[2021] UKFTT 0456 (TC)

TC 08340

CORPORATION TAX – McNight considered – whether a penalty – yes – deductible – no – wholly and exclusively incurred – no – whether a qualifying payment for Charitable Donations Relief CTA 2010 – no – appeals dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

Appeal number: TC/2019/09067 and TC/2019/09070

BETWEEN

BES COMMERCIAL ELECTRICITY LTD

AND

BUSINESS ENERGY SOLUTIONS LTD

Appellants

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Respondents

TRIBUNAL: JUDGE ANNE SCOTT
MEMBER MARK BUFFERY

The hearing took place on 10 and 11 August 2021 via the Tribunal video platform

Having heard Mr Michael Ripley, of counsel, for the Appellants

Mr Thomas Chacko, of counsel, for HMRC

DECISION

INTRODUCTION

1. This is an appeal against two partial Closure Notices for the year ended 30 April 2016 issued to the two appellants by the respondents ("HMRC") on 26 June 2019. Those denied the appellants their Corporation Tax deductions for payments ("the Payments") made by them pursuant to a settlement agreement with the Gas and Electricity Markets Authority ("GEMA") dated 23 November 2015 ("the Settlement Agreement").

2. The Payments and the Settlement Agreement arose following an investigation by GEMA into the appellants' compliance with a number of conditions and requirements set out in the Standard Licence Conditions ("SLCs") of their Gas and Electricity Supply Licenses and the Gas and Electricity (Consumer Complaints Handling Standards) Regulations 2008 ("CHSRs"). The Authority found that BES breached the following relevant conditions and requirements:

- SLC 7A.4(b) – Supply to Micro Business Consumers – these provisions require that, before a licensee enters into a Micro Business Consumer Contract, it must take all reasonable steps to bring the Principal Terms of the proposed contract to the attention of the consumer and ensure that the information is communicated in plain and intelligible language. These conditions were breached for the period 8 June 2010 to 12 July 2015 (Breaches 1 and 2).
- SLC 7B – Customer Objective and Standards of Conduct for non-domestic supply activities – These provisions require that the licensee takes all reasonable steps to achieve the Standards of Conduct and applies the Standard of Conduct in a manner consistent with the Customer Objective of ensuring that each Micro Business consumer is treated fairly. This condition was breached for the periods 26 August 2013 to 12 July 2015 (Breach 3) and 26 August 2013 to 14 August 2014 (Breach 4). The Standards of Conduct include that:
    - the licensee behaves and carries out any actions in a fair, honest, transparent, appropriate and professional manner (SLC 7B,4(a));
    - the licensee provides information (whether in writing or orally) to each Micro Business Consumer which is complete, accurate and not misleading (in terms of the information provided or omitted) and which is otherwise fair both in terms of its content and in terms of how it is presented (with more important information being given appropriate prominence) (SLCs 7B(i) and (iv)).
- SLC 7.6A(c) – Terms of Contracts and Deemed Contracts – These provisions state that a deemed contract must not require a customer to give any form of notice before they are able to change supplier, and were breached for the period 23 October 2013 to 9 June 2014 (Breach 5).
- SLC 14 – Non-Domestic Customer Transfer Blocking – These provisions state that a licensee must not prevent a Proposed Supplier Transfer except in accordance with certain specific provisions, one of which being that the licensee's Contract with that customer allows the licensee to prevent the transfer. Contract is a defined term within SLC 1 and the definition states that

a Contract does not include a Deemed Contract. This SLC was breached for the period 14 November 2012 to 9 June 2014 (Breach 6).

- Regulations 4 and 5 of the CHSRs. These regulations place requirements on regulated providers in relation to handling consumer complaints, and were breached for the period 1 January 2013 to 31 October 2014 (Breach 7).

The Issues

3. In terms of the Settlement Agreement, the appellants agreed to:-

(a) Pay a penalty of £2;

(b) Make payments of compensation (the "Compensation Arrangements") to certain affected customers; and

(c) Make payments ("Consumer Redress") to an independent charity called Money Advice Trust, which the appellants had nominated and the Office of Gas and Electricity Markets ("Ofgem") had approved, plus any sums that they were unable to make payment of under the Compensation Arrangements.

