A fine line to tread

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Ian Walker and *Elyse Waller* review the Upper Tribunal decision in *HMRC v Vaines* and other recent case law on the 'wholly and exclusively'

Key Points

What is the issue?

The question of whether an expense is deductible as having been incurred wholly and exclusively for the purpose of a trade or profession is not always an easy one to answer, as the cases referred to demonstrate

What does it mean for me?

The purpose for which an expense has been incurred is not always aligned with the benefits obtained. Close attention to the underlying facts is required, and familiarity with the case law can assist in determining whether payments made to settle a dispute, or legal fees paid to defend an action, are deductible for tax purposes

What can I take away?

The dividing line as to the allowability of an expense paid to settle a potential liability, or in connection with legal proceedings, is often a fine one. Legal costs to defend an action require close attention to the facts, to determine their allowability for tax purposes

A fundamental rule of tax law is that a person carrying on a trade can only claim a deduction for an expense that is incurred ‘wholly and exclusively’ for the purposes of the trade. In the application of this rule conflicts have often arisen between the outcome that arises from the strict interpretation of the ‘wholly and exclusively’ rule (The Income Tax (Trading and Other Income) Act (ITTOIA) 2005, s 34) and the common-sense result that may be expected, leading to the plethora of case law on the interpretation and application of the rule.

The decision of the Upper Tribunal (UT) in *HMRC v Vaines* [2016] UKUT 0002 (Vaines) again addresses this issue, among others, and provides a timely opportunity to review a sample of case law when the deductibility of expenses, particularly those incurred in relation to liabilities arising in a legal context, has been considered.

Vaines: are litigation settlement payments deductible?

The UT found in favour of HMRC and held that a payment made by Mr Vaines (a partner in a law firm) in settlement of a dispute to avoid potential litigation and bankruptcy was not a deductible expense.

The facts

Mr Vaines was a partner at Squire, Sanders & Dempsey LLP (SSD), before which he was a partner at Haarmann Hemmelrath (HH). When HH ceased trading it owed substantial sums to a bank (Bayerische Landesbank – 'the Bank'). To avoid litigation being undertaken by the Bank in respect of the debt, Mr Vaines entered into a settlement with it, paying €300,000 to release him from all claims. Mr Vaines claimed a deduction for the payment against his professional income, being his share of profits as a partner in SSD, the law firm at which he was then a partner, in his 2007/08 tax return.

HMRC disallowed the claim on several bases, including that the payment was not incurred wholly and exclusively for the purposes of the trade carried on by SSD.

The First-tier Tribunal

Mr Vaines appealed to the FTT on the basis that, pursuant to ITTOIA 2015, partners are treated collectively as carrying on a trade, and therefore each partner, including himself, personally carried on their own trade. Mr Vaines stated that his purpose in making the settlement payment was to avoid potential bankruptcy as a result of a negative court decision which, in turn, would prevent him carrying on his personal trade as a partner at SSD. Mr Vaines stated that his purpose in making the settlement payment was to preserve and protect his own trade and therefore payment was made wholly and exclusively for the purpose of his trade.

The FTT allowed Mr Vaines's appeal, holding that the payment had been wholly and exclusively incurred for the purposes of the trade that he was carrying on as a partner, and the payment was revenue rather than capital in nature, such that it was a deductible expense (*HMRC v Vaines* [2013] TC 02965).

The Upper Tribunal

On appeal, the UT held that the relevant trade being carried on was that of SSD, conducted by its members collectively. It was not a personal trade of Mr Vaines. As a result, if the payment was deductible at all, it would be deductible by SSD in the carrying on of its trade, not by Mr Vaines.

The UT noted that, since the payment was not made by SSD but was paid by Mr Vaines personally and that because the payment was in respect of Mr Vaines'

personal liability as a partner of HH, it was not connected with the trade of SSD.

The UT considered whether, if it had concluded that Mr Vaines was himself carrying on the relevant trade, he would have been able to claim that the payment had been made wholly and exclusively for his trade. The tribunal held that, since the payment operated to dispose of a liability that Mr Vaines had incurred through his partnership at HH, one must look to the underlying liability that was extinguished, not to the payment which achieved that, in determining the purpose of the payment.

