[2013] UKFTT 403 (TC)

TC02799

Appeal numbers: TC/2012/09334

INCOME TAX – section 34 Income Tax (Trading and Other Income) Act 2005 – appellant setting up in business in competition with former employer – expenditure incurred in settling legal proceedings and associated legal costs – whether expenditure wholly and exclusively for the purposes of the trade – duality of purpose – appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

PHILIP MCMAHON **Appellant**

- and -

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

TRIBUNAL: JUDGE JONATHAN CANNAN
MR ALAN REDDEN FCA

Sitting in public in Leeds on 3 June 2013

Mr Anthony Storey of Anthony Storey Accountancy & Taxation Services for the Appellant

Mrs Rosalind Oliver of HM Revenue & Customs for the Respondents

DECISION

Background

1. On 8 August 2007 the appellant signed a Tomlin order which compromised proceedings brought against him by Quantica plc. He had formerly been employed by Quantica plc in Quantica Search and Selection. Pursuant to the terms of the schedule to the Tomlin order the appellant agreed to pay Quantica £100,000 in full and final settlement of all claims brought against him and of all claims arising out of his previous employment. The order was made on the basis that there would be no order as to costs. The appellant had incurred legal costs of £15,354.70 in connection with the proceedings.

2. In his self assessment tax return for tax year 2007-08 the appellant declared trading income from his business as a recruitment consultant which he commenced on leaving Quantica. He also claimed relief for the sum of £100,000 paid to Quantica together with his legal costs in defending the claim against him.

3. On 30 April 2009 the respondents opened an enquiry into the appellant's self assessment return for 2007-08. Following a period of enquiry the respondents issued a closure notice on 7 June 2012 amending the self assessment so as to disallow the expenditure referred to above. The respondents had concluded that the expenditure was not incurred wholly and exclusively for the purposes of the appellant's trade. There was then a statutory review and the respondents upheld the decision to refuse relief in a letter dated 23 August 2012.

4. The appellant appealed the decision in a notice of appeal dated 2 October 2012. The appeal was out of time but no point was taken by the respondents and we extend the time for appealing accordingly.

5. The issue we have to decide on this appeal is whether the expenditure incurred by the appellant was allowable. In particular was the expenditure incurred wholly and exclusively for the purposes of the appellant's trade as required by *section 34 Income Tax (Trading and Other Income) Act 2005*? In deciding that issue we deal firstly with our findings of fact as to the nature of the expenditure and the circumstances in which it was made. In our reasons we consider the relevant legal principles and how they apply to the facts as found.

Findings of Fact

6. During the appeal we heard evidence from Mr McMahon and we were provided with a number of documents which have a bearing on the circumstances in which the expenditure was made. We make the following findings of fact.

7. The appellant commenced working for Quantica in November 2003 as a recruitment consultant. Save where it is otherwise necessary we shall use the term Quantica to refer to both Quantica plc and Quantica Search and Selection. Quantica were the sixth largest recruitment business in the UK dealing with the manufacturing sector and the second largest in the north of England. The appellant worked for Quantica until April 2007 by which stage he was Quantica's top performing manager.

8. In or about April 2007 the appellant decided to leave Quantica in order to set up his own recruitment business, working from home. He did not think that Quantica would seek to prevent him from doing so, but he was wrong. On 1 June 2007 Quantica's solicitors wrote to the appellant's solicitors following earlier correspondence. They identified that the appellant had, prior to his departure, sent their annualised "Top Customer List" dated December 2006 and other documents which they described as "highly confidential" to his private email address. They also identified what they described as instances where the appellant had been diverting work from Quantica to himself.

9. The letter from Quantica's solicitors enclosed particulars of claim and a draft order and sought wide undertakings from the appellant. The undertakings extended not only to compliance with restrictive covenants in the appellant's contract of employment but also an undertaking not to contact, canvass or deal with any client on the Top Customer List. In fact the Top Customer List was a list of all Quantica's customers amounting to some 992 businesses.

10. We do not have all the relevant documents in relation to the proceedings commenced by Quantica. For example we do not have a copy of the claim form or a copy of the particulars of claim. We were told by Mr Storey for the appellant that these documents had been archived and were not available. We do have a copy of the Tomlin order by which the proceedings were settled although we do not have any correspondence leading to the settlement. The Tomlin order was dated 8 August 2007. It refers to an order of His Honour Judge Waksman QC dated 21 June 2007 and it seems likely that this order recorded undertakings by the appellant. The Tomlin order also refers to a trial listed for hearing on 13 August 2007 which was vacated because the proceedings had been compromised.

