ScottishPower: the penalty principle

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We return to the *ScottishPower* case and the question of how the tax rules apply to regulatory penalties imposed on traders.

Key Points

What is the issue?
The Supreme Court has overturned the Court of Appeal's decision in *ScottishPower*, ruling that payments made to avoid regulatory penalties were not deductible because they failed the 'wholly and exclusively' test.

What does it mean to me?
Advisers must consider the substance of payments made following regulatory investigations, rather than relying on their legal description. Payments presented as compensation may still be non-deductible if they effectively substitute for penalties.

What can I take away?

The judgment clarifies the legal basis for denying deductions for penalties, but uncertainty remains over contractual charges and other payments. Further litigation may be needed to establish where the boundaries lie.

In April 2025, I wrote about the Court of Appeal's decision in *ScottishPower (SCPL) Limited v HMRC* [2025] EWCA Civ 3, a case that revisited the House of Lords' decision in *McKnight v Sheppard* [1999] 1 WLR 1333. At the heart of that dispute was a series of compensation payments made by Scottish Power in accordance with settlement agreements with the energy regulator. Although the payments had been made in circumstances where substantial penalties might otherwise have been imposed, the Court of Appeal concluded that they were not themselves penalties and should therefore be deductible from the company's profits.

The distinction between penalties and non-penalties was considered to be critical. It has long been assumed that traders cannot treat the cost of penalties as an allowable deduction from their trading profits, even when the penalties are incurred in the course of the trader's trade. However, the Court of Appeal decided that the principle should be given a narrow application: in the present case, the sums expended were designed to be compensatory in nature and were expressly charged to Scottish Power in place of penalties.

Previously, the question of the deductibility of penalties had been framed in terms of whether the amount was incurred wholly and exclusively for the purposes of the trade, the test for which is set out in Corporation Tax Act (CTA) 2009 s 54. However, the Court of Appeal considered that the restriction on penalties was not a consequence of the wholly and exclusively rule at all but rather a long-established principle derived from old case law.

The court considered that this principle was now preserved in the statute by CTA 2009 s 46(1) which, although requiring tax profits to be calculated in the first instance in accordance with generally accepted accounting practice (GAAP), permits a departure from GAAP where an 'adjustment is required … by law'.

This was a rather unorthodox route to denying traders a deduction for penalties, given that the calculation of a tax liability is usually determined wholly by reference to the statutory code rather than extra-statutory principles. The Court of Appeal

therefore considered that the scope of the principle should be kept narrow. As a result, something that was not actually a penalty should not be denied a deduction if it would otherwise have been available.

HMRC appealed against the decision to the Supreme Court, whose judgment was handed down on 21 October 2026 in *ScottishPower (SCPL) Limited v HMRC* [2026] UKSC 35.

The facts of the case

The facts were described in my earlier article and can therefore be summarised briefly.

Following a number of investigations by the Gas and Electricity Markets Authority (GEMA) and Ofgem, ScottishPower Energy Retail Limited entered into four settlement agreements concerning matters such as mis-selling, complaints handling, pricing practices and failures to meet energy-saving obligations.

Under those settlements, Scottish Power agreed to make payments worth approximately £28 million to consumers, charities and other beneficiaries. In each case, GEMA imposed only a nominal penalty of £1. However, the decision notices made clear that substantially larger penalties would otherwise have been imposed and that the payments formed part of the settlement arrangements.

Scottish Power claimed tax deductions for the payments. HMRC sought to add back the amounts deducted.

The First-tier Tribunal largely sided with HMRC, although it allowed relief for one element of the payments which it considered genuinely compensatory. The Upper Tribunal reversed that concession and concluded that none of the payments was deductible. The Court of Appeal then allowed Scottish Power’s appeal and held that all of the payments were deductible (bar the nominal £1 penalty itself). HMRC therefore appealed to the Supreme Court.

The Supreme Court’s decision

The case came before Lord Reed, Lord Stephens, Lady Rose, Lady Simler and Lord Doherty. The joint judgment was given by Lady Rose and Lord Doherty.

