Neutral Citation Number: [2025] EWCA Civ 3

Case No: CA-2023-002232

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)
MR JUSTICE MILES AND JUDGE SWAMI RAGHAVAN
[2023] UKUT 00218 (TCC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 17/01/2025

Before:

LORD JUSTICE SNOWDEN
LADY JUSTICE FALK
and
LORD JUSTICE ZACAROLI

- -

Between:

(1) SCOTTISHPOWER (SCPL) LIMITED **(2) SCOTTISHPOWER RENEWABLES (UK) LIMITED** **(3) SCOTTISHPOWER (DCL) LIMITED** **(4) SCOTTISHPOWER ENERGY RETAIL LIMITED**	**Appellants**
- and –	
THE COMMISSIONERS FOR HIS MAJESTY'S REVENUE AND CUSTOMS	**Respondents**

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David Goldberg KC and Laura Inglis (instructed by **Linklaters LLP**) for the **Appellants**
David Ewart KC and Thomas Chacko (instructed by **HMRC Solicitor's Office and Legal Services**) for the **Respondents**

Hearing dates: 26 and 27 November 2024

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Approved Judgment

This judgment was handed down remotely at 10.00am on 17 January 2025 by circulation to the parties or their representatives by e-mail and by release to the National Archives.

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Lady Justice Falk:

Introduction

1. This appeal addresses the existence and scope of a rule that payments in the nature of penalties incurred in the course of trading activities may not be deducted in computing taxable profits. More specifically, the issue between the parties is whether such a rule can prevent the deduction of payments made to consumers and consumer organisations pursuant to agreements made in settlement of regulatory investigations.

2. HMRC say that the rule, explained by Lord Hoffmann in *McKnight (HM Inspector of Taxes) v Sheppard* [1999] 1 WLR 1333, [1999] STC 669, exists and applies to the payments at issue in this case. The four appellants, to whom I shall refer collectively as "ScottishPower", maintain that the decision in *McKnight v Sheppard* was much more limited and there is no rule that prevents the deduction of the payments.

3. ScottishPower generate and supply gas and electricity. Under the Gas Act 1986 and Electricity Act 1989, these are regulated activities which may only be carried out under a licence. The relevant regulator is the Gas and Electricity Markets Authority ("GEMA"). GEMA's day to day work is carried out by the Office of Gas and Electricity Markets, known as Ofgem.

4. Between October 2013 and April 2016 ScottishPower entered into various agreements with GEMA in settlement of Ofgem investigations into matters such as mis-selling, complaints handling and costs transparency. This led to the payment of penalties in nominal amounts of £1 and payments to consumers and consumer organisations totalling around £28m. ScottishPower challenge HMRC's denial of deductions for the £28m.

5. The First-tier Tribunal ("FTT") dismissed ScottishPower's appeal against the denial of deductions, except for one element which it concluded was compensatory in nature ([2022] UKFTT 41 (TC), Judge Charles Hellier and John Woodman). Both parties appealed to the Upper Tribunal ("UT"), which held that all the payments were non-deductible ([2023] UKUT 218 (TCC), Miles J and Judge Swami Raghavan). ScottishPower now appeal with the permission of this court.

The facts

The regulatory regime in outline

6. Under the relevant statutory regime, licences to generate and supply gas and electricity are granted subject to certain conditions and statutory requirements. The conditions include standard licence conditions, or "SLCs". GEMA has also been granted enforcement powers, which include the power to impose a penalty in the event of contravention of those conditions or requirements or a failure to meet prescribed standards of performance. Penalties are paid into the Consolidated Fund, so they form part of general government resources. Since 2014 there has been an additional statutory power to make a consumer redress order where contraventions have resulted in consumer loss or inconvenience, but that power was not exercised in this case.

7. GEMA's published statement of policy in relation to penalties and consumer redress (dated 6 November 2014) refers to its principal statutory objective, namely "to protect

the interests of existing and future gas and electricity consumers", and describes its strategic objectives for enforcement as being to "deliver credible deterrence", "ensure visible and meaningful consequences" for businesses who do not comply and achieve the "greatest positive impact" by targeting enforcement resources and powers. The "central objectives" of imposing penalties are to "obtain fair outcomes for consumers" and "deter future non-compliance" both by the regulated person concerned and by others. Non-compliance should "normally cost significantly more than compliance" and penalties should act as a "significant deterrent". The amount of any penalty will generally both remove any detriment to customers or gain for the regulated persons and include a penal element, reflecting the seriousness of the contravention or failure and the need for deterrence. A discount may apply if there is a settlement. Voluntary compensation or redress payments are taken into account in determining the appropriate penalty.

The investigations and settlements

8. The UT's decision summarises the subject-matter of the investigations as follows:

> "14. The investigations leading to the four settlement agreements in issue involved the following regulatory breaches:
>
> (1) *Mis-selling* – Ofgem considered that SLC 25, which imposed obligations in relation to marketing activities, had been breached. Insufficiently robust training and monitoring of doorstep and telesales marketing had resulted in misleading information being provided to customers.
>
> (2) *Cost-reflectivity* – SLC 27.2A required that differences in terms and conditions between payment methods (e.g. between prepayment and direct debit) should reflect the relative costs of the different methods. Ofgem considered that the taxpayer did not have robust procedures to justify its price differentials.
>
> (3) *Energy Saving* (also referred to as CO_2 and CESP) – the taxpayers failed to meet prescribed carbon emission reduction targets by promoting energy saving actions to consumers as set out in relevant legislation (the Electricity and Gas (Community Energy Saving Programme) Order 2009) ("CESP").
>
> (4) *Complaints Handling* – Ofgem considered that the taxpayers breached SLC 25 (requiring suppliers to take reasonable steps to achieve matters such as fair, accurate and prompt behaviour), SLC 27 (timely billing and correction of billing errors), and the complaints handling standards and procedures in the Gas and Electricity (Consumer Complaints Handling Standards) Regulations 2008."

