of the same factor may be taken into account at various stages, both in culpability and harm in order to assess the seriousness of the offence. I would note in passing that this analogy did not sit well with HMRC's submission that the Penalty Notice was not a criminal charge for the purposes of Article 6 of the Convention. Be that as it may, Mrs Hall submitted that what was required was that the decision-maker must ensure that neither excessive nor insufficient weight is given to any particular factor.

609. It seems to me that Mrs Hall's approach is correct and that the same conduct may be taken into account under one or more of the matters in section 7C(2) to which HMRC must have regard. That said, I consider that it would be inappropriate mechanically to penalise the same conduct repeatedly simply because it potentially fell under different headings of section 7C(2).

610. The inadequate implementation of SERP was dealt with under Heading 2 of Appendix A and also under Heading 3. It was not clear to me to what extent there was an element of double counting in the "scoring" in respect of Factors 2 and 3, both of which "scored" BAT as 2 out of a possible 5. Those headings included a number of other matters which, as I have already stated, cannot form the basis of a penalty assessment. I have, therefore, reduced the "score" to 1 out of 5 in respect of Factor 2 which appears to be the main heading dealing with BAT's inadequate investigation of seizures. I have reduced Factor 3 to zero to because it seems to me that BAT's conduct in this regard has been appropriately penalised under Heading 2 and Factor 2.

611. Heading 8 of Appendix A dealt with the dispute regarding legitimate demand. In Factor 9 ("Any other matter HMRC thinks relevant") HMRC "scored" this issue at 2. In my view, because I have found that HMRC underestimated legitimate demand whilst BAT overestimated it, the appropriate action to take is to reduce the amount "scored" to 1.

612. Thus, on the method of scoring adopted by HMRC, BAT's score is 2 out of 100. This therefore produces a penalty of £100,000 and my decision is that the penalty of £650,000 imposed on BAT by the Penalty Notice should be reduced to £100,000.

Decision

613. Accordingly, for the reasons given above, BAT's appeal is allowed in part and the penalty imposed under section 7B(4) – 7C(1) shall be reduced to £100,000.

614. Although the result of my decision is that the penalty imposed on BAT should be substantially reduced, I trust that BAT will not derive undue satisfaction from the outcome.

615. There was no doubt in my mind that Mrs Green was justified in issuing the Initial Notice. BAT was lethargic, tardy and, in my view, reluctant to fulfil its obligations under the TPDA and the TPR 2001. I shall not repeat all the evidence, for example, about the late introduction of Track and Trace, the disorganised and unenthusiastic response to seizure notifications and BAT's somewhat over-optimistic estimate of legitimate demand (the details of which arrived late in the day), but it was hard to avoid the impression that BAT only took meaningful action when prompted and prodded by HMRC.

616. Although I have made a few criticisms of Mrs Green and have drawn attention to the defects in her Penalty Notice, I cannot refrain from observing that most of the improvements in BAT's compliance with its TPDA and TPR 2001 obligations were, in my view, attributable to her energetic and methodical approach to her responsibilities after she took up her post in January 2013.

617. Finally, I wish to express my gratitude to counsel and those instructing them for their helpful submissions and assistance in the efficient conduct of this appeal.

Rights of appeal

This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

GUY BRANNAN
TRIBUNAL JUDGE

RELEASE DATE: 14 FEBRUARY 2017

Appendix 1 – Initial Notice from HMRC to BAT dated 23 October 2013

Section 7B Tobacco Products Duty Act 1979 ("TPDA")

5

Penalty for facilitating smuggling: initial notice

Further to HM Revenue & Customs' ("HMRC") correspondence and meetings with British American Tobacco (Holdings) Limited ("BAT") in relation to its duty not to facilitate smuggling of cigarettes/hand-rolling tobacco ("HRT") into the UK (as set out in section 7A(1) TPDA), please treat this letter as a formal initial notice under section 7B(1) TPDA that HMRC is considering requiring BAT to pay a penalty. The background and details of the reasons for the issue of this initial notice are set out below.

All references to legislation below are to the TPDA unless otherwise indicated.

Background

As BAT is aware, legislation was introduced in October 2006 to prevent organised criminals from exploiting weaknesses in tobacco manufacturers' **("TMs")** supply chain controls. The legislation imposes various obligations on TMs such as BAT. In broad terms, BAT is required to conduct its business in a manner that ensures, so far as is reasonably practicable, that cigarettes and HRT manufactured by BAT (or on its behalf) are supplied in a manner that ensures that those products do not become available to smugglers. It also imposes a duty on TMs not to facilitate the smuggling of these products into the UK.

The legislation facilitates the sharing of information between HMRC and TMs in relation to:

(1) supply chains both in the UK and to countries/specific places outside the UK;

(2) seized HRT/cigarettes; and

(3) particular areas of risk for the purposes of providing a better understanding and early identification of smuggling risks in relation to HRT/cigarettes.

<u>The duty in section 7A(1) and matters HMRC is required to consider in issuing an initial notice under section 7B</u>

The TPDA and the Tobacco Products Regulations 2001 (S.I. 2001/1712, as amended by S.I. 2006/2368 (the "**TPR 2001**") impose specific requirements on TMs. It is the opinion of the HMRC team responsible for ensuring BAT complies with its duty under section 7A(1) that BAT has not met these obligations.

