Terminator 2

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Keith Gordon looks at a case which considers the tax treatment of payments made to terminate a commercial contract

Key Points

What is the issue?

The current Coronavirus crisis is likely to have caused (or will lead to) the early termination of many commercial relationships, and the terminator might well make a payment to the former supplier. The tax treatment of such a payment will have to be considered.

What does it mean to me?

The taxation of termination payments is the subject of established case law and different tax treatments can arise in different cases.

What can I take away?

Particularly in the current Coronavirus crisis, the legal concept of frustration might be the cause of the termination of a contract. Care should therefore be taken to consider carefully the basis of all termination payments.

Although always a business risk, the current Coronavirus crisis is likely to have caused (or will lead to) the early termination of many commercial relationships. In such cases, the terminator might well – for a variety of reasons, whether contractual or out of goodwill – make a payment to the former supplier. The question that will then have to be considered is the tax treatment of such a payment. This question lay at the heart of the recent case of *Looney v HMRC* [2020] UKUT 119 (TCC).

The facts of the case

Mr Looney was a partner in a firm (Kieran Looney & Associates) which provided management training to the senior management of a substantial commodities trading company, Trafigura Beheer (TB). Following the early termination of the contract, the partnership received £1 million, which Mr Looney sought to characterise as a capital receipt for the loss of a secret process in his proprietary performance management system. There was a further £3 million payment which Mr Looney sought to argue was attributable to entities that he owned separately from his interest in the partnership.

The contract with TB was entered into on 14 January 2009 and was to last for three years. Under the contract, the firm would receive £3 million each year, as well as a non-refundable £3 million deposit for certain training materials, which would remain in the partnership's ownership but able to be used by TB under licence. The contract

also contained a termination clause. Under that clause, the contract could be terminated by TB on written notice to the partnership by 1 November 2009 and would lead to the payment of the deposit and a £1 million termination fee.

TB duly exercised the termination clause (and despite Mr Looney's attempts to persuade the High Court that the clause had not been validly exercised later failed). During the lifetime of the contract, almost £3 million had been paid by TB, not to the partnership but to the Swiss bank account of a Panamanian company owned by Mr Looney.

In the First-tier Tribunal (FTT) hearing, Mr Looney explained that the reason for seeking a £1 million payment in the termination clause was to compensate the partnership for the loss of proprietary materials which would inevitably become available to TB after the cessation of any contractual relationship between the parties (point 1). The FTT rejected this analysis. It also considered that the payments represented part of the partnership's trading income, rather than that of another entity (point 2).

Mr Looney appealed against both conclusions to the Upper Tribunal.

The Upper Tribunal's decision

The case came before Judges Swami Raghavan and Ashley Greenbank.

Point 1: capital or income

In respect of the first issue, the judges recognised that qualitative decisions such as this would be difficult to overturn, as the FTT's decision should rarely be interfered with unless clearly wrong as a matter of law. Mr Looney put particular emphasis on one House of Lords' decision, *Evans Medical Supplies Ltd v Moriarty (HM Inspector of Taxes)* (1957) 37 TC 540, which concerned secret processes, a payment in respect of which was held to be capital. In *Evans*, the House of Lords said that it was obvious that the parting of a secret process did not represent the provision of a service in the normal trading sense. However, in *Evans*, the company's disposal of its secret process effectively destroyed the company's ability to trade profitably, which was why the receipt was categorised as capital in nature.

In the FTT hearing, the tribunal had also noted that Mr Looney's contentions about the nature of the training materials were not readily consistent with the written

terms of the contract and, in particular, the description of the termination payment itself. It also noted that the partnership's documents in the High Court proceedings did not suggest that the partnership was seeking compensation for the loss of a secret process. Furthermore, the FTT did not consider that divulging this material to TB had any serious impact on the partnership's ability to trade more broadly. Mr Looney argued, however, that the FTT had erred in its analysis.

Although the Upper Tribunal remarked that the FTT did not seem to have considered many of the authorities to which the Upper Tribunal had been referred, the Upper Tribunal considered the FTT had fully considered the facts of the case before it (which the authorities stated was paramount) and in particular the contract itself. The Upper Tribunal accepted that findings of the High Court judgment were not binding on the FTT (as the case there had involved different parties). However, the Upper Tribunal considered that the FTT did not actually rely upon the High Court's decision (besides drawing comfort from it).

Overall, the Upper Tribunal could not see any fault in the FTT's analysis and therefore it dismissed the appeal on this ground.

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Point 2: was the income that of the partnership or of a different entity?

The main argument before the FTT on this second point was that there had been a novation of the TB contract with the partnership and/or the assignment of the contractual benefits to a company owned by Mr Looney.

In the FTT, the tribunal had noted that there was nothing in writing to support the existence of the alleged variation (despite written confirmation being required under the contract itself); nor was there any evidence of TB having agreed to it (let alone TB's reasons). For these reasons, the FTT rejected the oral evidence from Mr Looney that asserted that there had been such a variation.

In the Upper Tribunal, Mr Looney abandoned those arguments but suggested that there was an implicit multi-party contract and that the payments received were properly accounted for by parties other than the partnership. HMRC accepted that a

multi-party contract was a possibility but one which was not supported by any evidence before the FTT. The Upper Tribunal agreed with that analysis.

As a result, Mr Looney's appeal was dismissed in its entirety.

Commentary

The case ultimately turned on its facts. However, the taxation of termination payments is the subject of established case law and, as the Upper Tribunal noted, different tax treatments can arise in different cases.

In my view, Mr Looney's case was not assisted by the fact that he was seemingly putting forward arguments that were not readily consistent with the documents before the tribunal (those documents being the contract itself and the correspondence arising from the High Court litigation).

From a personal perspective, I must also admit to raising an eyebrow when I read that payments were made not to the partnership but to the Swiss bank account of a Panamanian company owned by Mr Looney. In this respect, Mr Looney had received advice that 'to avoid any allegations of tax evasion' he ought to arrange for payments to be channelled through a UK company and that a UK company was subsequently incorporated for these purposes. Accordingly, there was no such allegation made in these proceedings and the tribunal reached its decision without such suggestions being made. Similarly, I make no suggestions of impropriety. Nevertheless, the set up is unusual and is unlikely to have helped initial perceptions of Mr Looney. For these reasons, such arrangements should be avoided wherever possible and, when it is not possible, it is essential that contemporaneous records are made to explain the reason for the set-up, with possibly clear, unprompted and upfront disclosure to HMRC.

What to do next

So far as the wider principles are concerned, it should be pointed out that, particularly in the current Coronavirus crisis, the legal concept of frustration might be the cause of the termination of a contract. That can cause the contractual analysis to change and this might well lead to a different tax treatment. Care should therefore be taken to consider carefully the basis of all termination payments.

- We should very much appreciate your completing our survey about the impact of coronavirus on you and your organisation. We are gathering this information to help us continue to support and inform you. Please click here to complete the survey. The closing date is 30 June and we shall provide a report on our websites in July.