4. The penalty is not in dispute. There are three issues between the parties:-

(a) Issue 1 is whether the Compensation Arrangements and Consumer Redress are non-deductible as fines or penalties within the scope of the principle identified by Lord Hoffman in *McKnight v Sheppard*[1] ("McNight").

(b) Issue 2 is whether the Payments were incurred wholly and exclusively for the purposes of the appellants' trades.

(c) Issue 3 is whether the Consumer Redress qualifies for Charitable Donations Relief under Part 6 of the Corporation Tax Act 2010 ("CTA 2010").

The Facts

5. The facts are largely uncontroversial and the parties had agreed a Statement of Agreed Facts which is incorporated herein.

The appellants

6. The appellants are each a licensed non-domestic energy supplier. The first appellant is a supplier of electricity and the second appellant, a supplier of gas. Their business had grown rapidly in the years before 2015 when between them they had approximately 40,000 gas and electricity customers, most of which were small businesses ("Micro Business Consumers") and approximately 30,000 of whom were acquired in the period covered by Breach 1. The gas supply licence has been held since 2005 and the electricity supply licence since 2010.

The regulatory environment

7. GEMA is the regulator for the appellants and Ofgem is its executive arm to whom it delegates its regulatory duties. The Settlement Agreement was achieved after the appellants admitted seven regulatory breaches.

8. The industry sectors in which the appellants operate are regulated under the Gas Act 1986 ("GA") and the Electricity Act 1989 ("EA"). Sections 28 to 30F of the former and sections 25 to 28 of the latter provide for enforcement powers in respect of breaches of licence conditions and relevant requirements.

9. Section 30A GA and section 27A EA provide that GEMA may impose a financial penalty and sections 30G GA and section 27G EA provide that from January 2013 GEMA

[1] [1999] 3 All ER 491

has the power to impose a Consumer Redress Order (orders to pay compensation to customers).

The 2013 and 2014 policies

10. Ofgem issued a "Statement of policy with respect to financial penalties" in October 2003 ("the 2003 policy"). It is short but it details factors which tended to make the imposition of a financial penalty more likely than not and, in particular, it states:-

> "• the contravention or the failure has damaged the interests of consumers or other market participants;
>
> • to do so would be likely to create an incentive to compliance and deter future breaches."

It also details factors tending to make the imposition of a financial penalty less likely than not being:

> "• if the contraventions were of a trivial nature
>
> • that the principal objective and duties of the Authority preclude the imposition of a penalty
>
> • that the breach or possibility of a breach would not have been apparent to a diligent licensee".

11. On 27 March 2014, the Chairman of GEMA, writing from Ofgem, to all stakeholders stated the Authority's position on future financial penalties. In line with its strategic objectives for enforcement, the Authority stated that it considered that enforcement should deliver strong deterrence against non-compliance and also ensure that regulatory compliance is given sufficient focus within business. It stated that it had decided to place greater emphasis on deterrence when imposing penalties and indicated that its decision would be likely to mean a substantial increase in levels of penalty in cases where the behaviour in question came to the Authority's attention on or after 1 June 2014.

12. After the introduction of Consumer Redress Orders by Sections 30G GA and 27G EA with effect from January 2013, Ofgem issued a revised Statement of Policy with Respect to Financial Penalties and Consumer Redress on 6 November 2014 (the "2014 policy"), which replaced the 2003 policy.

13. Although Breaches 1-3 extended beyond the commencement of the 2014 policy, all had commenced during the period of the 2003 policy so therefore the Authority decided that the penalty fell to be determined by reference to the 2003 policy. Accordingly, Consumer Redress Orders were not considered. Breach 7 came to the attention of the Authority after 1 June 2004 so therefore the principles outlined in the Chairman's letter apply.

The Ofgem Enforcement Guidelines

14. The relevant Guidelines were published on 12 September 2014 and took effect from that date. Paragraph 5.8 reads:

> "It is important to appreciate that settlement in the regulatory context is not the same as the settlement of a commercial dispute. An Ofgem settlement is a regulatory decision taken by us, the terms of which are accepted by the company under investigation. In sectoral cases, we must have regard to our statutory objective when agreeing the terms. We must also have regard to our statutory obligations to consult on proposed penalties and consumer redress orders."

