ScottishPower: Are fines and penalties deductible as trading expenses?

Large Corporate OMB



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The case of *ScottishPower* re-examines the guidance emanating from a House of Lords' decision relating to whether fines and penalties are deductible as trading expenses.

Key Points

What is the issue?

ScottishPower, a major energy supplier, reached a settlement with the Gas and Electricity Markets Authority involving payments to consumers and charities totalling £28million, following an investigation. ScottishPower attempted to claim this amount as a trading deduction.

What does it mean for me?

The Court of Appeal examined the principles from *McKnight v Sheppard* and *von Glehn*, focusing on whether fines and penalties can be deducted as trading expenses. It concluded that while fines and penalties are non-deductible due to their punitive nature, payments made in lieu of penalties could be deductible if incurred wholly and exclusively for trade purposes.

What can I take away?

When dealing with disciplinary actions, be clear to distinguish between different categories of expenditure – defence costs, actual penalties and other forms of redress. Based on the *ScottishPower* decision, only actual penalties are non-deductible, and non-statutory penalties might still be deductible.

I always think that the first tax rule that people learn is the one that prevents a trader from claiming a deduction for expenses that are not incurred wholly and exclusively for the purposes of the trade. Although this rule is well known, however, there are still occasional cases which test its application.

In 1999, the House of Lords decided one case which looked at this rule – the case of *McKnight (HM Inspector of Taxes) v Sheppard* [1999] STC 669 (discussed further in Ian Walker and Elyse Waller's article in the May 2016 issue of *Tax Adviser* 'A fine line to tread'). Mr Sheppard was a stockbroker who had faced disciplinary charges for the alleged breach of London Stock Exchange regulations and he argued that he should be permitted to deduct his legal defence costs from the profits of his trade.

So far as the fines imposed on Mr Sheppard were concerned, Lord Hoffmann's speech identified a number of principles that he suggested applied. The wider applicability of those principles was the focus of the present case, *ScottishPower Ltd v HMRC* [2025] EWCA Civ 3.

The facts of the case

ScottishPower is a major generator and supplier of gas and electricity and is regulated by the Gas and Electricity Markets Authority (GEMA), whose work is carried out by Ofgem (the Office of Gas and Electricity Markets). Around a decade

ago, the company (together with associated companies) reached a settlement with GEMA following an investigation into matters such as mis-selling, complaints handling and costs transparency. Under the settlement, ScottishPower agreed to make various payments to consumers and charities totalling around £28million, and to pay a nominal penalty of £1. It was agreed that, had the company paid a lower amount to its vulnerable customers (a part of the overall £28 million payment), the penalty would have increased on a pound-for-pound basis.

ScottishPower sought to treat the £28million as a trading deduction, but this deduction was denied by HMRC. For what it's worth, ScottishPower did not claim the £1 penalty as an allowable deduction from its trading profits. ScottishPower appealed to the First-tier Tribunal.

The First-tier Tribunal largely agreed with HMRC ([2022] UKFTT 41 (TC)), although it allowed a deduction for an element of the £28 million which it considered to be compensatory in nature. However, the Upper Tribunal dismissed the company's appeal and allowed HMRC's cross appeal in relation to the purely compensatory payment ([2023] UKUT 218 (TCC)). The company then appealed against the Upper Tribunal's decision to the Court of Appeal.

The Court of Appeal's decision

The case came before Lord Justice Snowden, Lady Justice Falk and Lord Justice Zacaroli. Lady Justice Falk gave the main judgment with her two colleagues concurring.

The court sought to explain the background behind the comments made by Lord Hoffmann in *McKnight v Sheppard*. Lord Hoffmann had himself tried to reconcile earlier case law and the Court of Appeal's attempt (in an earlier case) to articulate the reasons for refusing to allow a deduction for a penalty imposed on a company for breach of customs legislation that was in place during the First World War (*IRC v Alexander von Glehn & Co Ltd* [1920] 2 KB 553 ('*von Glehn'*)).

In particular in *von Glehn*, the court had accepted that the company had incurred the penalty in the course of its trade and therefore there must have been some other reason that led to the denial of the trading deduction. Lord Hoffmann observed that something in the nature of the expense must have prevented it from being

deductible, but thought that the Court of Appeal was looking in the wrong place:

‘They hoped to find the answer in the broad general principles of what counts as an allowable deduction. But the reason in my opinion is much more specific and relates to the particular character 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.’

Applying that approach, Lord Hoffmann (with whom the other four judges agreed) explained why Mr Sheppard should not be permitted a deduction in relation to the fines he incurred (although that question was not strictly in dispute in the case).

However, in relation to the legal costs incurred by Mr Sheppard, the actual point in issue in the case, Lord Hoffmann considered that the *von Glehn* had taken a wrong turn by treating fines and the associated legal costs in the same way.

He firstly asked what the position would have been if the allegations had proved to be groundless and the taxpayer had been acquitted, stating that ‘it would have seemed unfair not to allow any deduction for the taxpayer’s legal expenses’. This raised substantial difficulties, however:

‘The purpose of the payment will be the same whether the taxpayer’s defence turns out to be successful or not. Can there be a distinction between the costs of a successful and an unsuccessful defence? It might be argued that, as a matter of policy, the unsuccessful defendant should have to bear his legal costs personally in the same way as the penalty itself. But I think there would be great difficulties about giving effect to such a rule.’