9. During the investigation process Ofgem proposed substantial penalties. However, the payments that were ultimately agreed were made pursuant to contractual settlement agreements, under which ScottishPower agreed to pay significant amounts to customers, charities and a campaign focused on energy consumers. In more detail:

a) Under the mis-selling settlement agreement, entered into in October 2013, ScottishPower agreed to pay £7.5m to vulnerable customers, identified by being part of its "Warm Homes Scheme", and also to set aside £1m for customers actually affected by the mis-selling, with any unallocated amount going to a charitable trust supporting people affected by fuel poverty. The actual payments made comprised

£7,316,585 to vulnerable customers and £554,013 to affected customers. The balance of the total of £8.5m, comprising £183,615 of uncashed cheques payable to those in the Warm Homes Scheme and £445,987 that was unallocated to affected customers, was paid to the charity.

b) The cost-reflectivity settlement was agreed in May 2014. ScottishPower agreed to pay £750,000 to a public awareness campaign run by the Citizen's Advice Bureau.

c) The energy saving settlement, agreed in December 2014, provided for a £2.4m payment to the same charity that benefitted from the mis-selling settlement. Part of this amount was paid by a company that has now left the ScottishPower group and is not the subject of this appeal.

d) The complaints handling settlement was agreed in April 2016. It provided for up to £15m to be paid to priority or Warm Homes Scheme "qualifying" customers, plus £3m and any unused part of the £15m to be paid to charity. In the result £14,709,208 was paid to qualifying customers, calculated as round sum payments of £73 to each such customer, and £3,290,791 to two charities concerned with energy supply to consumers.

10. The settlements also provided for nominal penalties, which reduced the above amounts to that extent. As can be seen, the most significant settlements related to mis-selling and complaints handling, resulting in aggregate payments of £8.5m and £18m respectively.

11. The settlement agreements had appended to them not only arrangements in relation to consumers who were to benefit from the agreements (such as how they would be tracked down and contacted) but also notices proposed to be published by GEMA. Although those notices referred to the nominal penalty amounts they were detailed documents covering the failings said to have occurred, the criteria relevant to the level of the penalty, and mitigating and aggravating factors.

12. For example, paragraph 1.2 of the notice appended to the mis-selling settlement agreement, entered into with the fourth appellant on 10 October 2013, stated:

> "The Authority [GEMA] considers it appropriate to impose a penalty on SP [ScottishPower Energy Retail Limited]. However, SP has agreed to make contributions amounting to £8.5m in the form of compensation and payments to vulnerable customers. The Authority considers that the payments offered by SP to aid consumers will be of greater benefit to energy customers than if a substantial penalty was imposed. Accordingly, the Authority considers that a nominal penalty of £1 should be imposed. Furthermore, the level of the penalty contributions has been reduced to reflect the steps taken by SP to take corrective measures and the agreed settlement of this investigation."

13. Under the heading of "The Authority's proposed decision on penalty" the notice stated that a "significant penalty" was warranted by the seriousness and duration of the contraventions, the degree of harm to consumers and the financial gain made by ScottishPower, but that GEMA placed emphasis on the agreement to settle and a commitment to improve processes, and "had particular regard" to the commitment to pay £8.5m to consumers, such that a £1 penalty was reasonable in the circumstances. The notice spelt this out in the following terms at paragraph 6.9:

> "The penalty would have been higher if SP:
> - had not agreed a settlement and admitted the breaches;
> - had not agreed to make payments of £8.5 million to benefit consumers;
> - had not taken steps to improve its systems and processes and to introduce new checks and procedures to improve compliance."

14. The settlement agreement in respect of complaints handling and billing issues was entered into on 25 April 2016, also with the fourth appellant. The notice appended to that agreement noted that the breaches had been admitted and that "significant improvements" had been made to billing performance and customer service since the investigation was opened (paragraph 1.2). It went on:

> "1.3 The Authority has taken into account that ScottishPower has offered to settle this Investigation and also to undertake to make consumer redress payments set out in paragraph 1.6 to directly affected customers and to charity(ies)/third sector organisation(s) for the benefit of domestic energy consumers ("consumer redress").
>
> 1.4. Having considered all the circumstances of the case, the Authority considers the consumer redress payments will be of greater benefit to consumers than if a significant financial penalty were to be imposed.
>
> 1.5. Accordingly the Authority considers it appropriate in the circumstances of this investigation to impose a reduced financial penalty of £1 on ScottishPower provided that ScottishPower pays the sum of £18 million (less £l) in consumer redress."

15. After a section addressing the "criteria relevant to the level of financial penalty", paragraph 6.1 stated:

> "Taking account of all these factors and also mindful of [GEMA's] principal objective to protect the interests of existing and future energy consumers, ScottishPower has agreed to pay £18 million (less £l) in lieu of a higher penalty…"

The relevant tax provisions

16. Section 35 of the Corporation Tax Act 2009 ("CTA 2009") provides:

> "The charge to corporation tax on income applies to the profits of a trade."

17. Section 46(1) provides:

> "The profits of a trade must be calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits for corporation tax purposes."

18. One of those adjustments is in s.54, which provides:

> "(1) 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, or
> (b) losses not connected with or arising out of the trade.
>
> (2) If an expense is incurred for more than one purpose, this section does not prohibit a deduction for any identifiable part or identifiable proportion of the expense which is incurred wholly and exclusively for the purposes of the trade."

19. Mr Ewart KC, for HMRC, confirmed in oral submissions that HMRC relied on s.54(1)(a) and not on s.54(1)(b).

The statutory rules applicable to GEMA

20. We were shown relevant statutory provisions of Part I of the Electricity Act 1989 ("EA 1989"). The parties proceeded on the basis that there is no material difference between these provisions and those in the Gas Act 1986.