Section 7B requires HMRC to consider a range of factors when deciding whether to issue an initial notice. It does not require all of these factors to be present but that they have been considered. In order for BAT to understand why an initial notice has been issued, these areas of serious concern (including the evidence which demonstrates that the concern is justified) have been set out in detail below.

Section 7B(2)(a) & (b) – content of, and compliance with, BAT's written policy of steps taken to ensure compliance with section 7A(1)

While HMRC appreciates that an audit of BAT's written policy is still ongoing, HMRC is of the view that the policy does not meet the requirements of the legislation. In particular:

(i) BAT is unable to tell HMRC who the name and address of the first customer to whom it has supplied the cigarettes/HRT that have been manufactured by BAT.

Section 7D(4) confirms that HMRC is entitled to treat a parent company and its subsidiaries as a single undertaking. It is therefore not acceptable for BAT to treat supplies within its own corporate group as supplies to the first customer. The written policy must be altered to extend to the first customer outside the BAT corporate group.

(ii) BAT does not provide the information about the seized product(s) in accordance with the Schedule of the TPR 2001.

HMRC has provided BAT with all the information it sets out in its guidance (Public Notice 477) and the relevant legislation but no action is taken to establish where BAT's supply chain has been compromised. Although BAT's letter to me dated 18 July 2013 asserts that HMRC has not provided all the necessary information for BAT to carry out evaluations on its supply chain controls, HMRC's view is that all the necessary information has been provided, and of course our guidance is simply indicative of what we would aim to supply if it is available to us. This does not remove the obligation the legislation imposes on BAT to have a clear sight of the route to market of BAT's product(s).

(iii) BAT does not comply with its policy as it does not investigate or carry out any enquiries in relation to seizures of HRT/cigarettes.

HMRC's enquiries have revealed weakness within BAT's processes that prevent it from complying with its own SC policy. HMRC's view is that no individual or team has overall responsibility to carry out enquiries into qualifying seizures, as such there is no process in place. This view is supported by the fact that BAT currently take no action in respect of genuine cigarette/HRT seizures, despite these seizures being notified to BAT by HMRC. Jelena Udicki told me at a recent meeting, and confirmed later in the letter dated 18 July 2013, that BAT's Anti-Illicit Team only deals with counterfeit and illicit white cigarettes and its Security Team only deals with any breach of the policy whilst the HRT/cigarettes are under BAT's control, such as a

theft from a factory. It is HMRC's view that BAT does not consider genuine products that are smuggled back into the UK from abroad as an area of legitimate concern.

The letter of 18th July 2013 states BAT has plans to implement a Seizure Event Response but has not detailed any timeframe for doing so.

In HMRC's view, these circumstances demonstrate a lack of compliance on behalf of BAT with their own SC policy and steps need to be taken to address this. The Seizure Event Response (and a requirement in its policy for BAT to investigate seizures of its products) needs to be implemented and proved effective as soon as possible.

Section 7B(2)(c) – action taken by BAT in relation to information supplied by HMRC under section 7A(4)

Despite formal notification to BAT (in accordance with section 7A(4)) about specified products, brands and markets of concern), HMRC has seen insufficient evidence that BAT has taken steps to address these issues. HMRC acknowledges that BAT introduced a quota for supplies but that quota related to the supplies BAT had already made. These supplies have increased between 2011 and 2013[10]. HMRC does not consider this to be a targeted restriction of supply and the amount of the supply is, in HMRC's view, in excess of the legitimate demand for those products[11].

Furthermore, BAT's first tranche implementation of its track and trace system for certain tobacco products failed to take into account those countries identified by HMRC as high risk in relation to smuggling. HMRC understands that implementation of track and trace to these particular areas is not scheduled to be completed until 2016. This is too late and the track and trace system for these high risk areas needs to implemented as soon as possible.

Section 7B(2)(d) – compliance by BAT within any notices supplied under section 7A(5)

BAT has complied with any notices supplied under the provisions of section 7A(5) requiring the production of supply volume data. However despite several requests, BAT has not made the figures available to audit. Furthermore BAT have advised HMRC that the figures it has supplied are incorrect and has not as yet been able to explain why.

HMRC recommend that the requested audit of the compilation of the figures supplied is arranged as soon as possible and BAT investigates why its figures are believed to be incorrect and takes appropriate corrective action.

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[10] [Redacted]

[11] HMRC's estimate of legitimate demand for the year 2010 was for 34 tonnes. In the same period BAT supplied [redacted] tonnes.

Section 7B(2)(e) – the number, size and nature of seizures of BAT products where HMRC has provided information about those seizures to BAT

HMRC has considered the number, size and nature of the seizures of HRT manufactured by or for BAT. Although there was a reduction of notifiable[12] seizures of HRT in 2011/12, there was a significant rise of seizures from nine (9) to seventeen (17) in the period March 2012 to March 2013. In the period from March 2013 to August 2013 there have been six (6) seizures.[13] In HMRC's view, this demonstrates that BAT is not applying sufficient controls to deter smuggling of HRT in this market.

BAT should consider urgently bringing forward the introduction of the track and trace system to those countries specified by HMRC as being of concern so that BAT are able to provide the information required. An interim solution should be devised until this the track and trace system is available.