The UT held that Mr Vaines must be able to establish that preserving and protecting his professional career was not just a purpose of making the payment but that it was his only purpose, as there is no basis for 'apportioning' the payment to attribute part of it to a trade purpose. After considering several authorities on the interpretation of the rule, the tribunal concluded that Mr Vaines' professional considerations could not have been the sole purpose for making the payment due to the personal benefits that followed of avoiding extensive litigation and the risk of possible bankruptcy.

As a result, the UT found that the payment was not made wholly and exclusively for the purposes of the trade of Mr Vaines, or of SSD, and was therefore not an allowable deduction.

Relevant case law

As referred to by the UT in *Vaines*, the case law regarding whether an expense is deductible as having been incurred wholly and exclusively for the purposes of a trade is extensive and fact-dependant.

Set out below is an analysis of some of those cases that relate to expenses incurred to discharge a liability or pay fees in respect of legal proceedings.

Payment to be released from a contractual arrangement

Vodafone Cellular Limited v Shaw (Inspector of Taxes) **[1997] STC 734**

Vodafone paid $30m to extinguish its liability to pay 10% of its annual profits for 15 years to a US company in return for future know-how. It claimed a deduction for this expense for corporation tax purposes.

HMRC challenged the deduction on the basis that the expenditure had a dual purpose being to benefit its own trade and that of its subsidiaries. The Court of Appeal upheld the taxpayer's right to deduct the expense.

The court held that, in determining the purpose for which expenditure had been incurred, it must refer to the purposes which the taxpayer had in mind but is not confined only to the taxpayer's conscious motives. The primary enquiry to be made is to ascertain the particular object which the directors sought to achieve by making the payment. In this case, it was to benefit the trading position of the relevant entity. The possible resulting benefit to the subsidiaries did not automatically lead to the parent company, Vodafone, having a second purpose that does not relate to its own trade in incurring the expense.

Further, the court noted that a payment may be made exclusively for the purposes of its trade even though it also secures a further benefit not related to its own trade if that benefit was not the object of the payment but merely a consequential and incidental effect of the payment.

The court stated that, in the case of an individual taxpayer, the other purpose is usually a private purpose. But if the taxpayer is a company in a group, the other purpose is likely to be the purpose of the trade of one or more of the other companies in the group. However, regardless of this distinction the same principles apply in seeking to determine whether the expense was incurred wholly and exclusively for the purposes of the taxpayer's trade.

The court considered the leading cases on the application of the rule and stated that the words for 'the purposes of the trade' do not mean for the purposes of the taxpayer or for the benefit of the taxpayer.

Payment of legal costs

The deductibility of legal costs has been considered by the courts on a number of occasions with varying outcomes due to the factual nuances of each case.

Spofforth & Prince v Golder (Inspector of Taxes) [1945] 1 All ER 363

Spofforth & Prince was a firm of two accountants that incurred legal costs to successfully defend one of the partners against charges of conspiracy to defraud the Revenue. On being told that evidence from two of its employees was required, the firm sought legal advice. A summons was then issued against one of the partners, at which point the firm sought separate legal advice.

The firm claimed a deduction of all legal costs for the proceedings, on the basis that they were incurred wholly and exclusively for the purposes of the profession. On appeal, the firm provided an alternative argument that, if the costs were not deductible in full, those incurred before the service of the summons and those incurred by the partner who was not involved in the proceedings were deductible.

The court held that only the costs incurred by the firm up to the issue of the summons were deductible. Before that, the firm's solicitors were acting for the firm in the ordinary course of business and in circumstances where it could say the purpose of its instructions and the incurring of the legal costs were for an ordinary professional purpose, in protecting its business.

After that point, the purpose of the legal costs changed to being one where the partner's personal position was being defended. This was also a purpose of the expenditure, which resulted in a dual purpose so that the costs were not deductible.

In respect of the other partner, the purpose of the payments to the solicitors was not solely expended in the interests of the partnership's trade, but was also in the partner's own interest, in being properly advised of his position where his partner stood trial for a fraud allegedly abetted by himself and their clerks. As such, there was a dual purpose to that expenditure, so that it was not allowable for tax purposes.

Knight (Inspector of Taxes) v Parry [1973] STC 56

Mr Parry, a solicitor at a law firm, left his employment and set up his own practice upon the agreement of one of the firm's clients that they would instruct him. This led to the allegation that Mr Parry had solicited the client and engaged in unprofessional conduct, and a request that that Law Society have him struck off.