11. The terms of the compromise are in the schedule to the Tomlin order. As we have said, the appellant agreed to pay Quantica £100,000 with no order for costs. The schedule also contained the following terms:

> "*5. This settlement is in full and final settlement of these court proceedings against the Defendant and also in full and final settlement of all and any claims the Claimant [or any associated company, division or owner of the Claimant] has or may have against the Defendant arising out of the Defendant's previous employment with the Claimant and/or the termination thereof.*
>
> *6. It is agreed that the Defendant is hereby with effect from the date of agreeing this order released from all and any express and/or implied restrictive covenants or restrictions contained within his contract of employment with the*

Claimant dated 24/11/03 and any subsequent restrictions that may have been agreed with the Claimant and is released from any fiduciary duties arising out of his employment with the Claimant or the termination thereof.

7. For the avoidance of doubt it is agreed that the Defendant is free to contact and deal with any candidates or clients/customers he should choose without limitation or restriction from the date of agreeing this order …"

12. The appellant's contract of employment contained various restrictive covenants. We do not need to set out the terms of those restrictive covenants in detail. We can simply record that the appellant had agreed not to seek to conduct business with any "restricted customer" so as to compete with the company for a period of six months after the termination date. For these purposes a restricted customer was defined as any business which, during the twelve months prior to termination, was a client of Quantica and was in Quantica's top 20% of clients by way of turnover.

13. The appellant described in his oral evidence Quantica's claim against him. He said that Quantica claimed that he had breached the restrictive covenants in his contract of employment and his duty of good faith. They also claimed "springboard relief" in the form of a permanent injunction because of his actions in emailing the Top Customer List to himself.

14. For the purposes of this decision it is helpful to understand that springboard relief is a legal concept. It was succinctly described by Haddon-Cave J in *QBE Management Services Limited v Dymoke [2012] EWHC 80 (QB)* in the following terms:

"*239. The principles behind 'springboard' relief are now well-established and, in my view, can be summarised as follows.*

240. First, where a person has obtained a 'head start' as a result of unlawful acts, the Court has the power to grant an injunction which restrains the wrongdoer, so as to deprive him of the fruits of his unlawful acts. This is often known as 'springboard' relief.

241. Second, the purpose of a 'springboard' order as Nourse L.J. explained in Roger Bullivant v Ellis [1987] ICR 464 is "to prevent the defendants from taking unfair advantage of the springboard which [the Judge] considered they must have built up by their misuse of the information in the card index" (at page 476G). May L.J. added that an injunction could be granted depriving defendants of the springboard "which ex hypothesi they had unlawfully acquired for themselves by the use of the plaintiffs' customers' names in breach of the duty of fidelity" (at 478E-G). The Court of Appeal upheld Falconer J.'s decision restraining an employee who had taken away a customer card index from entering into any contracts made with customers.

242. Third, 'springboard' relief is not confined to cases of breach of confidence. It can be granted in relation to breaches of contractual and fiduciary duties (see Midas IT Services v Opus Portfolio Ltd., unreported

Ch.D, Blackburne J. 21/12/99, pp. 18-19), and flows from a wider principle that the court may grant an injunction to deprive a wrongdoer of the unlawful advantage derived from his wrongdoing. As Openshaw J. explained in UBS v Vestra Wealth (supra) at paragraphs [3] and [4]:

"There is some discussion in the authorities as to whether springboard relief is limited to cases where there is a misuse of confidential information. Such a limitation was expressly rejected in Midas IT Services v Opus Portfolio Ltd, an unreported decision of Blackburne J made on 21 December 1999, although it seems to have been accepted by Scott J in Balston Ltd v Headline Filters Ltd [1987] FSR 330 at 340. In the 20 years which have passed since that case, it seems to me that the law has developed; and I see no reason in principle by which it should be so limited.

In my judgment, springboard relief is not confined to cases where former employees threaten to abuse confidential information acquired during the currency of their employment. It is available to prevent any future or further economic loss to a previous employer caused by former staff members taking an unfair advantage, and 'unfair start', of any serious breaches of their contract of employment (or if they are acting in concert with others, of any breach by any of those others). That unfair advantage must still exist at the time that the injunction is sought, and it must be shown that it would continue unless retrained. I accept that injunctions are to protect against and to prevent future and further losses and must not be used merely to punish breaches of contract."

243. Fourth, 'springboard' relief must, however, be sought and obtained at a time when any unlawful advantage is still being enjoyed by the wrongdoer: Universal Thermosensors v. Hibben [1992] 1 WLR 840 Nicholls V-C; see also Sun Valley Foods Ltd v. Vincent [2000] FSR 825 esp at 834.