Section 7B(2)(f) – compliance by BAT in relation to supplying information and documents to HMRC about seizures as set out in the TPR 2001

There are serious failings in BAT's compliance with the requirements set out in the TPR 2001. Specifically, the information BAT is required to furnish to HMRC in respect of any seizures of HRT/cigarettes in accordance with regulation 31 and the Schedule is not adequate. In summary, of the 46 responses that were supplied by BAT to HMRC between August 2011 and April 2013 regarding those seizures, only three of the seven pieces of information required by paragraphs 4 – 10 of the Schedule to the TPR 2001 were supplied in those 46 responses. Certain pieces of information were also supplied after the time limit specified in regulation 31(2). A detailed breakdown of the responses and the information tested is enclosed at Annex B.

BAT has also failed to show who the first customer outside the BAT corporate group to which the supply of the relevant products was made on 31 occasions in accordance with paragraph 9 of the Schedule to the TPR 2001. BAT did not provide the date of invoice and total invoiced quantity of cigarettes/HRT on any occasion in accordance with paragraph 10 of the Schedule to the TPR 2001. In HMRC's view, BAT has not taken reasonable steps to provide all the information specified in paragraphs 4 – 10 of the Schedule to the TPR 2001.

BAT needs to supply all information/documents requested and as prescribed in the TPR 2001 going forwards.

Section 7B(2)(g) – demand for BAT's products for consumption outside the United Kingdom

HMRC considers that BAT is over supplying the legitimate demand for its HRT in the Belux market. HMRC's estimate in 2010 was that the legitimate demand for BAT's HRT brands in the Belux market was 34 tonnes per annum. BAT's supplies to the

[12] In the case of HRT this is seizures in excess of 50kg.

[13] See Annex A.

Belux market in the 12 months to 30 June 2013 amounted to 269 tonnes.[14] BAT has not been able to provide HMRC with any detailed evidence or analysis that shows how BAT has arrived at this level of demand for its HRT. Additionally, BAT has taken the decision to continue to increase its level of supply by the maximum allowed by the local authorities each year, despite HMRC providing evidence these products are returning to the UK as smuggled goods.

BAT should undertake a robust examination of its calculation of legitimate demand, in particular taking notice of the seizures both notified to BAT under this legislation and of others shared with BAT to demonstrate the interdictions carried out. The source of this calculation should be supported by independent evidence and not based on the supplies in previous periods.

Section 7B(2)(h) – any other matters HMRC consider relevant for the issue of the initial notice under section 7B(1)

There are currently no additional matters HMRC consider relevant. If other matters do arise, HMRC will write to BAT and set these out in detail and, if necessary, issue another initial notice under section 7B(1). HMRC would, however, draw to BAT's attention its concerns about the lack of firm timetables for implementing changes and the vagueness of some responses provided in its letter of 18th July 2013.

Time limits and penalty notice under section 7C

After the end of six months from the date of this initial notice, HMRC will issue BAT a further written notice setting out whether or not HMRC requires BAT to pay a penalty in accordance with section 7B(4).

During this period HMRC will continue to monitor any actions BAT take and the impact those changes have on its supply chain policy. BAT has the right to make representations on any grounds during this six month period. It would be very helpful for BAT to provide details of any steps it will take (including, but not limited to, any proposed timetable for implementing measures to improve BAT's written policy required under section 7A(2)(b)) and what BAT expects that to achieve so that this can be taken into account in HMRC's continuing discussions with BAT.

This initial notice gives warning that in six months from the date of this notice, HMRC will review the actions BAT has taken following the issue of this notice and make its decision as to whether or not to issue a penalty notice under section 7C. Any penalty must not exceed £5 million.

[14] An exercise conducted by HMRC analysts concluded that genuine UK cross border shoppers would generate a demand of 26 tonnes in 2010 and was based on information gathered from the International Passenger Survey conducted by the Office for National Statistics and BAT's domestic market share. It was further estimated that domestic Belux demand was for 6 tonnes and a further 2 tonnes would be legitimately consumed by other international travellers such as those from Ireland, by migrant workers and by cross border shoppers from other countries. The 2013 supply figures are provided by BAT in accordance with a notice to provide data.

Next steps

I have no doubt that you will wish to reflect on the contents of this initial notice and implement the points for action that have been outlined. I am, of course, happy to meet with you to discuss and work with BAT to make changes to improve its compliance with the supply chain legislation.

Appendix 2 – Penalty Notice from HMRC to BAT dated 5 June 2014

Dear Sirs

Section 7B and 7C Tobacco Products Duty Act 1979 ("TPDA")

Penalty for facilitating evasion: penalty notice

I write further to HM Revenue & Customs' ("HMRC") initial notice on 23 October 2013 (enclosed) (the "Initial Notice") to British American Tobacco (Holdings) Ltd ("BAT") in relation to its duty not to facilitate smuggling of cigarettes/hand-rolling tobacco ("HRT") into the United Kingdom (as set out in section 7A(1) TPDA).

This letter is a formal penalty notice to inform BAT that the Commissioners of HMRC have imposed a penalty under section 7B(4)(a) TPDA (the "Penalty Notice").

The grounds for the issue of the Penalty Notice are set out in Appendix A (as required by section 7C(1)(b) TPDA).

618. All references to legislation below are to the TPDA unless otherwise indicated.

Amount of the Penalty

As required by section 7C(1)(a), the amount of the penalty that the Commissioners of HMRC require BAT to pay is **£650,000**

The amount of the penalty has been determined according to published criteria in the HMRC Tobacco: Control of Supply Chains Manual which is available at:

http://www.hmrc.gov.uk/manuals/tobcscmanual/Index.htm.