The footnote to that paragraph references sections 30A and 30I of GA and sections 27A and 28I of EA.

15. Paragraph 5.9 goes on to point out that settlement does not reduce the seriousness of any breach but simply results in a "lower penalty". At paragraph 5.12, Ofgem states that it will consider settlement in all sectoral cases and, of course, the appellants' case is sectoral.

16. At paragraphs 5.15 and 5.16 it explains that in the event of early settlement "…the discount is applied to a penalty amount that has been agreed in the settlement".

17. Under the heading "Settlement framework" Ofgem indicate that they will usually serve the company with a Summary Statement of Initial Findings ("SSIF") which sets out the breaches that Ofgem consider have been committed, their thinking about the detriment and/or gain and any other matters. It makes it explicit at 5.21 that the purpose of that is not negotiation but to enable Ofgem to understand the company's position so that they can take account of it when making recommendations to the Settlement Committee.

18. Ofgem makes it explicit that they will arrange to contact a company to enable discussions to take place. At 5.26 it states that:

> "The aim of discussions will be to agree the terms of a penalty notice and/or consumer redress order and get comments on press notices. We may also agree other terms with the company as part of a settlement".

The investigation

19. Having corresponded in 2014 informally, on 30 October 2014, Ofgem opened a formal investigation into the compliance of the appellants with the conditions of their electricity and gas supply licenses. The scope of that investigation was widened on 15 July 2015 to include potential breaches of CHSRs.

20. Correspondence ensued.

21. On 23 July 2015, Ofgem wrote to the appellants enclosing the SSIF.

22. Ofgem had proposed a solution whereby directly affected customers should be released early from their fixed term contracts (typically 5 or 6 years) without payment of a termination fee. That was not acceptable to the appellants and would have had severe economic effects.

23. On 18 August 2015, in advance of a meeting scheduled for 3 September 2015, Mr Chapman the Head of Regulation and Compliance for the appellants wrote to Ofgem responding to the SSIF and acknowledging that "many key aspects of the SSIF are not in dispute". However, he also pointed out that some of the alleged breaches related to documentation that had been provided to Ofgem on at least four separate occasions prior to the investigation. He disputed Ofgem's assertion that some of the breaches "would have been obvious to a diligent licensee" where their own expert staff across various divisions and on a number of occasions had not noted it. He disagreed with them on a number of other points. However, he acknowledged previous shortfalls in some of the appellants' record keeping and procedures particularly in relation to complaints handling and deemed (out of contract) customers. He also acknowledged that the standing charge could have been explained.

24. He stated that he wished to engage with Ofgem with a view to resolving the case via Ofgem's settlement process. He proposed a financial settlement being compensation to certain customers and a charitable donation.

25. At the meeting on 3 September 2015, it was agreed that the Ofgem case officers would propose to its independent Enforcement Decision Panel that a settlement be achieved on the basis that compensation would be paid to customers directly affected by certain of the

breaches and a donation would be paid to a suitable independent organisation. That was identified as being Money Advice Trust.

26. Following the meeting on 3 September 2015, Ofgem wrote to Mr Chapman on 23 October 2015 ("the 23 October letter") intimating that they had a mandate for settlement and they enclosed a draft settlement agreement, draft penalty notice and draft press release. The appellants were offered a 29 day period to allow them to accept the proposed terms of settlement by signing the Settlement Agreement by no later than 5.00pm on 23 November 2015.

The 23 October letter

27. The letter was written on a "without prejudice and subject to contract basis" and set out the penalty policy on early resolution. In summary, because early settlement results in cases being resolved quickly and saves resources for both Ofgem and the appellants, Ofgem offered a discount on the penalty. The letter explicitly states that: "we will offer a discount to the penalty…The discount is applied to the penalty amount that is agreed in settlement…".

