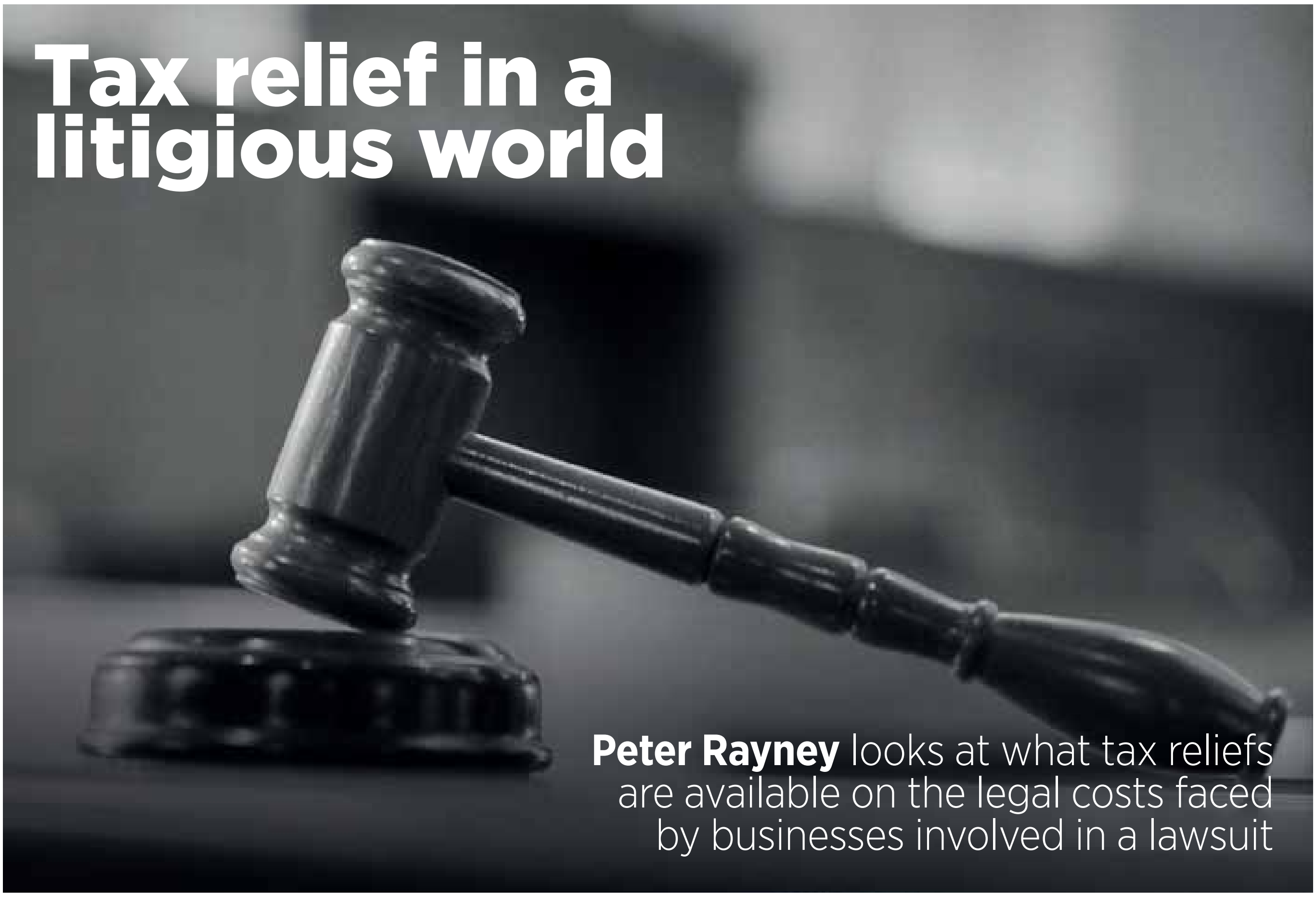
Tax relief in a litigious world



Peter Rayney looks at what tax reliefs are available on the legal costs faced by businesses involved in a lawsuit

We live in an increasingly litigious world, which can be expensive for businesses on the wrong end of a criminal or civil lawsuit. Tax jurisprudence does not generally help the taxpayer. In the majority of decided cases, the courts have prevented these legal or compensation costs from being tax-deductible expenses of the trade.