The law firm brought a civil action against Mr Parry, which was successfully defended, the court holding that he had not solicited the client. The Law Society did not proceed with any action.

Mr Parry sought to deduct his legal costs in defending the civil claim and the costs he was ordered to pay by the court from his taxable profits.

The court held that Mr Parry's purpose of protecting himself professionally was not a purpose wholly and exclusively referable to the carrying-on of his practice as a solicitor, but for the purpose of seeing that he was not precluded from doing so.

The court also held that, if Mr Parry had admitted liability in breach of contract and offered to pay damages or had paid a sum of money to the court, there would have been only the one purpose. Since this did not occur the expenses were not deductible on the ground of duality of purpose.

The effect of the court's decision is that, if a solicitor is incurring costs in defending a claim against him that, if successful, would result in him being unable to practise as a solicitor, those costs would usually be incurred at least in part for a personal purpose. This would render the expenses not deductible.

In reaching this conclusion, the court referred to *Spofforth & Prince* and stated that its decision was in line with that case.

McKnight (Inspector of Taxes) v Sheppard **[1999] STC 669**

Mr Sheppard was a stockbroker who was accused of breaching the London Stock Exchange regulations and incurred legal costs defending the allegations in disciplinary proceedings. He was found guilty of gross misconduct by the disciplinary committee of the stock exchange and suspended for six months. He appealed against the decision and, although the original findings were upheld, the suspension was lifted and a fine imposed instead.

Mr Sheppard sought deductions for the legal costs incurred and the £50,000 fine. The Inland Revenue (as was) denied both deductions. On appeal to the High Court, the judge upheld the Revenue's view. Mr Sheppard appealed against the decision denying the deduction for his legal costs on the basis that, in incurring these costs, he had not been concerned to protect his personal reputation, but rather his sole

object was to avoid the destruction of his business that would have resulted had he been suspended or expelled from the stock exchange.

On appeal, the House of Lords held that the legal expenses were wholly and exclusively for the purpose of Mr Sheppard's trade because they were made for the purpose of protecting his trade, albeit that there may have been a resulting benefit of protecting his reputation as well. Importantly, the court held that it does not follow that the costs of defence are not deductible simply because the fine is not deductible. Non-deductibility depends upon the nature of the expenditure and the specific policy of the rule that applies which affects the relevant considerations in each case. The court held that, in this case, there was no clear policy that would be infringed by allowing the deduction of the legal expenses incurred in opposing the disciplinary proceedings arising out of the conduct of a business.

The court held that 'non-deductibility would be in effect an additional fine or penalty for which the regulatory scheme does not provide'.

Where does this leave us?

The case law on applying the rule that expenses must be incurred wholly and exclusively for the purposes of the taxpayer's trade leads to varying outcomes when considering legal expenses and discharging liabilities.

In *Vaines*, the UT focused on the duality of purpose of Mr Vaines's payment as one reason for making the payment was the personal benefit to be obtained. This aligns with the court's finding in *Parry* that costs incurred in defending a claim against a solicitor, where losing would result in being unable to practise, would involve a dual purpose and therefore are not allowable. However, if Mr Vaines had accepted the claim of the Bank against the partnership and paid an amount in damages, such a payment may have been deductible in accordance with the guidance provided by the court in *Parry*.

The UT in *Vaines* considered the case of *Sheppard* and, although it recognised the analogies that could be drawn between the two cases, importance was placed on the fact that although Mr Vaines' actions were to protect his profession, it was not a payment that was made in relation to his current profession as a partner at SSD, nor was it made to protect his position at HH, at which he no longer was a partner. As such, the UT held that the purpose of making the settlement payment was a

personal one and the effect of the payment in protecting his professional career was not just incidental.

Conversely, had SSD paid the settlement amount to release it from liability, perhaps, in accordance with the decision in *Vodafone*, that amount would likely have been deductible against the partnership's profits.

Ultimately, in the words of the UT in Vaines, 'any case must ultimately depend on an evaluation of its particular circumstances' to determine which side of the fine line on deductibility a payment falls.

At the time of writing, Mr Vaines had sought permission from the UT to take his case to the Court of Appeal. This may provide us with yet further guidance on this area and fact-driven application of the 'wholly and exclusively' rule.