244. Fifth, 'springboard' relief should have the aim "simply of restoring the parties to the competitive position they each set out to occupy and would have occupied but for the defendant's misconduct" (per Sir David Nicholls VC Universal Thermosensors v. Hibben [1992] 1 WLR 840 at [855A]). It is not fair and just if it has a much more far-reaching effect than this, such as driving the defendant out of business [855A],

245. Sixth, 'springboard' relief will not be granted where a monetary award would have provided an adequate remedy to the Claimant for the wrong done to it (Universal Thermosensors v. Hibben [1992] 1 WLR 840 at [855B]).

246. Seventh, 'springboard' relief is not intended to punish the Defendant for wrongdoing. It is merely to provide fair and just protection for unlawful harm on an interim basis. What is fair and just in any particular circumstances will be measured by (i) the effect of the unlawful acts upon the Claimant; and (ii) the extent to which the Defendant has gained an illegitimate competitive advantage (see Sectrack NV. v. (1) Satamatics Ltd (2) Jan Leemans [2007] EWHC 3003 Flaux J.). The seriousness or egregiousness of the particular breach has no bearing on the period for which the injunction should be

granted. In this regard, it is worth bearing in mind what Flaux J, said at paragraph [68]:

"[68] I agree with Mr Lowenstein that logically, the seriousness of the breach and the egregiousness of the Defendants' conduct cannot have any bearing on the period for which the injunction should be granted - what matters is the effect of the breach of confidence upon the Claimant in the sense of the extent to which the First Defendant has gained an illegitimate competitive advantage. In my judgment, Mr Cohen's submissions seriously underestimate the unfair competitive advantage gained by the Defendants from access to the Claimant's "customer list" and ignore, in any event, the impact (if the injunction were lifted) of actual or potential misuse of other confidential information such as volume of business or pricing information. It is important in that context to have in mind that the Claimant maintains in its evidence that all the information said to be confidential remains confidential." (emphasis added)

247. Eighth, the burden is on the Claimant to spell out the precise nature and period of the competitive advantage. An 'ephemeral' and 'short term' advantage will not be sufficient (per Jonathan Parker J. in Sun Valley Foods Ltd v. Vincent [2000] FSR 825 esp at 834)."

15. The appellant said in evidence and we accept that he had admitted breach of contract and had agreed to abide by the restrictive covenants on the basis that Quantica had agreed to the appellant operating with a handful of clients whilst the proceedings continued. Those clients were Knauf, Eagle Ottawa, Thompson Plastics and Linpac. The reason Quantica were content for the appellant to act for those clients was because they were confident that they would be entitled to an account of the appellant's profits from dealing with them. Presumably they thought that on any view those clients were in the top 20% of clients.

16. The appellant's principal concern was the claim for springboard relief. The 992 companies in the Top Customer List effectively included all manufacturing clients in the north of England. Without access to those clients the appellant would not have had a business.

17. The particulars of claim were not in evidence but we were provided with a copy of the appellant's defence dated 3 July 2007. Whilst it is not possible to make out from the defence the precise position of the two parties, we can make certain findings based on the defence alone. In particular the appellant's defence to the proceedings included the following:

(1) That the appellant was employed by Quantica plc.

(2) The restricted customers for the purposes of the appellant's restrictive covenants should be determined by reference to Quantica plc and not by reference to Quantica Search and Selection as maintained by the claimant. The Claimant was thereby mistaken as to the identity of the restricted customers which did not include the four clients mentioned above.

(3) The appellant admitted breach of his duties of good faith whilst an employee of Quantica.

(4) The appellant denied that the information in the Top Customer List was confidential information or that by sending the list to his private email address he was in breach of his duty of good faith.

(5) The appellant admitted that Quantica had suffered some loss which he would be liable to meet.

18. The appellant told us and we accept that his defence to the claim for springboard relief was partly that it was not in all the circumstances fair for Quantica to obtain such relief unlimited in time.

19. The appellant also told us and we accept that the sum of £100,000 was the best estimate of the profits Quantica had lost as a result of the appellant dealing with Knauf, Eagle Ottawa, Thompson Plastics and Linpac. Whilst these were in the top 20% clients by way of turnover of Quantica Search and Selection the appellant had disputed that they were in the top 20% of clients of Quantica plc.