As a general rule, it might only be possible to claim relief for payments relating to a breach of the law that has been committed in carrying out the relevant trading activity – for example, the payment of damages for libel by a publisher. Similarly, compensation payments made to customers will normally be allowed since they are considered to be non-punitive.

Where GAAP-compliant year-end provisions for such compensation payments have been recorded in the accounts, these should also be deducted for tax purposes (since the expense will be treated as having been incurred).

KEY LEGAL PRINCIPLES

The main legal hurdles that must be overcome to establish a claim for tax relief are found in s54, Corporation Tax Act 2009, or for unincorporated businesses, s34 Income Tax (Trading and Other Income) Act 2005. These rules prevent expenses from being deducted against a company's trading profits if:

- they are not incurred wholly and exclusively for the purposes of the trade; or
- they represent losses not connected with or arising out of the trade.

Consequently, if an expense is incurred for more than one purpose, with only one of the reasons being for trading objectives, it follows that the expense cannot be incurred wholly and exclusively for trading purposes. This 'duality of purpose' rule first emerged in *Strong and Company of Romsey Limited v Woodifield* (1906) 5 TC 215 and tends to cause most of the difficulties in this area.

Perhaps one of the most important precedents is found in *Fairrie v Hall* (1947) 28 TC 200, which involved the tortious act of libel. This case involved a sugar broker (F) who worked as a sales agent for a Cuban company, and a Ministry of Food official (R) who was connected with a rival company. F made libellous comments about R, stating that he abused his position as a Ministry of Food official to further the interests of the rival company. R took legal action and F had to pay damages for his malicious libellous actions. F's claim to deduct the damages payment failed since it was not incurred wholly and exclusively for the purposes of his sugar-broking trade. Justice Macnaghten held that such payments cannot be deducted because: "The loss fell upon the appellant in this case in the character of a calumniator of a rival sugar broker. It was only remotely connected with his trade as a sugar broker."

FINES AND PENALTIES

A number of early cases – *CIR v Alexander von Glehn & Co Ltd* (1920) 12 TC 232 and *CIR v E C Warnes and Co Ltd* (1919) 12 TC 227 – laid down the principle that fines or penalties incurred for infractions of the law were disallowable for tax purposes. The general supposition was that such costs were not connected with and did not arise from the carrying on of the trade but arose from infringing the relevant laws and regulations.

In *McKnight v Sheppard* (1999) 71 TC 419, the reasoning seems to have been articulated into a matter of public policy. Mr Sheppard (S) worked as a stockbroker and incurred legal costs of some £200,000 in defending himself on various charges before the Stock Exchange's disciplinary and appeal

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committees. The appeals committee set aside the disciplinary committee's suspension order and instead levied fines of £50,000.

The House of Lords concluded that the Special Commissioner and High Court were right to refuse relief for the £50,000 fine. Lord Hoffman considered that this was due to the legal nature of a fine or penalty: "Its purpose is to punish the taxpayer and a court may easily conclude that the legislative policy would be diluted if the taxpayer were allowed to share the burden with the rest of the community by a deduction for the purposes of tax."

Many tax lawyers would not necessarily agree with this 'legislative policy' argument. If a penalty or fine is incurred directly in the course of carrying out the trading activities, then there are good reasons for allowing it as a deductible trading expense.

DAMAGES

Case law tells us that compensatory damages incurred "wholly and exclusively" in the course of a trade will normally be tax-deductible. For example, the High Court of Australia in *The Herald and Weekly Times Ltd v The Federal Commissioner for Taxation* (1932) 48 CLR 113 held that damages for defamation were allowable expenses wholly and exclusively laid out for the purposes of the newspaper's business. Similar compensatory costs in bringing to an end or altering a trading relationship will also be deductible (*G Scammell & Nephew Ltd v Rowles* CA (1939) 22 TC 479).

However, in future, it is likely that banks and similar financial businesses will be faced with a statutory prohibition on deducting customer compensation payments for mis-selling and misconduct fines (see the Treasury's March 2015 consultation paper *Consultation on restricting tax relief for banks' compensation expenditure*).