The scoring criteria for the penalty applied to BAT for its failure to comply with its duty not to facilitate smuggling is provided in Appendix B to this Penalty Notice.

Right of Review/Appeal

If you do not agree with my decision to issue a penalty or the level of that penalty, you can:

ask for my decision to be reviewed by an HMRC officer not previously involved in the matter; or

appeal to an independent tribunal.

If you opt for a review you can still appeal to the tribunal after the review has finished.

If you want a review you should write to the decision maker at the above address within 30 days of the date of this Penalty Notice, giving your reasons why you do not agree with my decision. We will not take any action to collect the penalty while the review of the decision is being carried out.

If you want to appeal to the tribunal you should send them your appeal within 30 days of the date of this Penalty Notice.

You can find further information about appeals and reviews on the HMRC website http://www.hmrc.gov.uk/dealingwith/appeals.htm or you can phone the number on this letter. You can find out more about tribunals on the Tribunals Service website www.tribunals.gov.uk/tax/ or you can phone them on 0845 223 8080.

Yours sincerely

Sue Green (Mrs) CTA

Tobacco Supply Chain Manager

For, and on behalf of, HM Revenue & Customs

Appendix A

Grounds for issue of the Penalty Notice under section 7B(4)(a) (as required by section 7C(1)(b))

Background

As BAT is aware, legislation was introduced in October 2006 to prevent criminals from exploiting weaknesses in tobacco manufacturers' ("**TMs**") supply chain controls. The legislation imposes various obligations on TMs such as BAT. In broad terms, BAT is required to ensure, so far as is reasonably practicable, that cigarettes and HRT manufactured by BAT (or on its behalf) are supplied in a manner that ensures that those products do not become available to smugglers. It also imposes a duty on TMs not to facilitate the smuggling of these products into the United Kingdom.

The legislation facilitates the sharing of information between HMRC and TMs in relation to:

(i) supply chains both in the United Kingdom and to countries/specific places outside the United Kingdom;
(ii) seized HRT/cigarettes; and
(iii) particular areas of risk for the purposes of providing a better understanding and early identification of smuggling risks in relation to HRT/cigarettes.

HMRC Large Business ("**HMRC LB**") is the primary interface between HMRC and the TMs in relation to assuring supply chain policies and is the decision maker responsible for calculating and issuing any penalty.

The duty in section 7A(1) and matters HMRC is required to consider in issuing a penalty notice under section 7C

The TPDA and the Tobacco Products Regulations 2001 (S.I. 2001/1712, as amended by S.I. 2006/2368 (the "**TPR 2001**")) impose specific requirements on TMs. It is the opinion of the HMRC LB that BAT has not met these obligations and, despite the issue of the Initial Notice, has still failed to meet these obligations.

Section 7C requires HMRC to consider a range of factors when deciding whether to issue a penalty notice. In order for BAT to understand the decision to issue the Penalty Notice, the range of factors and evidence that HMRC has considered in relation to BAT's failure to meet these obligations is set out in detail below.

1. Section 7C(2)(a) – the nature and extent of BAT's failure to comply with the duty under section 7A(1)

The duty in section 7A(1) can be summarised as follows:

That a TM shall so far as reasonably practicable avoid:

- supplying cigarettes or HRT to persons who are likely to smuggle them into the United Kingdom.
- supplying cigarettes or HRT where the nature and circumstances of the supply makes it likely that they will be resupplied to persons who are likely to smuggle them into the United Kingdom.
- Otherwise facilitating smuggling into the United Kingdom.

BAT has been made aware of the significant concerns HMRC has with the nature and circumstances of BAT supplies of its products which make it likely that those products are being made available to smugglers. HMRC has notified BAT of its concerns about specific products from specific markets being smuggled into the

United Kingdom by virtue of the notices issued to it under section 7A(4), the most recent notice being issued on 9 December 2013. BAT product continues to be seized at all United Kingdom borders but most significantly at the Channel Ports and from people travelling to the United Kingdom from Belgium/Luxembourg.

5 In the Initial Notice, BAT was made aware that HMRC believed BAT was failing in its obligation to have a robust supply chain policy. A number of concerns were raised in the Initial Notice. In summary, the most significant concerns were as follows:

A. The written policy (required under section 7A(2)(b)) was defective in that it employed no mechanism to enable BAT to trace the point at which their product had 10 entered the illicit market and been smuggled into the United Kingdom nor did it contain a mechanism to adequately investigate seizures where HMRC had provided information on those seizures.

B. BAT was unable to comply with its obligations under the TPR 2001 to provide the information required to identify its first customer outside the BAT group of 15 companies.

C. BAT took no specific actions to counter the significant threat posed by the markets for HRT in Belgium and Luxembourg ("**Belux**") despite HMRC providing information to BAT both in notices, correspondence and the Initial Notice about these threats.

20 D. The supply of BAT HRT to the Belux market is significantly in excess of HMRC's estimate of legitimate demand in that market.