Reasons

20. The issue which we have to decide arises from *section 34 Income Tax (Trading and Other Income) Act 2005* which provides as follows:

> *"(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) …*
>
> *(2) If an expense is incurred for more than one purpose, this section does not prohibit a deduction for any identifiable part or identifiable portion of the expense which is incurred wholly and exclusively for the purposes of the trade."*

21. Put briefly, the respondents contend that the sum paid by the appellant was at least partly referable to the appellant's breach of contract. As such there was a duality of purpose and it was not incurred wholly and exclusively for the purposes of the trade. The appellant contends that the payment was made for the sole purpose of preserving his business and should be deductible. We set out the competing submissions in more detail below.

22. It is well established that where there is duality of purpose, expenditure in connection with a trade will not be allowable for tax purposes. Mr Storey accepted that if in the present case there was duality of purpose then no part of the expenditure could be separately identified as being wholly and exclusively incurred for the purposes of the appellant's trade. Hence section 34(2) is not in point.

23. The question of duality of purpose has been considered in a number of well known authorities. The appellant relied on the decision of the House of Lords in *McKnight v Shepherd [1999] STC 669*. The respondents relied upon the decision of the High Court in *Knight v Parry [1973] STC 56*. We have also had regard to a recent decision of the Upper Tribunal in *Duckmanton v Commissioners for HM Revenue & Customs [2013] UKUT 0305 (TCC)*. This decision was released after the hearing in the present appeal. Henderson J conveniently summarises the law in relation to the interpretation and application of the test for deductible expenditure at [13] to [20].

24. In McKnight v Sheppard the taxpayer was a stockbroker who incurred legal expenses defending disciplinary charges. He sought to deduct the expenditure on the basis that it was wholly and exclusively for the purposes of the trade. In the House of Lords the Revenue contended that there were two purposes in paying the legal expenses, namely the preservation of his business and his personal reputation.

25. The House of Lords found that there was only one purpose. It distinguished the purpose of the expenditure from its effect. The purpose was the preservation of the trade. The effect was also to preserve the taxpayer's personal reputation. The House of Lords held that expenditure for that purpose was deductible, relying on the principle in *Morgan (Inspector of Taxes) v Tate & Lyle Ltd [1955] AC 21* that expenditure for the purpose of preserving a trade from destruction can properly be treated as being expended wholly and exclusively for the purposes of the trade.

26. In referring to the distinction between purpose and effect the House of Lords quoted a well-known passage from the judgment of Lord Brightman in *Mallalieu v Drummond [1983] STC 655* at p699 where he stated:

> " *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 purpose. 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 in section 130.*"

27. In Knight v Parry the taxpayer was employed as an assistant solicitor. On leaving his employment he agreed with one of the firm's clients that the client would instruct him. The firm alleged that the taxpayer had solicited the client and that this amounted to unprofessional conduct. They reported the taxpayer to the Law Society.

28. The Law Society considered that there was a prima facie case of unprofessional conduct but suggested that the firm bring a civil action against the taxpayer which they did. The taxpayer defended the action and in due course it was found that he had not solicited the client but he had committed a breach of the duty of good faith owed to his employer. The firm was awarded damages and costs. The taxpayer accepted that the damages were not deductible for Schedule D purposes. However he sought to deduct the costs he was ordered to pay and his own costs.

29. Goff J held that the taxpayer had two purposes in defending the action. One was to protect himself against the charge of unprofessional conduct. The second purpose was defending the claim to damages. The purpose of protecting himself professionally was not wholly and exclusively referable to the carrying on of his practice as a solicitor, but to ensure that he was not precluded from doing so. We do not need to consider whether, in the light of McKnight v Shepherd, that conclusion is correct. This is because Goff J also held that even if his conclusion on that issue was wrong the second purpose clearly took the expenditure outside the relief because duality of purpose meant that no relief was available.

30. Mr Storey contends that as in McKnight v Sheppard, the only reason why the appellant paid the sum of £100,000 was to preserve his business and allow him to continue trading. The fact that the appellant was also released from the restrictive covenants in his contract of employment was merely the incidental effect of the Tomlin order.

31. Mrs Oliver for the respondents contends that in the present appeal, as in Knight v Parry, the purpose of the expenditure was twofold:

(1) To defend the claim for damages, and

(2) To maintain customers for the business.

32. She sought to distinguish McKnight v Sheppard on the basis that the defence costs in that case did not relate to a former employer and there was no duality of purpose. We do not consider that this distinction affects the principle to be drawn from McKnight v Sheppard, in particular the need to distinguish between the purpose or purposes of expenditure and the effect of that expenditure.

33. It is important to consider why the appellant made the payment of £100,000 and incurred costs in defending the proceedings. We accept that he was particularly concerned with the claim to springboard relief because that would effectively destroy any prospects for his business.