THE MCLAREN RACING CASE

In practice, there can be difficulties in demonstrating a sufficiently strong trading connection, as shown in the case of *McLaren Racing Ltd v HMRC* [2014] UKUT 0269 (TCC).

McLaren Racing (M) owned the motor racing team that competed in the Formula 1 championship. The Federation Internationale de l'Automobile (FIA) found that M's employees and agents had obtained and "in some way used" proprietary documents belonging to a rival motor company (Ferrari). This contravened the rules of the International Sporting Code. Consequently, the FIA levied a penalty fine of some £32m for breach of competition rules; M also lost its prize money.

The Upper Tribunal (UT) upheld HMRC's claim that the £32m fine was not an allowable deduction against M's trading profits. It concluded that M suffered the penalty for cheating and this was deemed to fall outside the company's trading activities. Thus, it held that the First-tier Tribunal's (FTT) findings of fact were incorrect and wrong in law.

M contended that it paid the penalty to continue its participation in the Formula 1 championship. However, this argument was dismissed by the tribunal which held that M had another reason for paying the £32m fine, which was to discharge contractual duty to pay it after the disciplinary hearing. This contractual duty arose outside the activities of M's trade. Consequently, M did not incur the fine wholly and exclusively for its trading purposes.

> Relief will be denied if the payment is seen as a punishment or legal penalty for infringing the law

The tribunal's reasoning is a little hard to follow and it is worth noting that many tax commentators disagree with its conclusions (for example, see Keith Gordon's article *Another fine mess?* in *Tax Adviser*, December 2014). Many would reasonably argue that these fines were incurred as an inherent risk of the trade. They were levied because of the actions of M's employees and because of the way in which the information was used.

LEGAL COSTS

The deductibility of legal costs associated with the relevant action will frequently follow the tax treatment of the compensation payment or fine.

However, in the *McKnight v Sheppard* case, the House of Lords unanimously held that the legal expenses had been incurred wholly and exclusively for business purposes and were therefore deductible (even though the fines were not, as described previously). The rationale was that S had incurred the legal costs exclusively to preserve his trade rather than to protect his personal reputation. Their Lordships distinguished between the purpose and effect of S's expenditure. They found that the personal advantage that a successful defence would have had for S's personal reputation was an effect of incurring the expenditure rather than a purpose. However, HMRC's manuals indicate it does not necessarily agree with this analysis (see the *Business Income Manual* at BIM37965).

On the other hand, in *Paul Duckmanton v HMRC* [2013] UKUT 0305 (TCC), the finding of facts went the other way. Mr Duckmanton (D) carried on a car transporter business. One of D's car transporters was involved in a road accident and killed a pedestrian. D was charged with gross negligence, manslaughter and two counts of attempting to pervert the course of justice. He admitted some maintenance records had been falsified to conceal his failure to keep up with a mandatory maintenance programme.

Although D was eventually acquitted of gross negligence and manslaughter, he failed to obtain a trading deduction for his legal and other professional defence costs totalling £268,672. The UT upheld the FTT decision and determined that it would "defy common sense not to conclude" that D's main purpose in incurring the expenditure was to protect his liberty and personal reputation. Consequently, the relevant costs were not incurred wholly and exclusively for the purposes of his trade.

FINAL THOUGHTS

The above case law shows that the ability to obtain trading deductions for penalties, legal fines and compensatory payments is completely dependent on the precise construction and interpretation of the facts of each case.

Relief may be obtained if HMRC or an appellate tribunal can be convinced that the damages payment was incurred as a normal incident of the trading activities. On the other hand, relief would be denied if the payment was seen as a punishment or legal penalty for infringing the law.

While I have no inside knowledge of the details relating to BP's \$18.7bn (£11.9bn) environmental fine which was paid to settle legal actions over the fatal 2010 Gulf of Mexico oil spill, it will be interesting to see whether BP's (likely) claim for tax relief emerges as a contested case. In my view, the UT analysis in the *McLaren* case might prove to be unhelpful to BP's tax advisers!

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