Lord Hoffmann also highlighted the problems incurred where a taxpayer was convicted on some counts and acquitted on others, stating: ‘It might not be easy to tell which costs had been expended successfully and which unsuccessfully.’

However, he went on to highlight some more fundamental issues:

‘[E]veryone, guilty or not guilty, should be entitled to defend themselves. I do not see that any clear policy would be infringed by allowing the deduction of the legal expenses incurred in resisting the disciplinary proceedings. On the contrary, I think that non-deductibility would be in effect an additional fine or penalty for which the

regulatory scheme does not provide.’

Lord Hoffmann therefore believed that the Special Commissioner was right to treat the case as governed by the general principle in *Morgan v Tate & Lyle Ltd* [1955] AC 21, which is that money spent for the purpose of preserving the trade from destruction can properly be treated as wholly and exclusively expended for the purposes of the trade.

In the present case, the court proceeded on the basis that there was a ‘policy’ reason for precluding the deduction of fines and penalties in a calculation of a trader’s trading profits. However, it saw no reason why payments in lieu of such a penalty or fine should automatically be subject to the same treatment. Indeed, any such decision would have the effect of creating such a policy and that would be to trespass into the role of the legislature.

Since the payments were incurred by ScottishPower wholly and exclusively for the purposes of ScottishPower’s trade and because they were not in fact penalties or fines, the court considered that they were allowable deductions. The company’s appeal was therefore allowed.

Commentary

It is hard to find fault with the conclusion reached by the Court of Appeal. However, what makes the decision particularly interesting is the route that the court took to get to its result.

The court started by looking at what was decided in *von Glehn* and what formed the basis of Lord Hoffmann’s comments in *McKnight*, being that a fine or penalty cannot qualify for a trading deduction. The court recognised that the initial question to be considered in these cases is whether the expense is incurred for the purposes of the taxpayer’s trade. However, Lord Hoffmann had referred to the ‘legislative policy’, which the court interpreted as meaning the legislative policy under which the fine or penalty was imposed (as opposed to the tax code). However, the court then noted that this approach was hard to reconcile with the wholly and exclusively test in the Corporation Tax Act 2009, which focuses on the purpose of the trader in incurring the expenditure.

The court tentatively put forward two possible explanations. The first is that that penalties are simply not incurred for the purposes of the trade; the second is that penalties are precluded under a wholly different provision (CTA 2009 s46) which requires accounts to follow GAAP 'subject to any adjustment required or authorised by law', with the long-established rule in *von Glehn* representing an adjustment required by law.

In my view, the first approach would lead to some further difficult questions. For example, consider a trader who parks a car on a street, overstays on a parking meter and incurs a £70 penalty from the local authority. What is the practical distinction between this trader and another trader who uses a private car park which is intended for short-term stays but then stays too long and is contractually obliged to pay a parking fee of £70 for the excess time? Fortunately, the court did not have to address such a question and stated a preference for the second approach.

However, having decided that the rule preventing a deduction for penalties represents an adjustment required by law, the court considered that its bounds should be clearly demarcated. If so, the court accepted that it is possible to continue with the idea that statutory penalties are non-deductible so as not to dilute the legislative policy (using Lord Hoffmann's words). (However, I interpose here that it is still unclear why, using my previous example, the statutory £70 fine should be treated differently from a contractual parking charge of the same amount.)

For non-statutory penalties, that legislative policy would not exist and perhaps such penalties should not be routinely disallowed. One case where such penalties were incurred and held not to be deductible was the Upper Tribunal's decision in *McLaren Racing Ltd v HMRC* [2014] UKUT 269 (TCC). However, the court in *ScottishPower* addressed that by noting the justification reached for the decision, being that the fine was imposed for conduct that was so egregious it should not be considered as a part of the taxpayer's trade. For a broader discussion of that case, I would refer readers to Peter Rayney's article in the August 2015 issue of *Tax Adviser* 'Tax relief in a litigious world', which refers in turn to my own article 'Another fine mess?' in the December 2014 issue.

In *ScottishPower*, the court noted that the *McKnight v Sheppard* case also considered non-statutory penalties but made the point that the deductibility of those penalties was not in issue in that case.

So far as the *ScottishPower* case itself is concerned, the penalties were statutory and therefore the court did not need to consider this particular question any further. Had it done so, it might then have asked why (if there was a general rule precluding all statutory fines and penalties from being allowable deductions) the statute then lists a number of penalties under the tax code itself which are non-deductible (see the Income Tax (Trading and Other Income) Act 2005 s 54 and its corporation tax equivalent, Corporation Tax Act 2009 s1303).

In accordance with the doctrine of judicial precedent, the court was not going to suggest that earlier decisions of the court or of the House of Lords were wrong. However, the court has raised certain important issues for what I believe to be the first time and, were these issues ever to get to the Supreme Court, it is possible that even the 'policy' precluding the deduction of statutory fines might be revisited. On the other hand, there is the greater likelihood that legislation will be introduced to put the matter firmly beyond doubt.

What to do next

When dealing with a client who faces disciplinary action, be clear to distinguish between different categories of expenditure – defence costs, actual penalties and other forms of redress. On the basis of the *ScottishPower* decision, only actual penalties are non-deductible and, even then, if the penalties are imposed under a non-statutory scheme, deductibility might still be possible.

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