21. Section 3A EA 1989 states that the principal objective of GEMA (the "Authority") in carrying out its functions under that part of the Act "is to protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems" and that (among other things) its functions must be carried out in the manner it considers to be "best calculated to further the principal objective".

22. Section 27A EA 1989 confers the power on GEMA to impose penalties. Sub-section (1) provides:

> "Where the Authority is satisfied that a regulated person—
> (a) has contravened or is contravening any relevant condition or requirement; or
> (b) has failed or is failing to achieve any standard of performance prescribed under section 39 or 39A,
> the Authority may, subject to section 27C, impose on the regulated person a penalty of such amount as is reasonable in all the circumstances of the case."

23. Section 27A goes on to specify the procedure that must be followed, which includes a formal notice of intention to impose a penalty, which is publicised and invites representations or objections in relation to the proposed penalty (s.27A(3)), followed by a further notice that imposes the penalty (s.27A(5)). Under s.27A(10), any penalty received by GEMA must be paid into the Consolidated Fund. In this case the notices appended to the settlement agreements were the notices of intention to impose a penalty, under s.27A(3).

24. Section 27B requires GEMA to publish a statement of policy "with respect to the imposition of penalties and the determination of their amount", to which it must have regard. This is the November 2014 statement referred to at [7] above (no earlier version was provided). Section 27E confers a right of appeal to the court against a penalty, but only in certain respects, namely that the penalty was not within GEMA's power, that the various notice-related requirements were not met or the proposed timing of payment was unreasonable.

25. It was common ground that the power to enter into the kind of agreements that GEMA did in this case is not spelt out in the legislation, albeit that its existence was not disputed. The approach that GEMA takes appears to be based on the requirement in s.27A(1) to impose a penalty of "such amount as is reasonable in all the circumstances of the case". The provisions of the agreements required substantial sums to be paid to third parties, and this (together with other relevant considerations) enabled GEMA to conclude that nominal penalties were reasonable in all the circumstances.

26. In contrast, the legislation introduced in 2014 to allow GEMA to make consumer redress orders provides for the first time an express statutory mechanism for GEMA to require payments to be made, not by way of penalty into the Consolidated Fund, but to others. The relevant provisions are in sections 27G-27N EA 1989. A consumer redress order may be made where "one or more consumers have suffered loss or damage or been caused inconvenience" as a result of the contravention of a relevant condition or requirement. Such an order may require a regulated person to:

> "…do such things as appear to the Authority necessary for the purposes of—
> (a) remedying the consequences of the contravention, or
> (b) preventing a contravention of the same or a similar kind from being repeated." (section 27G(2))

Section 27H specifies that such things may include paying compensation to affected consumers. As already indicated, the power to make a consumer redress order was not exercised in this case, even though three of the four settlements post-dated its introduction.

The FTT and UT decisions

27. The FTT found that ScottishPower agreed to the settlement terms "in the expectation that if they did not a penalty greater than £1 would be imposed" ([110]). The reasons for agreeing to them were to avoid litigation risk, to address the possible reputational risk of a substantial penalty and the diversion of management time, to avoid brand damage and also to promote goodwill through payments to customers, which could be directed to those who had suffered harm rather than accruing to the Exchequer ([35]).

28. The FTT found that the payments were deducted in computing the profits of the relevant trade in accordance with ordinary principles of commercial accounting ([111]). The acts and omissions that gave rise to them were carried out as part of ScottishPower's trading activity and for the purposes of earning income from it. Infractions were common but serious ones such as those in issue here were less so. Breaches of the complaints handling and CO_2 rules were "practically almost unavoidable", but there was no such finding as regards the other breaches ([112]; [164]). There was no intention to breach the rules but the behaviour was "not inadvertent or accidental" ([114]). While the payments:

> "…were incurred in the course of activities carried on for the purpose of the trade, they were also made for the purpose of closing down the investigation and avoiding adverse publicity and so differed from ordinary compensation. But it seems to us that those two purposes were…both purposes of the trade." ([119])

29. The FTT decided that there is a principle that payments in respect of a penalty or in lieu of a penalty are non-deductible, whereas compensation payments are deductible. It concluded that only the £554,013 paid to customers affected by mis-selling was compensatory. It further concluded that both that element, and if it was wrong on its principal conclusion the remainder of the payments, were made wholly and exclusively for the purposes of the taxpayers' trades: [158]-[172]. That conclusion was not challenged either in the Upper Tribunal or in this court.

30. The FTT also rejected an argument that payments to charities were deductible as charitable donations. No appeal was pursued in respect of that decision.

31. The UT decided that *McKnight v Sheppard* is authority for the proposition that an expense which has the nature or character of a penalty is precluded from deduction as a matter of law, and that on the facts no part of the £28m was deductible. The FTT was wrong to draw a distinction between punitive and compensatory payments. Rather, "the proper approach was to ask whether, on a global assessment of the evidence, the relevant payment has a punitive character" ([68]). The tribunal was required to assess whether "payments are properly to be regarded as being in the nature of penalties", one relevant feature being whether they can be regarded as compensatory ([88]). However, a punitive characterisation was not precluded by some compensatory element ([89]). Here the £554,013 was part of a package that was "put together under the threat of penalty and was (just as much as the other parts of the package) paid in lieu of a penalty – in the sense that it was arrived at under the regulatory auspices and would have been imposed if the deal was not done".

The grounds of appeal

32. ScottishPower maintain that the UT erred in treating *McKnight v Sheppard* as establishing that a payment in the nature of a penalty is non-deductible, by failing to apply s.54 CTA 2009 correctly by reference to the purpose of the expenditure, and by failing to decide that on the FTT's factual findings the payments had to be deductible. The discussion of penalties in *McKnight v Sheppard* was obiter and in any event the payments in issue in this case were not penalties in form or substance. There was also no discussion in *McKnight v Sheppard* about payments in lieu of penalties, and the UT further erred in deciding that a "global assessment" was required which treated the entire £28m in the same way, without recognising that identifiable parts of an expense may be treated differently.