28. In their view, in the event that the case was contested, they would have intended to have sought a penalty of £1,400,000. The discount was available on a sliding scale depending on when agreement was reached. Ofgem offered three settlement windows in accordance with their Enforcement Guidelines. The early settlement window offered a proposed penalty of £980,000, a middle settlement window would be £1,120,000 and a late settlement window would be £1,260,000.

29. In the event, the appellants opted for settlement at £980,000 and signed the Settlement Agreement and returned it to Ofgem on 23 November 2015. Ofgem published the press release on 25 November 2015 confirming the outcome of the investigation. Ofgem had not accepted the appellants' proposed amendment to the Press Release.

The Settlement Agreement, Notice of Intention and Penalty Notice

30. Under the Settlement Agreement, which was signed on 23 November 2015, GEMA agreed to discontinue the investigation conducted by Ofgem with the proviso that that would not happen if the appellants did not pay the penalty in full, or on time, or if the appellants did not make the Compensation Arrangements or the Consumer Redress "in the manner set out in the Final Penalty Notice".

31. At paragraph 4, amongst other things, it stipulated that as far as Consumer Redress payments are concerned, the appellants had to:-

(a) Provide proof of all payments

(b) Not reduce any other charitable donations

(c) Ensure that they did not describe it as a charitable donation in any marketing, and

(d) A director had to confirm in writing that the appellants had honoured the points in (b) and (c) above.

32. At paragraph 5, the appellants agreed that, at their own expense, they would commission an independent report for Ofgem verifying their compliance with the requirements for the Compensation Arrangements. They also agreed that they would comply with various paragraphs in the Penalty Notice relating to those Customer Arrangements (set out in the Notice of Intention).

33. The Settlement Agreement had annexed to it the Penalty Notice, the agreed "Authority Press Notice" and a notice of intention to impose a financial penalty ("the Notice of Intention") (which would be dated 25 November 2015) recording that the appellants agreed

not to make any representations or raise any objections to GEMA or any other person in relation to the provisions of the Penalty Notice except in certain circumstances (where Clause 5(a) of the Settlement Agreement applied).

34. The Penalty Notice set out:

(a) The Background to Ofgem's (on behalf of GEMA) investigation into the appellants;

(b) GEMA's decision on the relevant regulatory contraventions;

(c) GEMA's decision on whether to impose a financial penalty;

(d) Criteria relevant to the level of financial penalty;

(e) GEMA's final decision.

35. The Notice of Intention notified the appellants of Ofgem's intention to impose a financial penalty pursuant to Section 30A(3) of the Gas Act 1986 and Section 27A(3) of the Electricity Act 1989. It identified the various SLCs and CHSRs that we have quoted at paragraph 2 above.

Notice of Decision to impose a financial penalty…

36. Ofgem issued the Notice of Decision on 18 December 2015 stating at paragraph 1.1 that they had decided "to impose a financial penalty". That Decision recorded that:

(a) The appellants had "…offered to pay £980,000 in total by way of settlement".

(b) Of that amount £311,000 would be compensation to customers affected by Breaches 1-3 and 6, ie the Compensation Arrangements.

(c) The Consumer Redress (£668,998) had been paid to Money Advice Trust on 17 December 2015. (On 17 December 2015, the appellants wrote to Ofgem confirming that £668,998 had that day been paid to Money Advice Trust. In fact, the first appellant had paid £467,999 and the second appellant had paid £299,000).

(d) The appellants had agreed to make further payment to Money Advice Trust following completion of the Compensation Arrangements where they had been unable to trace the customers.

(e) "In the circumstances, and in recognition of the redress payment made for the benefit of consumers, as well as the compensation arrangements and further redress" the penalty would be £2.

37. The appellants processed payment for the penalty of £2 (being £1 for each of them) on 18 December 2015 and the funds were received by Ofgem on 23 December 2015.

38. There are a number of paragraphs in the Notice of Decision, which extends to 22 pages, which are worthy of note. The Notice of Decision refers to both appellants collectively as "BES". Those provisions include:-

(a) 1.6 - "If BES had not agreed to settle this investigation by making these redress and compensation payments, the Authority would have considered it appropriate to impose a much larger penalty in view of the seriousness of the contraventions".