In addition to details of notifiable seizures given to BAT under section 7A(7)(a), HMRC has provided a variety of additional information during 2013/14 to assist BAT in identifying how its product(s) for the Belux market had entered the illicit market 25 and subsequently been smuggled. This information includes the following:

1. The report from Project Falcon[15] which demonstrated that retailers appeared to be facilitating smuggling by making multiple successive supplies to purchasers to help disguise the fact that they were purchasing over the indicative limits for own use 30 ("**MILs**") as set out in the Excise Goods (Holding, Movement and Duty Point) Regulations 2010.[16]

2. In May 2013, HMRC formed a team to debrief tobacco product seizures and gather additional intelligence information. This activity included seizures below the notifiable limit and seizures made outside the United Kingdom (but destined for the

[15] Project Falcon was designed to explore the risk posed by smuggling of genuine product into the United Kingdom. It identified that groups of people were acting together to repeatedly bring quantities in excess of the MILs but below what would be recognised as commercial quantities into the United Kingdom to be used on the illicit market.

[16] Regulation 13(4)(h).

United Kingdom). HMRC LB has shared reports of this additional information with BAT. Between 20 May 2013 and 10 April 2014, HMRC LB has shared 19 such reports with BAT. These reports covered a total of 909kg of Cutters Choice and 66kg of Samson[17], although HMRC accepts that BAT has not had the opportunity to confirm the authenticity of seizures which were below the notifiable threshold or which were made overseas. HMRC, however, notes that of the seizures made above the notification threshold between 2011/12 and 2013/14 none of these brands were found to be counterfeit.

3. An analysis was conducted of the seizures of HRT below 50kg and the outcome of this analysis was shared with BAT.[18]

4. An analysis was also conducted of the non-notified seizures of cigarettes. This was also shared with BAT.[19]

5. HMRC undertook an audit of the governance around BAT's supply chain policy in 2013. Following on from this, a number of recommendations were made to BAT by HMRC in letters dated 22 October 2013 and 12 December 2013. The recommendations covered a number of areas including: (i) BAT's 'Know Your Customer' policy; (ii) the response and investigation of seizures; (iii) the Anti-Illicit Trade strategy document for Belux; and (iv) the Cutters Choice sales plan. Potential weaknesses were highlighted to BAT and improvements suggested by HMRC.

2. Section 7C(2)(b) – action taken by BAT to secure compliance with the duty under section 7A(1)

All the points of concern at points A - D under Heading 1 above were explored with BAT during 6 (six) months following the issue of the Initial Notice (the "**Warning Period**") in both written correspondence and face-to-face meetings.

At each face-to-face meeting, BAT made a presentation and made notes of the discussions at those meetings which have been agreed with HMRC. At the end of the Warning Period, HMRC have concluded that the present position against each point in Heading 1 is as follows:

A. The supply chain policy still fails to deliver a solution that allows BAT to identify where the products were obtained by smugglers. BAT is considering second level tracking (i.e. from wholesaler to retailer) and has a four week trial planned but it has no intention of requiring wholesalers to participate or requiring second level tracking that would allow BAT to exert any proper and fit-for-purpose supply chain control.[20] Although BAT did bring forward the planned implementation date of their track and

[17] Cutters Choice and Samson are brands of HRT/fine cut tobacco manufactured and supplied by BAT.

[18] Letter dated 19 February 2014.

[19] Letter dated 1 April 2014.

[20] See letters dated 6 April 2014 and 15 April 2014 from BAT.

trace technology in Belux from 2016 to 2014 and the new system (which went live during April 2014) enables BAT to see which first **wholesaler** handled any product that is subsequently seized as a result of smuggling, BAT is still unable to determine to whom its products have been supplied **throughout** its supply chain.

5 Since the issue of the Initial Notice, BAT has introduced a process to investigate seizures (Seizure Event Review Process (the "**SERP**")) but the examples of investigations carried out under this process [21] do not demonstrate any level control of their supply chain and show them to have no impact. The investigations did not take place until many months after the seizure and in all cases, the investigations
10 concluded that BAT was unable to establish to whom the product was supplied and where their product was supplied to smugglers. For example, in relation to a seizure E 3745165 of 80kg of HRT, BAT indicated that it was not possible to determine whether the purchase had been made for the customers own use or as a gift. It is HMRCs reasonable estimation that 80kgs of HRT would last a single average smoker
15 20 years, so it is difficult to see how BAT can conclude that it may have been for own consumption or as a gift when the average shelf life of the product is no more than 12 months.[22] Ms Udicki does say in her letter of 15 April 2014 that her colleague Mr Olive has been told that he must better describe what he has done and use the intelligence derived but HMRC have seen no evidence of this being achieved. As a
20 result, HMRC has seen no evidence of a fully operable procedure in place for investigation of seizures, or any corrective action identified or taken as a result of investigations made. Of the four notified seizures made during the Warning Period, HMRC have seen no successful investigation reports.

B. This failure has continued throughout the Warning Period but the introduction of
25 the track and trace technology should mean that this inability even to identify the first wholesaler is corrected (it is hoped) for the future, even though there will be no track and trace beyond that first wholesaler until such time as such required by the Tobacco Products Directive (see below). During the Warning Period, BAT shared with HMRC the results of an audit in to supplies to wholesalers in the Belux area. The audit
30 concluded that all supplies made to wholesalers had been accounted for as sales to retailers. This is beside the point. There has not been any suggestion from HMRC that wholesalers were releasing product on to the illicit market. HMRC is of the view that this audit failed to provide any meaningful assurance that BAT is taking any, or any material, supply chain measures to ensure that retailers do not, so far as possible,
35 sell tobacco products to smugglers. HMRC therefore concludes that this action did not do anything to address the weaknesses identified in BAT's control systems and, consequently, its supply chains.