Von Glehn and *Herald*

33. As the UT correctly recognised, *McKnight v Sheppard* must be considered in the context of two earlier decisions, *Commissioners of Inland Revenue v Alexander von Glehn & Co. Ltd* [1920] 2 KB 553 ("*von Glehn*") and *The Herald and Weekly Times Limited v The Federal Commission of Taxation* (1932) 48 CLR 113 ("*Herald*").

34. *Von Glehn* concerned wartime rules under which Customs & Excise could require evidence of the ultimate destination of exported goods and could impose penalties for a failure to show that all reasonable steps had been taken to prevent them reaching enemy territory. Proceedings for penalties were brought against the taxpayer in the King's Bench Division and it was agreed, apparently at the hearing, that there was no defence because it could not prove that all reasonable steps had been taken. The taxpayer agreed to pay

£3000 and claimed to deduct both that amount and the legal costs it had incurred in the proceedings for the purposes of excess profits duty. The Special Commissioners allowed the claim but Rowlatt J reversed the decision in relation to both elements, and his decision was affirmed by this court.

35. The relevant rules included restrictions on deductions in similar terms to the two limbs of s.54(1) CTA 2009. No distinction is drawn in the decision between the £3000, which was treated as payment of a penalty, and the costs. Lord Sterndale MR referred at p.564 to the absence of authority but said that he had found some remarks of Lord Davey in *Strong & Co. of Romsey Ltd v Woodifield* [1906] AC 448, 453 ("*Strong v Woodifield*") to be of assistance. That case concerned the deductibility of damages paid to compensate for injuries suffered by the customer of an inn from the fall of a chimney. Lord Davey had said this on the question whether the disbursement was wholly and exclusively laid out for the purposes of the trade:

> "I think that the payment of these damages was not money expended 'for the purpose of the trade.' These words are used in other rules, and appear to me to mean for the purpose of enabling a person to carry on and earn profits in the trade, etc. I think the disbursements permitted are such as are made for that purpose. It is not enough that the disbursement is made in the course of, or arises out of, or is connected with, the trade, or is made out of the profit of the trade. It must be made for the purpose of earning the profits."

36. At pp.565-566 Lord Sterndale MR referred to the fact that the business "could perfectly well be carried on without any infraction of the law". A penalty had been imposed "because of an infraction of the law", which was not an expense incurred for the purposes of the trade nor (albeit more questionably) a loss connected with or arising out of the trade. It was not "connected" in the sense required by the legislation. Rather than being a loss connected with the business, it was:

> "…a fine imposed on the company personally…for a breach of the law which it had committed. It is perhaps a little difficult to put the distinction into very exact language, but there seems to me to be a difference between a commercial loss in trading and a penalty imposed upon a person or a company for a breach of the law which they have committed in that trading."

37. Warrington LJ made clear at p.567 that:

> "…the question whether this deduction is to be allowed is one that must be determined by the rules regulating the assessment of income tax and not by rules regulating what may be allowed in the preparation either for a company, an individual, or a firm, of the balance sheet or the profit and loss account. A firm or a company carrying on business may within certain limits treat as a deduction from profits such sum as it pleases, but for the purposes of income tax the deductions which may be allowed from the gross profits are strictly regulated by the Income Tax Acts."

38. He went on to say at p.569:

> "Now is the expenditure in this case a loss connected with or arising out of a trade or manufacture? That it arises out of the trade I think may well be

> conceded. It does arise out of the trade, because if it had not been that the company were carrying on the trade they would not have had to incur this expenditure; but, in my opinion, it is not a loss connected with or arising out of the trade. It is a sum which the persons conducting the trade have had to pay because in conducting it they have so acted as to render themselves liable to this penalty. It is not a commercial loss, and I think when the Act speaks of a loss connected with or arising out of such trade it means a commercial loss connected with or arising out of the trade."

39. Despite this statement, Warrington LJ went on to express some doubt about whether a deduction was properly denied under what is now s.54(1)(b) (losses not connected with or arising out of the trade). However, he concluded at pp.569-570 that the disbursement was not incurred wholly and exclusively for the purposes of the trade but rather because there had been an infraction of the law, relying like Lord Sterndale MR on Lord Davey's comments in *Strong v Woodifield*.

40. Scrutton LJ observed that it seemed obvious that penalties for trading in an unlawful manner should not be deductible but explaining the reasons for that was not so easy. He appears to have focused on what is now s.54(1)(a), stating at p.572 that the payments were "unfortunate incidents which followed after the profits had been earned".

41. As already mentioned, the Court of Appeal's decision in *von Glehn* affirmed a decision of Rowlatt J, a judge who was highly respected both for his significant experience in tax cases and his extremely pithy judgments. His one paragraph judgment in *von Glehn* (12 TC 232) followed his decision in *Commissioners of Inland Revenue v Warnes & Co Ltd* [1919] 2 KB 444 ("*Warnes*") in relation to the same legislation. In *Warnes*, Rowlatt J addressed an argument based on what is now s.54(1)(b), observed that it was impossible to "frame any formula" to describe what is a loss connected with or arising out of a trade, but that:

> "…it seems to me that a penal liability of this kind cannot be regarded as a loss connected with or arising out of a trade. I think that a loss connected with or arising out of a trade must, at any rate, amount to something in the nature of a loss which is contemplable and in the nature of a commercial loss. I do not intend that to be an exhaustive definition, but I do not think it is possible to say that when a fine – which is what the penalty in the present case amounted to – has been inflicted upon a trading body, it can be said that that is a 'loss connected with or arising out of' the trade within the meaning of this rule."