Like the Court of Appeal, the Supreme Court identified a number of key cases in which the principle concerning the deductibility of penalties was developed or applied. In addition to *McKnight* itself, those cases included:

- *Strong & Co of Romsey v Woodifield* [1906] AC 448, 5 TC 215: A brewery company was denied a deduction for the damages it had paid to a customer who had been injured by a falling chimney.
- *Inland Revenue Commissioners v Alexander von Glehn & Co Ltd* [1920] 2 KB 553: A company was denied the costs of the penalties it had incurred for exporting goods to Russia without making the necessary declaration as to the ultimate destination of the goods.
- The Australian case of *Herald and Weekly Times v Federal Commission of Taxation* (1932) 48 CLR 113: A newspaper publisher was entitled to a deduction for the damages it had paid following a libel claim.
- *G4S Cash Solutions (UK) Ltd v HMRC* [2016] UKFTT 239 (TC): This held that parking fines are not deductible from a security and delivery company's profits even though they were an almost inevitable hazard of its trade.
- *McLaren Racing Ltd v HMRC* [2014] UKUT 269 (TCC): The Formula 1 racing company was prevented from claiming a deduction for the fines it had been charged by the Formula 1 authorities.

Despite considering the same materials, the Supreme Court disagreed with the Court of Appeal's analysis of the nature of penalties. It considered that the question of deductibility was to be assessed by reference to the 'wholly and exclusively' test itself. It then concluded that penalties are non-deductible because they are not incurred for the purposes of the trade. Their purpose, the Supreme Court held, is fundamentally different. Penalties are imposed as a punishment for wrongdoing and are incurred because the taxpayer has breached legal obligations. As such, the Supreme Court held that penalties fail the wholly and exclusively test.

The court therefore rejected the Court of Appeal's suggestion that there was a separate judge-made adjustment operating outside the wholly and exclusively rule. In the Supreme Court's view, the explanation lies wholly within the trading deduction code itself.

Having reached that conclusion, the court then considered the nature of the redress payments made by Scottish Power.

The court rejected Scottish Power’s characterisation of the payments as voluntary. While it was true that the company was not legally compelled to enter into the settlement agreements, it was clear that, if the settlements had not been agreed, substantial penalties would have followed. Indeed, the First-tier Tribunal had found that Scottish Power was effectively paying an amount of the same order as the penalties that would otherwise have been imposed.

The court therefore considered the payments to be sufficiently akin to penalties that the same analysis should apply. Looking at the substance of the arrangements rather than their form, the payments had been made under the threat of regulatory sanctions, were linked directly to admitted breaches and were negotiated as part of settlements designed to avoid larger penalties. They were therefore not incurred for the purposes of the trade.

The appeal was accordingly allowed and the Upper Tribunal’s decision restored.

Commentary

Keen readers will recall that in my previous article I had commended the Court of Appeal’s decision, although I described the route taken by the court to reach that decision as ‘interesting’. The Supreme Court has clearly not agreed with the Court of Appeal’s methodology (perhaps agreeing that it was too ‘interesting’), nor with my endorsement of its decision.

The difficulty in all these cases (and the reason for the contrasting analyses by the different courts) arises from the fact that there is, with limited exceptions, no express rule in the tax code preventing a deduction for a penalty incurred by a trader. Furthermore, there are specific statutory provisions denying deductions for certain penalties. For example, Corporation Tax Act 2009 s 1303(1) expressly prohibits deductions for the penalties and interest listed in the table in sub-section (2). If there were a rule of principle that penalties are not tax-deductible, that section would be otiose.

Of course, it can be said that penalties are not incurred **for the purposes** of the trade but are rather incurred as a consequence of the trade being carried on. On that basis, it could be said that they should not qualify for a deduction. However, insisting upon a literal approach to the wholly and exclusively rule in the case of every item of expenditure would depart from common practice and common sense.

