TC02965

Appeal number: TC/2012/06845

Income Tax – Whether payment of €300,000 (£215,455) to settle German litigation was an expense incurred wholly and exclusively for the purposes of the trade or profession of an individual partner – Whether the payment was revenue or capital expenditure – Whether deductible under s 34 Income Tax (Trading and Other Income) Act 2005 – Appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

PETER VAINES **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE JOHN BROOKS
REBECCA NEWNS

Sitting in public at 45 Bedford Square, London WC1 on 27 September 2013

The Appellant in person

Jake Hillier of HM Revenue and Customs, for the Respondents

DECISION

1. Mr Peter Vaines appeals against a closure notice issued by HM Revenue and Customs ("HMRC"), under s 28A of the Taxes Management Act 1970, on 28 February 2012. This amended his 2007-08 self-assessment tax return and, as a result of a deduction of £215,455 claimed in his return being disallowed, increased the amount of tax he was required to pay by £86,182 to £180,829.95.

2. The circumstances giving rise to the deduction were not disputed and the parties provided the following "Statement of Agreed Facts":

> (1) At all material times the Appellant was a partner in the law firm of Squire Sanders & Dempsey. In the year ended 5 April 2008 the Appellant was in professional practice as a partner in Squire Sanders & Dempsey and his share of profits from the firm represented his only source of professional income for the year.
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> (2) Until 31 December 2005 the Appellant had worked in the London office of the law firm Haarmann Hemmelrath which had many offices, in Germany and elsewhere.
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> (3) On 27 October 2009 the Appellant made an amendment to his personal income tax return for the year ended 5 April 2008, claiming a deduction of £215,455 against his professional income from Squire Sanders & Dempsey.
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> (4) The deduction claimed related to a payment to Bayerische Landesbank under an agreement made by a number of individuals who were connected with the law firm Haarmann Hemmelrath. Haarmann Hemmelrath had ceased to trade and owed approximately €17 million to Bayerische Landesbank and other banks.
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> (5) The Appellant believed that the risk of challenging the German banks through the German courts was unacceptably high because if they were successful he would be made bankrupt. If he were made bankrupt, the Appellant would lose his position as a Partner in Squire Sanders & Dempsey.
>
> (6) Following negotiations with Bayerische Landesbank, the Appellant agreed to pay them €300,000 (£215,455) to release him from all claims to the Bank. The payment was made to the Bank in January 2008, in the tax year 2007-08.

3. In addition to the Statement of Agreed Facts Mr Vaines gave oral evidence and was cross examined by Mr Hillier. Although he accepted that the payment to Bayerische Landesbank had enabled him to avoid bankruptcy and protect his reputation we find, as a matter of fact, that his purpose for making that payment was to preserve and his protect his professional career or trade.

4. Mr Vaines contends that this payment was wholly and exclusively for purposes of his profession or trade and that it was revenue and not capital expenditure. He therefore submits that it was properly deductible under the relevant legislation.

5. For HMRC, Mr Hillier submits that the payment is not deductible as Mr Vaines does not carry on, as an individual, a trade, profession or vocation. Alternatively Mr Hillier contends that if Mr Vaines does carry on a trade, profession or vocation that the expenditure is not wholly and exclusively for purposes of that trade and, in any event even if it were, it was a capital expense and not deductible.

6. In considering these arguments more closely, it is clear that the following issues arise:

(1) whether Mr Vaines carries on, as an individual, a profession or trade;

(2) if so, whether the payment of €300,000 he made to Bayerische Landesbank wholly and exclusively for purposes of that profession or trade; and

(3) whether that payment was revenue or capital expenditure.

Although we have referred to Mr Vaines carrying on a "profession or trade", for ease of reference and consistency with the relevant legislation, which we have set out below and notwithstanding the fact that Mr Vaines is a solicitor, all subsequent references are solely to "trade".

Trade

7. It is not disputed that Mr Vaines was, at the time he made the payment to Bayerische Landesbank, a member of the limited liability partnership of Squire, Sanders and Dempsey LLP and that it is against his share of the profits of the limited liability partnership or, as Mr Vaines puts it, his professional income for 2007-08 that he seeks a deduction of the €300,000 payment.

8. Turning to the relevant legislation, s 863 ITTOIA, which sets out how limited liability partnerships are to be treated for income tax purposes, provides:

> (1) For income tax purposes, if a limited liability partnership carries on a trade, profession or business with a view to profit–
>
> (a) all the activities of the limited liability partnership are treated as carried on in partnership by its members (and not by the limited liability partnership as such),
>
> (b) anything done by, to or in relation to the limited liability partnership for the purposes of, or in connection with, any of its activities is treated as done by, to or in relation to the members as partners, and
>
> (c) the property of the limited liability partnership is treated as held by the members as partnership property.
>
> References in this subsection to the activities of the limited liability partnership are to anything that it does, whether or not in the course of carrying on a trade, profession or business with a view to profit.
>
> (2) For all purposes, except as otherwise provided, in the Income Tax Acts–

(a) references to a firm or partnership include a limited liability partnership in relation to which subsection (1) applies,

(b) references to members or partners of a firm or partnership include members of such a limited liability partnership,

(c) references to a company do not include such a limited liability partnership, and

(d) references to members of a company do not include members of such a limited liability partnership.