42. Mr Goldberg KC, for ScottishPower, relied on Rowlatt J's reference to a "a loss which is contemplable and in the nature of a commercial loss". In response to Mr Ewart's submission that this did not assist ScottishPower because HMRC relied on s.54(1)(a) and not s.54(1)(b) (based on the preferred approach of the Court of Appeal in *von Glehn*), Mr Goldberg suggested that in its decision in *McKnight v Sheppard* [1997] STC 846 the Court of Appeal had accepted at p.851 that the two tests were for present purposes "essentially the same". In fact, however, in that passage Nourse LJ simply recorded an acceptance of what was effectively a concession by the Inland Revenue to that effect, rather than undertaking any analysis of the point.

43. In the same way as in *McKnight v Sheppard* we are not concerned with what is now s.54(1)(b), since HMRC rely only on s.54(1)(a). In any event, and with great respect to Rowlatt J, I do not find the notion of a "contemplable" loss to be of great assistance. The question is whether the particular payments in issue are deductible on the facts of this case.

44. *Herald* was a majority decision of the High Court of Australia. It concerned the deductibility of damages paid by a newspaper publisher in response to defamation claims. In a majority decision the court held that the sums were "wholly and exclusively laid out or expended for the production of assessable income", within the applicable statutory test. Gavan Duffy CJ and Dixon J considered that the liability arose from the very thing that produced the assessable income, that is publishing the newspaper. It was a "necessary or a natural consequence from the inclusion of the alleged defamatory matter in the newspaper and its publication" (p.118). Inclusion in the newspaper of matter alleged to be defamatory was "a regular and almost unavoidable incident of publishing it" and the claims directly flowed from "acts forming the essence of the business" (p.119). The decision in *von Glehn* was distinguishable because:

> "The penalty is imposed as a punishment of the offender considered as a responsible person owing obedience to the law. Its nature severs it from the expenses of trading. It is inflicted on the offender as a personal deterrent, and it is not incurred by him in his character of trader."

McKnight v Sheppard

45. *McKnight v Sheppard* concerned a stockbroker, Mr Sheppard, who incurred legal expenses in defending himself against Stock Exchange disciplinary proceedings. He managed through the Stock Exchange appeal process to have some findings against him modified or set aside and to have an order for suspension replaced by fines. Mr Sheppard then sought to deduct both the fines and his legal expenses. He failed on the former both before the Special Commissioner and Lightman J in the High Court, and dropped his challenge in the Court of Appeal. However, his claim to deduct the legal expenses ultimately succeeded, with Lightman J's reversal of the Special Commissioner's decision to that effect being disapproved both by this court and by the House of Lords, where Lord Hoffmann gave the only substantive speech.

46. At the time, what is now s.54(1)(a) CTA 2009 was contained in s.130(a) of the Income and Corporation Taxes Act 1970 ("ICTA 1970"), which applied for both income and corporation tax purposes. Lord Hoffmann framed the question at pp.1334-1335 as being whether the deduction of the legal expenses was excluded by that provision. He noted that the Special Commissioner had found that the exclusive purpose of the expenditure was preservation of the trade. After addressing and rejecting an argument that the expenditure was non-deductible because it had a dual purpose, he addressed the Revenue's second argument, which was that the requirement for expenditure to be "for the purposes of the trade" required there to be a "sufficient connection" with the earning of profits, whereas expenditure which resulted from the taxpayer's own misconduct was "outside the proper scope" of the trade, relying on *von Glehn*.

47. Lord Hoffmann said he had "no doubt" that *von Glehn* was correctly decided but thought the Court of Appeal's reasoning "curiously inarticulate", with Scrutton LJ's rationale doing no more than restating the question. The case was unlike *Smith's Potato Estates*

Ltd v Bolland [1948] AC 508, where the costs of contesting a tax assessment were held to be non-deductible because they were both logically and temporally subsequent to the profits being earned. He went on to explain *von Glehn* as follows at pp.1337-1338:

> "But there would have been no similar illogicality in treating the penalty in *von Glehn's* case as a trading expense. It was, as the Court of Appeal accepted, incurred in the course of the company's trade. There must therefore have been something in the nature of the expense which prevented it from being deductible. I think with great respect that the Court of Appeal had difficulty in identifying exactly what this was because they were 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. This, I think, is what Lord Sterndale M.R. meant when he said that the fine was imposed 'upon the company personally'."

48. Lord Hoffmann commented that by "parity of reasoning", a deduction for the fines imposed on Mr Sheppard had been correctly denied. However, the same did not follow for the costs. Non-deductibility depended on "the nature of the expenditure and the specific policy of the rule under which it became payable", which explained the divergent answers in different cases, giving *Herald* as an example. Thus:

> "The question is then whether there is any reason of policy which prohibits the deduction of legal expenses incurred as a result of penal or disciplinary proceedings arising out of the conduct of the business." (p.1338)

Lord Hoffmann indicated that he thought that the Court of Appeal was wrong in *von Glehn* not to draw a distinction between the legal expenses and the penalty, because the issues were different. The purpose of the expenditure was the same whether the defence was successful or not. While it could be argued that as a matter of policy an unsuccessful defendant should bear his own costs personally:

> "…I think there would be great difficulties about giving effect to such a rule. It might not be easy to tell which costs had been expended successfully and which unsuccessfully. The taxpayer may, as in this case, have been convicted on some counts and acquitted on others. He may have had substantial success in mitigation of the penalty. More important, it is fundamental that everyone, 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."