34. As a matter of law a claim to springboard relief can arise not only where there has been a breach of confidence, but also where there has been a serious breach of a contractual or fiduciary duty giving the former employee an unfair advantage over the employer. It is not clear to us whether Quantica's claim to springboard relief derived solely from the misuse of confidential information or whether it also derived from the admitted breaches of contract and fiduciary duty. In this regard we do not have the benefit of all the relevant material.

35. At 1.11 of his skeleton argument Mr Storey submitted that "*…most importantly, the clients with whom Mr McMahon had already done business were not, in Mr McMahon's view, clients on the restricted list as defined by the contract of employment* ". At 4.5 he submitted that "*Mr McMahon was not defending himself against a breach of contract because he had already admitted that he had breached his contract. What was in dispute was the list of clients that Quantica was trying to prevent him from dealing with and the fact that they intended to require the restriction to be imposed for longer than the 6 months contained in the employment contract*".

36. In the light of the evidence, and the basis upon which the appellant puts his case, we find that there was a significant issue in the proceedings as to which customers Mr McMahon was entitled to work for, even putting to one side the claim for springboard relief. Until the Tomlin order was agreed, the proceedings were being contested by the appellant not just in relation to the availability of springboard relief for breach of confidence, but also as to the extent of the breach of contract and the measure of damages for that breach.

37. Mr Storey put the appellant's case on the basis that Knauf was clearly in the list therefore there was "*no real dispute*" that there had been a breach of contract. He acknowledged that there was still a dispute regarding the others clients. This is relevant for the following reasons:

(1) It implies that whilst there may have been an issue on the pleadings as to whether the restrictive covenant applied to Knauf, the appellant was always going to concede that he was restricted from dealing with Knauf for 6 months by the terms of his contract.

(2) It acknowledges that there was still an issue regarding the other companies, Eagle Ottawa, Thompson Plastics and Linpac.

38. Mr Storey submitted that the matters which were in dispute in the proceedings were outside the employment contract and directly connected to the operation of the appellant's business. As such, he said, they were wholly and exclusively for the purposes of the business.

39. We do not accept that submission. The matters in dispute were plainly connected to the operation of the appellant's business. However they were also concerned with his employment contract. In particular the sum of £100,000 was calculated by reference to the sums earned by the appellant from the 4 businesses referred to above. The extent to which the appellant was bound by the restrictive covenants in his contract of employment and thereby bound to pay damages for breach of contract was at issue in the proceedings. It may be that the threat of springboard relief caused the appellant to pay more to settle the proceedings than he would otherwise have done. Indeed Mr Storey submitted that if the matter had gone to a hearing "the damages would have been nothing like that amount".

40. Mr Storey submitted that Quantica would have paid tax on the £100,000 which it received as income (see *London and Thames Haven Oil Wharves Ltd v Attwool*

(1966) 43 TC 491). As such he argued that it could only have been a business payment and ought to be allowable for tax. However that argument if anything is founded upon how the tax system ought to work. It pays no regard to the terms of the statute and the effect of the authorities referred to above. In deciding whether relief is available for the expenditure we must have regard to the terms of section 34 and to the authorities. We cannot decide the appeal on the basis of how we think the provisions ought to operate.

41. Mr Storey referred us to extracts from HMRC's Business Income Manual. These simply confirmed that "*Civil damages are generally allowable. But where the expenditure in fact serves a dual purpose it is disallowed*". At BIM50620 there is reference to athletes' expenses, in particular medical expenses which might normally be considered to have an intrinsic duality of purpose. The manual states as follows:

> "*…HMRC takes the view that … expenditure may be deductible in the case of professional athletes … where it is far removed from their ordinary needs as human beings and is of a special character dictated by their occupation as a matter of physical necessity and any private purpose is an unavoidable effect of the expenditure.* "

42. It seems to us that this is nothing more than recognition of what Lord Brightman said in Mallalieu v Drummond in relation to purpose and effect.

43. On the basis of our findings of fact we conclude that the payment was a global settlement relating to both admitted and non-admitted breaches of contract as well as removing the threat of springboard relief and releasing the appellant from any future restrictions.

44. The payment of £100,000 and the legal costs incurred by the appellant had two purposes. One to preserve the business which, on its own, would have been wholly and exclusively for the purposes of the trade. The other to defend and settle the proceedings including the claim for damages for breach of contract and breach of fiduciary duty. Those claims arose out of the appellant's contract of employment. We do not consider that on any view this second purpose could be described as merely an effect of preserving the business. It was part of the reason the expenditure was incurred.

45. For the reasons given above we dismiss the appeal.

46. 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.

JONATHAN CANNAN
TRIBUNAL JUDGE

RELEASE DATE: 24 July 2013