9. Section 847 ITTOIA provides:

(1) In this Act persons carrying on a trade in partnership are referred to collectively as a "firm".

(2) The provisions of this Part are expressed to apply to trades but unless otherwise indicated (whether expressly or by implication) also apply:

(a) to professions; and

(b) in the case of this section and sections 849, 850, 857 and 858 to businesses that are not trades or professions.

10. However, s 848 ITTOIA makes it clear that:

Unless otherwise indicated (whether expressly or by implication), a firm is not to be regarded for income tax purposes as an entity separate and distinct from the partners.

11. Section 849 ITTOIA makes provision for the calculation of a firm's profits or losses as follows:

(1)If–

(a)a firm carries on a trade; and

(b)any partner in the firm is chargeable to income tax

the profits or losses of the trade are calculated on the basis set out in subsection (2) or (3), as the case may require.

(2)For any period of account in which the partner is a UK resident individual, the profits or losses of the trade are calculated as if the firm were a UK resident individual.

(3)For any period of account in which the partner is non-UK resident, the profits or losses of the trade are calculated as if the firm were a non-UK resident individual.

12. Section 852(1) ITTOIA provides:

For each tax year in which a firm carries on a trade (the "actual trade"), each partner's share of the firm's trading profits or losses is treated, for the purposes of Chapter 15 of Part 2 (basis periods), as profits or losses of a trade carried on by the partner alone (the "notional trade").

13. Mr Hillier contends, relying on s 263 ITTOIA, that it is clear that although it is the limited liability partnership that carries on the trade, it (the trade) is treated as carried on in partnership by the members. He submits that there is only one trade, that of the limited liability partnership, and the purpose and effect of ss 863(1), 847, 848 and 852 ITTOIA is to ensure that it is the partners who are taxed on the partnership profits as opposed to the partnership.

14. In support of his argument Mr Hillier cites the decision of the High Court in *MacKinlay (HM Inspector of Taxes) v Arthur Young McClelland Moores & Co.* [1986] STC 491. In this case, which concerned the deduction by a partnership of individual partners' removal expenses Vinelott J referred to the "three stages" in the assessment to tax of partnership and in doing so said, at 504:

> "Before turning to those cases I should, I think, say something about the way in which partnership profits are assessed to tax. There are, in effect, three stages. First, the profits of the firm for an appropriate basis period must be ascertained. What has to be ascertained is the profits of the firm and not of the individual partners. That is not, I think, stated anywhere in the Income Tax Acts, but it follows necessarily from the fact that there is only one business and not a number of different businesses carried on by each of the partners."

Although we were not referred to the decision of the House of Lords in this case (reported at [1989] STC 898) we note that the words of Vinelott J were quoted and adopted by Lord Oliver of Aylmerton (at 901), with whom the other member of the House of Lords agreed.

15. However, as Mr Vaines correctly pointed out, Vinelott J, and indeed the House of Lords in that case, was concerned with the position as it existed before the introduction of self-assessment when a partnership was treated for income tax purposes, under s 111 of the Income and Corporation Taxes Act 1988, as "*an entity which is separate and distinct from those persons*" who carried out the trade or profession in partnership and it would appear that this was why Vinelott J referred to there being "only one business". This can, and should, be contrasted with the present position under s 848 ITTOIA that a partnership is not to be regarded for income tax purposes as separate and distinct from the partners.

16. For this reason Mr Vaines contends that the effect of the legislation is that it is the partners who are treated as carrying out the trade and not the firm itself, indeed s 862 ITTOIA expressly provides that this is the position with regards to limited liability partnerships. Therefore, he submits, that each partner is carrying on a trade albeit collectively with others and accordingly his profits are taxed on him individually.

17. We agree with Mr Vaines and reject the argument advanced by Mr Hillier that there is only one trade – that of the partnership.

18. Although Mr Hillier is correct that various sections of Part 9 of ITTOIA, which "*contains some special rules about partnerships*" (see s 846 ITTOIA), do refer to "a

trade" or "the trade", we see no reason why this should be restricted to meaning the trade of the partnership as opposed to that of the individual partners.