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[21] Reports in to seizure E3745165 of 80kg Cutters Choice made at the Channel Tunnel made on 20/3/13, notified to BAT on 9/4/13, investigation initiated on 15/11/13 and concluded on 17/12/13 and E3898092 of 300kg of Cutters Choice seized at Dover on 19/5/13, notified to BAT on 09/7/13, investigation initiated on 15/11/13 and concluded on 17/12/13.

[22] 0.4g per roll up (assumption of 26 smokes a day) gives weekly consumption of 75g which makes 80kg last 20 years. HMRC believes that actual consumption is nearer 12 per day so this would be nearer 40 years worth.

C. As described above BAT have undertaken a series of meetings with wholesalers and retailers[23] to raise awareness of BAT's Anti Illicit Trade (AIT) messages. As far as HMRC are aware this is the first time BAT has undertaken such activity, even though the other major TMs have been carrying out retail engagement for many years. Although this is a step in right direction HMRC consider that the activity falls short of what can be reasonably expected in relation to supply chain control. The nature of fraud in HRT has been set out by HMRC in detail, i.e. criminals purchase large volumes of products through multiple purchases from retailers supplied by wholesalers in the markets concerned. BAT does not dispute that but consider there is no action they can legally take in relation to influencing the relationship between wholesaler and retailer.

Ms Udicki's letters of 4 April 2014 and 15 April 2014 conclude that BAT will consider two measures: (i) asking wholesalers (not retailers) to introduce 'Know Your Customer' process; and (ii) a process to ask retailers to notify any commercial (as opposed to private) sales, which they advise is a facility enabled under Belgian domestic VAT legislation but will not or cannot commit to any other measures.

Whilst these changes would be welcome, they will not assist BAT in preventing their product from entering the illicit market and fall short of the preventive control actions taken by the other TMs. HMRC assess that failure to implement similar level of controls into the relationship between BAT and their wholesale customers (as other TMs have done) represents a failure to take reasonable steps to avoid the resupply of products for smuggling as required by the legislation.

D. BAT has now shared with us their calculation of legitimate demand for its products in the Belux market. This issue is explored in more detail in Heading 8 below.

3. *Section 7C(2)(c) and (d) – the content of, and the compliance with, BAT's policy under section 7A(2)(b)*

It remains HMRC's view that BAT's supply chain policy is fundamentally flawed as it does not contain any mechanism to identify and investigate where its products have entered the illicit market and subsequently smuggled into the United Kingdom.

The SERP is only a trial and HMRC have not seen it produce any meaningful results. The initial results simply show its ineffectiveness as all review examples shared have concluded BAT do not know who they sold the products to and therefore cannot identify the point of diversion on to the illicit market.

BAT's Anti-Illicit Trade Team (which is provided for in BAT's written policy), unlike their counterparts at all their major competitors, are only concerned with counterfeit product and illicit white cigarettes. Discussions between BAT and HMRC have indicated that BAT have not engaged in tackling the availability of genuine

[23] Presentation from BAT on 14 January 2014 details the retailers selected and the purpose of those meetings.

product in the illicit market and, as a consequence, tackling smuggling by policing its supply chains robustly.

Towards the end of the Warning Period, HMRC LB set out four questions to BAT to understand how the changes they had made were going to improve their supply chain policy[24]. BAT's responses to HMRC LB's questions confirm the BAT will tackle seizures where their product(s) that have been found on the illicit market are higher than BAT expected. HMRC would expect that BAT would investigate all seizures of their product(s) regardless of whether or not those seizures were higher than BAT expected.

These letters also confirm that BAT is not intending to require their wholesalers to participate in second level track and trace as they feel that the introduction of the revised Tobacco and Related Products Directive will take care of this issue. That Directive is not expected to be implemented for several years. BAT also conclude that it is not necessary for them to make any amendments to their supply chain policies as, in BAT's view, those policies are robust enough.

4. ***Section 7C(2)(e) – action taken by BAT following notifications from HMRC of high smuggling risks in relation to products: (i) marketed under a specified brand name; (ii) supplied to persons carrying on business in or in relation to a specified country or place as set out in section 7A(4)***

HMRC are not aware of any specific actions BAT have taken in response to letters issued under this provision[25]. When this has been raised in discussions, the indication from the BAT core team is that (other than advising the market concerned), no additional action is taken as they operate global policies and systems and would not vary them for one jurisdiction. That view is not consistent with, or compliant with, the obligations set out in this section of the TPDA.

5. Section 7C(2)(f) – compliance by BAT in relation to supplying to HMRC specified information about: (i) the supply of products marketed under a specified brand name; (ii) supply to persons carrying on business in or in relation to a specified country or place; (iii) demand for cigarettes or HRT in a specified country or place as set out in section 7A(5)

HMRC does not have significant concerns with BAT's compliance with subsections (i), (ii) and (iii) in this heading. There are occasional errors and delays in supplying the information but these are dealt with promptly by Ms Udicki (BAT's AIT Relationship Manager). If BAT anticipates that a deadline will be missed, HMRC is warned in advance and a revised date proposed.