For example, a trader's hotel costs when away from home are generally incurred to give the trader somewhere comfortable to rest. That is clearly not wholly or exclusively for the purposes of the trade (in the same way as an individual's clothes are rarely acquired wholly and exclusively for the purposes of a trade). However, any attempt by HMRC to deny a trader a deduction for hotel costs in such cases is likely to be given short shrift (see, for example, the Upper Tribunal's decision in the case of *HMRC v Healy* [2013] UKUT 337 (TCC)).

As this particular case has shown, whenever attempts are made to justify the principle that penalties are not deductible, articulating the rationale for the principle can cause some confusion. That confusion can, in my view, be best illustrated by contrasting the *Herald* and *McLaren* decisions. In the former, libelling members of the public was considered to be an ordinary hazard of publishing a newspaper; whereas the latter concerns a company that breached the rules of its sport's governing body. Unlike parking fines, for example, where the relationship between the trader and the enforcement authority is governed by statute, McLaren's relationship with the governing body of its sport was purely contractual.

I have no doubt that academics could legitimately revisit these discussions and reach their own different conclusions. However, pending a significant shift in academic thinking (which I suspect is unlikely to be forthcoming in the near future), we at last have a clear determination of the principle: penalties are not tax deductible because, in the case of traders, they do not satisfy the 'wholly and exclusively for the purposes of the trade' test.

That certainty (in the meantime) should be welcomed.

Of course, focus will now turn to where the boundary lies between payments that do and do not fall within the restriction. For example, in a construction contract, contractors may well be subject to penalties if certain milestones in the project are not met. These are entirely contractual in nature (and the Supreme Court's decision could be interpreted as suggesting that contractual charges are not disallowable penalties).

However, the *McLaren* case was also based on a contractual relationship. McLaren was fined by its governing body rather than a body exercising statutory powers. Given the significant financial penalties that are often imposed on organisations by similar bodies, I suspect that it will not be long before the correctness of the

McLaren decision is considered afresh. On the other hand, it cannot be denied that McLaren was being punished by its governing body; penalty charges in a construction contract might be considered to be of a different nature. If so, there is clearly a boundary whose precise location may need to be determined by further case law.

I also see potential arguments about the distinction between penalties incurred for overstaying in different types of off-street car parks; those arguments could well mirror much VAT litigation. Many private car park operators might charge a modest fee for the first couple of hours (say) but then impose a hefty ‘penalty’ rate for longer stays. The relationship between the operator and the user is entirely contractual and the operator is not operating under any statutory powers. The inference to be drawn from the Supreme Court’s decision is that such higher fees are not precluded from being deductible under the wholly and exclusively rule. If that is the case, should the position differ if the off-street car park is owned and operated by a local authority?

Another possibility is that a 50p hourly rate increasing to £10 after two hours will not be considered to be penal, whereas a much larger charge (say £100) will be. Will the terminology used by the car park operator be relevant or even determinative? And would the private use of clamps make a release charge a penalty? Will the ultimate arbiter be the tribunal, potentially leading to different outcomes before different constitutions of the tribunal?

One further takeaway point from the Supreme Court’s decision is that it did not adopt the approach taken by the lower court, under which the non-deductibility of penalties was treated as an adjustment to a trader’s profits that was ‘required by law’. There is therefore, to the best of my knowledge, no extant authority confirming that a particular departure from GAAP may be permitted where it is not expressly provided for in statute. Prior to 2008, HMRC sometimes suggested that adjustments under the rule in *Sharkey v Wernher* [1956] AC 58 (requiring appropriations from a trader’s own stock to be effected at market value) could be justified on that basis. However, in anticipation of many proposed challenges to HMRC’s position, the rule was formally codified, meaning that the point was never considered by the courts.

What to do next

The key lesson is a practical one. When analysing payments made following regulatory investigations, advisers should not focus exclusively on the legal label attached to the payment. If a payment forms part of a settlement reached in circumstances where penalties would otherwise have been imposed, the courts may be prepared to regard it as sufficiently akin to a penalty for a tax deduction to be denied.

However, the precise boundary between deductible and non-deductible payments remains uncertain and will need to be clarified in subsequent cases.