19. In addition we do not accept that s 852 ITTOIA with its references to the "actual trade" of the firm and "notional trade" of each partner's share of profits as losses provides any assistance to HMRC. As is made abundantly clear in the legislation where it states "*for the purposes of Chapter 15 of Part 2 (basis periods)*" that that the carrying on by a partner of a "notional trade" is in relation to those purposes only and does not have the general application suggested by Mr Hillier.

Wholly and Exclusively

20. Section 34(1) ITTOIA provides:

> In calculating the profits of a trade, no deduction is allowed for–
>
> (a)expenses not incurred wholly and exclusively for the purposes of the trade, …

21. As Henderson J said in *Duckmanton v HMRC* [2013] UKUT (TCC) at [14]:

> "It is well known that the UK tax legislation has never made positive provision about what expenses or deductions are deductible in the computation of profits of a taxable business. The relevant test has always been framed in purely negative terms"

22. He continued:

> 16. The modern law on the interpretation and application of this test was summarised by Millett LJ, as he then was, with the agreement of Hirst LJ and Sir John Balcombe, in *Vodafone Cellular Limited v Shaw* (1997) 69 TC 376 at 436-437, [1997] STC 734 at 742-743:
>
> > "*Was the payment made wholly and exclusively for the purposes of the taxpayers trade?*
> >
> > Whether a payment is made exclusively for the purpose of the taxpayer's trade or partly for that purpose and partly for another is a question of fact for the Commissioners. The Court can interfere only if the Commissioners have made an error of law in reaching their conclusion. The principles on which the Court acts are to be found in the speech of Lord Radcliffe in *Edwards v Bairstow & Another* 36 TC 207; [1956] AC 14 and are too well known to repeat. It is sufficient to say that the Court will interfere where the true and only reasonable conclusion from the facts found by the Commissioners contradicts the determination.
> >
> > In the case of an individual taxpayer, the other purpose is usually a private purpose of his own. In a case like the present, where the taxpayer is a company forming part of 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. But the same principles apply ...

The leading modern cases on the application of the "exclusively" test are *Mallalieu v Drummond* 57 TC 330; [1983] 2 AC 861 and *MacKinlay v Arthur Young McClelland Moores & Co* 62 TC 704; [1990] 2 AC 239. From these cases the following propositions may be derived:

> 1. The words "for the purposes of the trade" mean "to serve the purposes of the trade". They do not mean "for the purposes of the taxpayer" but for "the purposes of the trade", which is a different concept. *A fortiori* they do not mean "for the benefit of the taxpayer".
>
> 2. To ascertain whether the payment was made for the purposes of the taxpayer's trade it is necessary to discover his object in making the payment. Save in obvious cases which speak for themselves, this involves an inquiry into the taxpayer's subjective intentions at the time of the payment.
>
> 3. The object of the taxpayer in making the payment must be distinguished from the effect of the payment. A payment may be made exclusively for the purposes of the trade even though it also secures a private benefit. This will be the case if the securing of the private benefit was not the object of the payment but merely a consequential and incidental effect of the payment.
>
> 4. Although the taxpayer's subjective intentions are determinative, these are not limited to the conscious motives which were in his mind at the time of the payment. Some consequences are so inevitably and inextricably involved in the payment that unless merely incidental they must be taken to be a purpose for which the payment was made.
>
> To these propositions I would add one more. The question does not involve an inquiry of the taxpayer whether he consciously intended to obtain a trade or personal advantage by the payment. The primary inquiry is to ascertain what was the particular object of the taxpayer in making the payment. Once that is ascertained, its characterisation as a trade or private purpose is in my opinion a matter for the Commissioners, not for the taxpayer. Thus in *Mallalieu v Drummond* the primary question was not whether Miss Mallalieu intended her expenditure on clothes to serve exclusively a professional purpose or partly a professional and partly a private purpose; but whether it was intended not only to enable her to comply with the requirements of the Bar Council when appearing as a barrister in Court but also to preserve warmth and decency."

The only point I need to add to the above summary, by way of explanation, is that the fact-finding role of the General or Special Commissioners is now performed by the FTT. It remains the case that

an appeal from the FTT to the Upper Tribunal lies only on questions of law, and that the principles on which the Upper Tribunal will interfere with the facts found by the FTT are still those stated in *Edwards v Bairstow*.

17. The distinction between the object of the taxpayer in spending money and the effect of the expenditure was explained by Lord Brightman in *Mallalieu v Drummond* [1983] 2 AC 861 at 870F-871A:

> "The object of the taxpayer in making the expenditure must be distinguished from the effect of the expenditure. An expenditure may be made exclusively to serve the purposes of the business, but it may have a private advantage. The existence of that private advantage does not necessarily preclude the exclusivity of the business purposes. For example, a medical consultant has a friend in the South of France who is also his patient. He flies to the South of France for a week, staying in the home of his friend and attending professionally upon him. He seeks to recover the cost of his air fare. The question of fact will be whether the journey was undertaken solely to serve the purposes of the medical practice. This will be judged in the light of the taxpayer's object in making the journey. The question will be answered by considering whether the stay in the South of France was a reason, however subordinate, for undertaking the journey, or was not a reason but only the effect. If a week's stay on the Riviera was not an object of the consultant, if the consultant's only object was to attend upon his patient, his stay on the Riviera was an unavoidable effect of the expenditure on the journey and the expenditure lies outside the prohibition ..."