Discussion

The basis of the von Glehn principle

49. The Court of Appeal's decision in *von Glehn* established that a penalty or fine incurred under a statutory regime such as the one considered in that case is not deductible in computing trading profits, even where it was incurred in the course of trading activities. In *McKnight v Sheppard* Lord Hoffmann explained this in terms of the "legislative policy" otherwise being diluted, because the taxpayer would be "allowed to share the burden with the rest of the community" by a tax deduction. The legislative policy to which he referred can only be the legislation under which the fine or penalty was imposed.

50. HMRC's primary case rested on s.54(1)(a) CTA 2009. It is not straightforward to interpret that provision as encapsulating the principle referred to in the previous paragraph. The focus of s.54(1)(a) is the taxpayer's purpose or object in incurring the expenditure: see generally *Mallalieu v Drummond* [1983] 2 AC 861, 870-871. In contrast, the application of *von Glehn* depends on the character or nature of the payment rather than the taxpayer's purpose; as Lord Hoffmann put it, "the nature of the expenditure and the specific policy of the rule under which it became payable". However, the principle clearly exists. One explanation is that, in construing s.54(1)(a), expenditure to meet fines or penalties is simply not to be regarded as incurred "for the purposes of the trade". There is certainly support for that in *von Glehn* itself and perhaps in the explanation in *Herald* that they are not incurred in the taxpayer's "character as trader". Based on Lord Hoffmann's rationale, the point might also appear to gain some support from the general principle of legal policy that the law should be coherent and self-consistent, a principle which may be taken into account in interpreting one piece of legislation – here tax legislation – in the context of another (see *Bennion, Bailey and Norbury on Statutory Interpretation*, 8th ed. at 26.8).

51. However, the alternative explanation is that the rule established in *von Glehn* should now be regarded as an "adjustment required…by law" within s.46(1) CTA 2009. This was HMRC's fallback argument and I consider it to be the better analysis. In *NCL Investments Ltd v HMRC* [2022] UKSC 9, [2022] 1 WLR 1829 ("*NCL*"), Lord Hamblen and Lady Rose (with whom Lord Reed, Lord Briggs and Lord Sales agreed) discussed s.46 CTA 2009 – a provision which it is worth noting had no statutory equivalent before 1998 – and said this at [29]:

> "Tax is the creature of statute and…adjustments required or authorised to be made to profits calculated in accordance with generally accepted accounting principles are likely to be adjustments specified by statute. While it is possible for a judge-made rule to require or authorise such an adjustment to be made, it would have to be a rule which it is clear applies notwithstanding that the company's profits have been calculated in accordance with generally accepted accounting principles."

52. Thus, the general expectation is that adjustments to profits will have a statutory basis. However, a "judge-made rule" may exist which adjusts properly computed accounting profits, but only if it clearly has that effect.

53. The Supreme Court's use of the expression "judge-made rule" should not be taken to suggest that new restrictions on the tax deductibility of expenditure may be created through case law, effectively at the discretion of judges. That would trespass on the function of Parliament and is obviously impermissible. It is axiomatic that the imposition of taxation is a matter for Parliament, not courts or tribunals.

54. However, in enacting s.46 Parliament recognised that restrictions may exist which do not have an express statutory basis and which are instead found to exist by case law. In this case the principle established by *von Glehn*, many years before either s.46 or its statutory predecessor (s.42 of the Finance Act 1998) was enacted, may be regarded as a recognition by the courts that when computing profits for tax purposes an adjustment must be made to prevent a deduction being obtained for fines or penalties imposed by a statutory regime, notwithstanding that the expenditure would otherwise be taken into account in determining profits in accordance with generally accepted accounting principles. An adjustment is required because otherwise the "legislative policy [of the penalty regime] 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".

55. Lord Hoffmann's explanation of *von Glehn* refers to *legislative* policy. That was clearly apt on the facts of *von Glehn* itself, which related to a statutory penalty regime. That explanation would not address fines or penalties incurred under a non-statutory regime. One example of that would be the Formula One regulatory regime considered by the Upper Tribunal in *McLaren Racing Ltd v HMRC* [2014] UKUT 269 (TCC), [2014] STC 2417 ("*McLaren*"). However, the penalty in issue in that case was non-deductible for the more fundamental reason that it was imposed for actions, being the wrongful receipt and dissemination of another team's confidential information, that were simply not carried out in the course of McLaren's trade at all.

56. Less straightforwardly, it appears that another example of a deduction being denied for fines imposed under a non-statutory regime may have been *McKnight v Sheppard* itself, on the basis that at the relevant time the relevant Stock Exchange rules had a contractual rather than legislative basis: see the discussion in *McLaren* at [44]. This possibly explains why Lord Hoffmann justified the denial of a deduction for the fines in that case by "parity of reasoning" with his explanation of *von Glehn* (see also *McLaren* at [69]). However, it is not clear that the relevance or otherwise of the non-statutory basis of the fines was considered by Lord Hoffmann. Given that the deductibility of the fines in that case was not in issue in the House of Lords (or this court) there was no need to do so.

57. The facts of this case concern a legislative regime so we do not need to consider the possible application of *von Glehn* in a non-legislative context. The decision in *McLaren* is explicable on another basis: see above.

The scope of the von Glehn principle

58. As the Supreme Court recognised in *NCL*, a rule that denies a deduction for expenses that are not only incurred in the course of trading activities but are taken into account in calculating profits in accordance with generally accepted accounting practice will generally be expected to be statutory rather than "judge-made". Any rule which does not have an express statutory basis needs to be clear in its effect.

59. It is clear that such a rule exists in relation to the deduction of fines and penalties, at least where they are imposed under a legislative regime: *von Glehn*, as explained in *McKnight v Sheppard*. However, there is no support in the authorities for that rule to extend to amounts which are not, in fact, fines or penalties. Further, the scope of any such extension would be anything but clear. On the contrary, it would be highly uncertain. That would neither be consistent with what was said in *NCL* nor would it be easy to reconcile with one of Lord Hoffmann's reasons for allowing a deduction for the legal costs in *McKnight v Sheppard*, namely the "great difficulties about giving effect to such a rule" (see [48] above).