6. ***Section 7C(2)(g) – the number, size and nature of seizures of which BAT has been given notice by HMRC under section 7A(7)(a)***

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[24] Ms Udicki's letters of 4 and 15 April 2014.

[25] The most current notice, issued on 9 December 2013, is attached for reference.

An updated annex of all notified seizures is attached at Appendix C to this Penalty Notice. There were a further four notified seizures made during the Warning Period totalling 254kg of HRT and 283,180 cigarettes

In addition to the seizures notified, there were also seizures of Cutters Choice and 5 Samson totalling 1,895kg made during the Warning Period. Whilst it is accepted that BAT have not been able to examine the product to confirm it is genuine, the source and nature of the seizures leads HMRC to conclude that the majority of those seizures are of genuine product.

7. ***Section 7C(2)(h) – the loss of revenue by way of duty under section 2, or VAT,*** 10 ***in respect of products seized***

Duty and tax losses on notified seizures are calculated to be £59,944 for the HRT and £86,936 for the cigarettes.[26]

The duty and tax loss on 1,895kg of small seizures referred to in Heading 6 above amounts to £447,220.

15 8. ***Section 7C(2)(i) - any other matter HMRC thinks relevant***

Calculation for legitimate demand

HMRC have considerable concerns with the assumption made in the BAT's calculation for legitimate demand for HRT[27] in the Belux market. These points were 20 explored in detail at the meeting of 17 March 2014 and recorded in the agreed minutes of that meeting. That meeting was attended by statistical experts for both BAT and HMRC (as well as core team members from both parties) and BAT presented its rationale for arriving at its estimation of legitimate demand.

HMRC estimates that **legitimate** demand for Cutters Choice[28] in 2012 is around 37 25 tonnes whereas BAT supplied [redacted] tonnes in the same period[29].

There are a number of assumptions made by BAT which HMRC consider to be fundamentally flawed and therefore have led BAT to arrive at a significantly inflated figure for that legitimate demand. HMRC believe that the assumptions BAT has made during its calculations cannot be supported by independent evidence whereas 30 HMRC's calculations use evidence such as the passenger surveys conducted by the Office of National Statistics (ONS). As a consequence of using this figure, BAT is facilitating smuggling of HRT into the United Kingdom by allowing its product(s) in excessive quantities that, in HMRC's view, does not reflect the legitimate demand for those products.

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[26] Calculated at £307 per 1000 sticks and £236 per kg of HRT.

[27] Also referred to in BAT papers as "fine cut tobacco".

[28] Cutters Choice is a brand of HRT/fine cut tobacco manufactured and supplied by BAT.

[29] Increasing to [redacted] in 2013.

The assumptions (which, in HMRC's view are incorrect) made by BAT are as follows:

(i) BAT estimates that an average 'roll your own' (RYO) stick contains 0.8g of tobacco. On its analysis, HMRC consider it is 0.4g. It is HMRC's view that BAT is erroneously using the conversion rate in the EUCA agreement to allow comparison of HRT to cigarettes rather than the amount of tobacco actually used by smokers.

(ii) BAT's calculation assumes that 30% of smokers who cross the English Channel with an intended destination of France divert to Belgium to buy HRT or fine cut tobacco/cigarettes. This assumption includes all passengers on the Eurostar trains who had a return ticket to Paris or even Euro Disney.

(iii) The assumption that cross-border shoppers buy, on average, 2.5 kilograms of HRT each time they purchase HRT/fine cut tobacco in Belux. This is more than double the United Kingdom indicative limit for personal use of 1 kilogram (which would cost in excess £100).[30]If it is accepted that the majority of people who engage in cross-border shopping adhere to the indicative limit of 1 kilogram, it is reasonable to conclude others will purchase HRT/fine cut tobacco vastly in excess of this limit which is a clear indication of smuggling.

(iv) BAT assumes that 26% of all visitors to Belgium from the UK purchase HRT/fine cut tobacco. This needs to be seen against BAT's own estimate of a HRT smoking incidence of 9.5% in the United Kingdom. The UK resident visitor numbers to Belgium would, of course, include all visitors travelling to and from Brussels on business by air and train, typically markedly more expensive modes of travel that are likely to be inconsistent with the profile of a genuine cross-border HRT shopper.

BAT's reliance on such assumptions has (in HMRC opinion) led to inflated estimates of legitimate demand and an over-supply of their products to the Belux market. A consequence of so doing has to present a purported legitimacy for the level of supply to the specified markets that is not justifiable. In doing, so BAT claim justification for a failure to take corrective action in these specified markets. The unsupportable premise for the level of supply to these markets and consequent inaction serves to facilitate the continued smuggling of HRT into the United Kingdom.

On 19 February 2014, HMRC sent BAT details of seizures made which are below the 50kg HRT/100,000 sticks notifiable limits[31]. HMRC's letter explained that details of the brand are not recorded against all seizures, especially where multiple brands are made from a single passenger so that this was only a proportion of the seizures made. It does, however, demonstrate that significant seizures are made of product that HMRC considers was destined for the illicit market:

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[30] Cutters Choice generally retails for around €5.20 per 50g pouch in retail outlets in Belgium.

[31] Letters dated 19 February 2014 and 1 April 2014.

(1) In respect of HRT, it demonstrated that between April 2013 and November 2013, a total of 1,931kg of Cutters Choice was seized in 282 seizures and 334 kg of Samson was seized in 98 seizures. The letter goes on to provide more detail on the nature of the seizures and the source of the product. The vast majority are from the near continent.