18. The importance of the distinction between object and effect, and of the findings of fact made by the fact-finding tribunal, is well illustrated by the subsequent decision of the House of Lords in *McKnight v Sheppard* (1999) 71 TC 419, [1999] 1 WLR 1333. The taxpayer in that case was a stockbroker, who had incurred legal expenses of around £200,000 in defending himself on a number of charges before the disciplinary committee of the Stock Exchange and appearing before the appeals committee. The appeals committee set aside an order for suspension imposed by the disciplinary committee, and substituted fines totalling £50,000. The taxpayer sought to deduct both the fines and the legal expenses in computing his profits under Case I of Schedule D. On appeal from the disallowance of the deductions by the Inspector of Taxes, the Special Commissioner (Mr Theodore Wallace) found that the taxpayer's exclusive purpose in incurring the legal expenses had been to preserve his business, although he had also been concerned with his personal reputation. Accordingly, the expenses had been incurred wholly and exclusively for the purposes of his trade, and their deduction was not prohibited.

23. Mr Hillier, relying on the fourth Millet LJ's propositions in *Vodafone* quoted by Henderson J, submitted that the payment to Bayerische Landesbank by Mr Vaines was not wholly and exclusively for the purposes of his trade in that it prevented his bankruptcy and preserved his reputation.

24. However, given our finding of fact (in paragraph 3, above) that the purpose of Mr Vaines in making that payment was to preserve and his protect his professional career or trade and that in *Mcknight (HM Inspector of Taxes) v Sheppard* [1999] STC 669 Lord Hoffman giving the decision of the House of Lords said, at 673:

> "The well known case of *Morgan (Inspector of Taxes) v Tate & Lyle Ltd* [1955] AC 21, 35 TC 367 is authority for the proposition 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."

We find that the payment of €300,000 made by Mr Vaines to Bayerische Landesbank was wholly and exclusively for the purposes of his trade.

Capital or Revenue

25. Section 33 ITTOIA provides:

> In calculating the profits of a trade, no deduction is allowed for items of a capital nature

26. Mr Hillier submits that this precludes a deduction of the €300,000. However, Mr Vaines referred us to several authorities in support of his contention that the expense was not of a capital nature.

27. In *British Insulated and Helsby Cables v Atherton* [1926] AC 205 Lord Cave LC said, at 213-214:

> "Where expenditure is made, not only once and for all, but with a view to bringing into existence an asset or advantage for the enduring benefit of a trade, I think there is very good reason (in the absence of special circumstances leading to the opposite conclusion) for treating such expenditure as property attributable not to revenue but to capital."

28. Lawrence J in *Southern (HM Inspector of Taxes) v Borax Consolidated Ltd* (1940) 23 TC 597 said, at 602:

> "… as to whether this is a payment properly attributable to capital or to revenue, in my opinion the principle which is to be deduced from the cases is that where a sum of money is laid out for the acquisition or improvement of a fixed capital asset it is attributable to capital, but that if no alteration is made in the fixed capital asset by the payment, then it is properly attributable to revenue, being in substance a matter of maintenance, the maintenance of the capital structure or the capital assets of the Company."

He continued, at 605:

> "It appears to me that the legal expenses which were incurred by the Respondent Company did not create any new asset at all but were expenses which were incurred in the ordinary course of maintaining the assets of the Company, and the fact that it was maintaining the title

> and not the value of the Company's business does not, in my opinion, make it any different."

29. As Mr Vaines submits, in the present case no asset or enduring advantage was brought into existence by the payment he made to Bayerische Landesbank. Given our finding that this payment was to preserve and his protect his professional career or trade it must follow that it is a revenue and not capital payment and for the reasons above is deductible being incurred wholly and exclusively for the purposes of his trade.

Summary of Conclusions

30. To summarise our conclusions:

(1) Mr Vaines does carry on a profession or trade as an individual albeit collectively with others (in partnership) and accordingly his profits are taxed on him individually;

(2) the payment of €300,000 to Bayerische Landesbank was incurred wholly and exclusively for purposes of that profession or trade; and

(3) that payment was revenue expenditure.

Decision

31. For the above reasons the appeal is allowed

Right to Apply for Permission to Appeal

32. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

JOHN BROOKS
TRIBUNAL JUDGE

RELEASE DATE: 15 October 2013