60. HMRC's case, essentially accepted by the FTT and UT, is that the disputed payments in this case should be treated as having the same nature or character as penalties because that is what they replaced. However, even accepting that the payments replaced penalties that would otherwise have been levied in fact (as to which see below), I would disagree with the premise. No authority was cited to support any general proposition that the deductibility of a payment should be determined by reference to the nature of a payment which it replaces. Rather, it is necessary to consider whether the payment <u>actually made</u> is deductible or is to be denied a deduction, whether because it is of a capital nature, because it was not in fact an expense incurred wholly and exclusively for the purposes of the trade, or for some other reason.

61. I do not consider that any general considerations of policy, whether legislative or otherwise, require a conclusion that a principle which prohibits a deduction for fines or penalties must extend to payments which are not in fact fines or penalties, even if they can be seen as replacing them. As Mr Goldberg fairly pointed out, judges have been warned against making decisions based on vague concepts of "public policy" (see, albeit in the very different context of breach of promise, the comments of Lord Atkin in *Fender v St John-Mildmay* [1938] AC 1, 10-12). More specifically here, in my view such a conclusion could be seen – with some justification – as going beyond the proper role of the judiciary: see [53] above.

62. My concerns on this issue are strongly reinforced by the lack of clarity about the scope of any such rule as is contended for by HMRC. As discussed further below, the difficulties that would create are well illustrated by the facts of this case and the regulatory regime in question. That is itself a strong indicator that this is properly a matter for Parliament, not the courts.

63. More generally, I can see no reason in principle why a regulator or other body imposing a penalty or fine may not, if it is contemplating agreeing to some alternative form of redress, take account of the fact that such an alternative may attract a more beneficial tax treatment. The possibility that the payer may obtain a tax deduction for an alternative form of redress does not undermine the regulator's position either generally or specifically in relation to its power to penalise. It would simply be one of the factors that it may be appropriate for it to take into account, whether in fixing the level of any penalty or the nature and amount of any alternative form of redress that it may require, or both.

64. In short, there is no need for judges to step in to ensure that differences in tax treatment between penalties or fines and alternative forms of redress are avoided. The policy imperative for a rule that would deny a deduction for amounts that are not in fact penalties or fines is simply not there. Further, I cannot see that it would properly be a matter for the courts, rather than Parliament, to develop such a rule. The principle established by

von Glehn is clear and obviously correct for the reason explained by Lord Hoffmann in *McKnight v Sheppard*, but its proper limits need to be observed.

Application to this case

65. The only penalties actually imposed in this case were nominal £1 amounts. It is clear from the documentation that this is the basis on which the regulator proceeded. For example, the representations required to be sought under s.27A EA 1989 were only invited in respect of the proposed £1 penalties, and not any other aspect of the settlements.

66. HMRC relied on correspondence between Ofgem and ScottishPower before the settlement agreements were entered into to support the submission that the amounts in question were agreed "in lieu" or in substitution for penalties. This was clearest with the complaints handling settlement, where a prior letter from Ofgem referred to a proposed penalty of £23m with specified discounts for early settlement within specified "windows", the largest discount being available for the earliest settlement. Settlement was achieved within the first such window, which the letter stated would attract a penalty of £18m. The letter noted the alternative possibility of "redress payments to the value of £18 million (minus a £1 financial penalty)… in lieu of a full £18 million financial penalty".

67. This letter was really the high point of HMRC's case. It does indicate that, at least in the case of the complaints handling settlement, Ofgem was prepared to accept the substitution of redress payments for penalties on a pound for pound basis. Further, I do not accept Mr Goldberg's broader submissions that the amount of the penalties that would otherwise have been imposed was entirely at large. First, Mr Goldberg relied on the fact that any penalty that was imposed could have been appealed by ScottishPower with the result that no, or a reduced, penalty would have been imposed. However, the scope for an appeal is limited: see [24] above. Secondly, while I agree that no penalties were ever actually accepted by ScottishPower beyond the nominal amounts, it is apparent that there were negotiations between the parties about what Ofgem would accept, which in at least one case resulted in a material reduction in the amount ScottishPower ultimately paid (see the FTT's decision at [29] and the detailed findings from [34]-[64]).

68. Nevertheless, a closer look at the complaints handling settlement illustrates the difficulties of HMRC's approach. It is clear from the relevant notices that a number of factors were taken into account in determining the appropriate penalty, of which only one was ScottishPower's agreement to make redress payments. Apart from the seriousness and impact of the contraventions, another was the action that ScottishPower had already taken to resolve its customer service issues. As the notices recognised, "ScottishPower made significant improvements to its billing performance and its customer service during the investigation". Similarly in respect of mis-selling, GEMA had regard not only to the agreement to pay £8.5m to consumers but to "the commitment by [ScottishPower] to improve its processes and the steps taken to secure compliance throughout the period of the investigation". There is an explicit statement that the penalty would have been higher if ScottishPower had not both agreed to pay £8.5m and "taken steps to improve its systems and processes and to introduce new checks and procedures to improve compliance".

69. All those improvements would undoubtedly have required expenditure, yet no issue has been raised as to its deductibility, notwithstanding that it was presumably at least prompted by the regulator's involvement. Other examples readily come to mind. What, for example, would have been the position if ScottishPower had made voluntary payments to consumers, consumer bodies or charities during the investigation period (or even before any investigation started) with a view to avoiding the poor publicity that might accompany a substantial penalty, or if it had done so after an investigation had completed but before Ofgem had reached any conclusions as to whether a penalty would be appropriate or as to the level of penalty that it would propose? In those cases Ofgem might well be expected to take account of the payments in determining what if any penalty might be appropriate, just as it took account of the payments in this case. If HMRC were right, where would the dividing line lie? Why should it make all the difference that a financial equivalence can be identified between a penalty amount that is not in fact charged and an alternative form of redress?