(2) Whilst it is accepted that there is a small possibility that products seized from some countries could be counterfeit, the nature and type of seizures leads HMRC to conclude that a significant proportion is genuine product that has been obtained by person(s) who smuggled it into the United Kingdom. As it was seized and not restored, it was illicit product and therefore the controls BAT had over these products failed.

'Little and often' smuggling

BAT do not consider organised "little and often" smuggling as a threat to their supply chain as confirmed by BAT in their letter of 15 April 2014. It is recognised during the Warning Period that BAT has now engaged with the majority of the retailers in the Adinkirke area of Belgium to highlight HMRC concerns and to ask them to display leaflets provided by BAT confirming the MILs. During one of these meetings, one retailer confirmed selling practices that HMRC believe facilitates smuggling and mirrored those evidenced in the Project Falcon report. BAT was challenged in the meeting of 18 February 2014 to suspend supply of their product to this retailer but BAT stated they are unable to do so. BAT also offered no proposals to change the behaviour of this retailer.

Appendix B

Scoring criteria for the issue of the penalty and basis of calculation

Factor 1: The nature and extent of the breach of duty not to facilitate smuggling

See Heading 1 in Appendix A to this Penalty Notice.

(HMRC Guidance states: Score 1 – 25 where there is no breach of duty, no points should be applied and a penalty should not be issued. A score of 25 would indicate a gross and blatant breach of duty).

Despite the presentation of targeted and detailed evidence by HMRC to BAT of seizures and issues in particular supply chains, it is HMRC's opinion that BAT have done little of substance to alter the 'extent' and 'nature' of their supplies to the Belux market and absence of a response has directly led to the smuggling of these products into the United Kingdom. BAT had applied limited resources to supply chain control issues. HMRC have seen minimal engagement of Senior Executives in this issue throughout the Warning Period. It is also HMRC's view that BAT has unrealistic estimates of legitimate demand for its products in the Belux market.

There is sporadic and ineffectual interaction with HMRC on notifiable seizures as there are no systems to identify where product has been diverted. Smuggling activity can be linked to direct supplies from first and second customers.

Score: 4

5

Factor 2: The action BAT has taken to ensure they have complied with that duty

See Heading 2 in Appendix A to this Penalty Notice.

10 *(HMRC Guidance states: Some action, but not comprehensive, score up to 5. Little or no action, score up to 10).*

Whilst HMRC acknowledge that BAT has bought forward its implementation of track and trace, that it in itself is not a solution or effective in BAT discharging the duty under section 7A(1) and it would appear that BAT are reluctant to take any further 15 action.

Score: 2

Factors 3 and 4: The content of BAT's written supply chain policy (Factor 3), and compliance with that policy (Factor 4) required under section 7A(2)(b)

20 See Heading 3 in Appendix A to this Penalty Notice.

(HMRC Guidance states: A score of 0 would be appropriate if we are satisfied that the manufacturer has taken all reasonably practicable steps to comply with his duty and we would not issue a penalty. A maximum score of 15 would indicate a policy not 25 *fit for purpose and / or not being followed).*

The policy remains silent on some key areas as highlighted in Heading 3 of Appendix A above.

Score: 2

30

Factor 5: The action BAT has taken in response to specified brands and countries where smuggling risks have been identified in the Initial Notice

See Heading 4 in Appendix A to this Penalty Notice.

35 *(HMRC Guidance states: Where all reasonable controls are already in place, or a manufacturer takes positive action to ensure that they are implemented in the future score 0, fails to respond to the additional risks, score up to 5).*

BAT has taken minimal specific action about supplies to the Belux market.

40 **Score: 2**

Factor 6: Supply of the required information by BAT to HMRC on the specified brands and countries where smuggling risks have been identified in the Initial Notice

See Heading 5 in Appendix A to this Penalty Notice.

(HMRC Guidance states: manufacturer has made every reasonable effort to comply with the information requirements score 0, manufacturer has not provided the information without reasonable excuse, or has failed to take steps to ensure its future availability, score up to 5).

Score: 0

Factor 7: The number, size and nature of notified seizures of BAT cigarettes/HRT

See Heading 6 in Appendix A to this Penalty Notice.

*(HMRC Guidance states: In the 6-month period since the issuing of an initial notice, there have been * between 1 and 50 notified seizures score up to 5, * There have been over 50 notified seizures, score up to 10).*

Four notifiable seizures were made during the Warning Period.

Score: 1

Factor 8: The potential loss of excise duty and VAT on notified seizures during the 6 month period following the issue of the Initial Notice

See Heading 7 in Appendix A to this Penalty Notice.

(HMRC Guidance states: £1 to £3 million score up to 5, over £3 million to £6 million score up to 10, over £6 million score up to 20).

Score: 0

Factor 9: Any other matter HMRC thinks relevant

See Heading 8 in Appendix A to this Penalty Notice.

The calculation of legitimate demand has numerous assumptions (without any evidence base) that lead BAT to conclude that the legitimate demand is higher than it is which enables excess product to be available for smugglers to purchase.

Score: 2

Total: 13/100

Penalty calculation

The full penalty calculation is expressed as:

£5 million x (score/100) =	base penalty
base penalty +/- factor 9 =	final penalty

Final penalty payable: **£650,000**

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