70. The introduction in 2014 of a statutory power to make consumer redress orders (see [26] above) provides a further illustration of the difficulties. Mr Ewart suggested that payments made pursuant to such an order may be deductible as being in the nature of compensation, but in truth there is no clear distinction between payments made under such an order and the payments made in this case. If such an order were made then GEMA would obviously have to take that into account in deciding what if any penalty should also be imposed, just as it did with the payments in this case. Indeed, paragraphs 1.5 and 6.1 of GEMA's statement of policy ([7] above) explicitly confirm that it will take both forms of redress into account. More generally, the statement of policy appears to draw little distinction between GEMA's approach to consumer redress orders and the sort of "voluntary" consumer redress made in this case. Both forms of redress are to be taken into account in determining any penalty. Further, the statement anticipates that a consumer redress order may require payments to be made not only to customers but to third party organisations, just like the payments made by ScottishPower in this case. Indeed, GEMA used the term "consumer redress" in referring to those payments: see [14] above.

71. Mr Ewart submitted that we should not be concerned by such matters because this was a clear case. But even if the facts of this case were clear, that misses the point that examples that illustrate the inherent uncertainty of HMRC's approach undermine the existence of the principle for which they contend. (As it happens the facts as found by the FTT are in any event not quite as clear as HMRC suggest. The FTT's findings included at [137] that "it cannot be said that the settlement amounts were in place of certain penalties of the same amounts", although it was "likely" that any penalties would have been "of the same order of magnitude".)

72. One of the difficulties with HMRC's submissions is that they were forced to rely to a substantial extent on what might be taken to have been the purposes of the regulator. In particular, in a section headed "Penalty and punishment" the FTT said this, on which HMRC relied:

> "134. We think it clear that GEMA intended the obligations to make the Redress Payments [ie the disputed payments] to be punishments:
>
> (a) GEMA's statements that its enforcement objective was to deliver credible deterrence and that non-compliance should cost more than

compliance indicates that its purpose was to ensure future compliance with the rules;

(b) GEMA's statement that any penalty (and therefore any amount paid in settlement where absent settlement GEMA would have sought a penalty) should remove any gain made and contain an amount reflecting the seriousness of the contravention indicates a policy of deterrence; and

(c) that settlement was offered as an alternative to the imposition of a penalty and described a penalty as being necessary to create an incentive to ensure compliance to our minds suggests punishment."

73. However, for the purposes of s.54(1)(a) (if that was the relevant test) the focus is on the purpose of the paying party, that is ScottishPower in this case: *Mallalieu v Drummond*. The test does not turn on the objective or intention of anyone else. If the rule against the deduction of fines or penalties is instead an adjustment required by law, which I consider to be the preferable analysis, then there is equally nothing to suggest that third parties' aims or objectives have any role to play beyond what might be necessary to determine whether the amount in question is in fact a fine or penalty. Here it is quite clear that GEMA (correctly) considered that the disputed amounts were <u>not</u> penalties, not least because its only relevant statutory power was to levy a penalty which it was required to pay into the Consolidated Fund.

74. Mr Ewart and Mr Chacko, who made submissions for HMRC on the FTT's decision to allow a deduction for the £554,013 paid to customers affected by mis-selling, also relied on an argument that no part of the disputed payments was compensatory in nature. They suggested that this was supported by the fact that it appears that the payments did not extinguish claims that customers may have had.

75. I do not consider that the availability of a deduction depends on whether or not a particular payment can be regarded as compensating for a loss suffered by the recipient. Rather, and assuming that the payment has been taken into account in computing profits for accounting purposes within s.46 CTA 2009, it depends on whether a deduction is denied by a rule of law, whether that rule is one contained in s.54 or is to be found elsewhere.

76. To take one example, a trader may decide to make a voluntary payment to all its customers by way of an "apology" for a period of poor customer service (a term incidentally also used by ScottishPower when making some of the disputed payments in this case). Many of the trader's customers might have suffered no inconvenience at all, and the cost of inconvenience to others might bear no relationship to the sum received by them. But neither of those features would prevent a deduction being obtained if the expense was incurred wholly and exclusively for the purposes of the trader's business.

77. I accept that, when considering *Herald*, Lord Hoffmann referred to the damages in that case as being "compensatory rather than punitive". This may have been the basis for the FTT's analysis of whether individual elements of the payments were compensatory or not. However, in my view Lord Hoffmann was simply explaining the decision in *Herald* rather than saying that the relevant distinction to draw in each case is between a penalty on the one hand and compensation for a loss on the other. The fact that a payment is compensatory may indicate that it does not have the character of a penalty, but the point goes no further than that.

78. I also do not accept Mr Chacko's submission that the payments should be regarded as penalties because when GEMA obtained ScottishPower's agreement to make them that was done in the exercise of GEMA's penalty-levying power. As I have already explained, the only penalties imposed were the nominal amounts. GEMA's basis for agreeing to nominal penalties was the requirement to have regard to all the circumstances when fixing their amount, but that does not mean that its agreement to the disputed payments was itself an exercise of that power. This was not a case of a penalty payment simply being redirected to consumers and others. GEMA had no power to redirect a penalty payment away from the Consolidated Fund, and it did not do so.

Conclusion

79. In this case the FTT decided that the payments were made in the course of the trade, that they were deducted in computing profits in accordance with ordinary principles of commercial accounting and that (absent the penalty issue) they were made wholly and exclusively for the purposes of the trade: see [27] to [29] above. Since they were not in fact penalty payments there is therefore nothing that prevents them from being deductible. I would therefore allow the appeal.

Lord Justice Zacaroli:

80. I agree.

Lord Justice Snowden:

81. I also agree.