(b) 1.8 - it confirmed that the penalty would be £2 "In the circumstances, and in recognition of the redress payment made for the benefit of consumers, as well as the compensation arrangements and further redress which BES agreed to undertake …".

(c) 2.2 - The investigation had been launched because of a formal referral from Citizens Advice to Ofgem on 21 May 2014 and a high number of complaints from consumers and from Members of Parliament on behalf of their constituents.

(d) 4.8 - 4.10 - "The Authority considered that the contraventions taken as a whole, given their nature and extent, were serious" and BES had damaged the interests of its customers and other market participants.

(e) 4.11 - "The Authority considered that it was appropriate to impose a financial penalty in order to deter BES and other licensees from engaging in the same or similar conduct".

(f) 4.12 - "…the imposition of a financial penalty in relation to Breach 7 was warranted to reflect strong deterrence against future non-compliance by BES and other companies. The Authority also considered that imposing a financial penalty would create an incentive to ensure the underlying issues are fully and effectively addressed".

(g) 4.13 - The breaches were viewed as not being trivial and there had been multiple breaches over significant time periods affecting a large proportion of the customer base.

(h) 4.15 - 4.18 – the breaches should have been apparent to a diligent licensee and BES should have realised that breaches were occurring given the consistently high level of complaints throughout the years.

(i) 5.4 - "The Authority consider that the majority of the contraventions were serious, wide-ranging and were committed over a protracted period".

(j) 5.9 - "The Authority considered that affected customers and other market participants were likely to be harmed by the contraventions".

(k) 5.13 - prior to the investigation, BES had not made contact with the affected customers to make compensatory payments where appropriate.

(l) 5.14 - 5.19 - The duration of the contraventions was significant, in two cases being more than five years. BES had financially gained from the breaches and in the case of Breach 7 BES had gained financially by failing to invest appropriately in staff, IT, training and new processes for complaints handling.

(m) 5.22 - "…the Authority considered that the penalty it imposed, to the extent it reflects Breach 7, must act to deter future breaches and reinforce the need for senior management to ensure regulatory compliance going forward".

(n) 5.24 - 5.25 - Breaches 1-3 continued after they were brought to the appellants' attention by Ofgem and after senior management were made aware of the complaint by Citizens Advice in April 2013. The contravention continued until June 2014.

(o) 5.37 - 5.41 - The Authority acknowledged that it had had sight of certain of the appellants' documents and processes which were the subject of the investigation but considered "…that the context in which this correspondence took place and the content of the correspondence made clear that Ofgem's purpose was not to approve licensees' processes and documentation" and that compliance was the responsibility of the appellants particularly in a context where there were "very significant levels of dissatisfaction" from the appellants' customers (thereby rebutting the appellants' argument – see paragraph 23 above).

(p) 6.5 - "Having considered all the circumstances of the case, the Authority considered that this compensation and redress package would be of greater benefit to consumers overall than if a significant financial penalty was imposed. If BES had not

agreed to settle this investigation by making these redress and compensation payments, the Authority would have considered it appropriate to impose a much larger penalty in view of the seriousness of the contraventions.

Deed of Grant

39. On 2 February 2016, the second appellant entered a Deed of Grant setting out the terms and conditions relating to the donation, namely:-

(a) The donation was for charitable purposes and related to the year 2015.

(b) The agreement was deemed to have commenced on 1 January 2016 and terminates on 31 December 2017.

(c) The donation of £668,998 had been paid [on 17 December 2015] in anticipation of execution of the Deed.

(d) The monies would be applied as to £623,998 for Business Debtline and £45,000 for research.

(e) Money Advice Trust would furnish quarterly reports providing information as to how the monies were spent and what outputs were achieved.

The sums actually paid

40. In fact the sums actually paid by the appellants are not the sums reflected in the Settlement Agreement or the Decision Notice. In the period after November and December 2015, being the timing of the Settlement Agreement and the December Notice, other problems were identified.

41. Ultimately the first appellant paid the £1 penalty and in the accounting period ended 30 April 2016 paid Compensation Arrangements of £529,665 and Consumer Redress of £467,999. Excluding the penalty that amounted to a total of £997,664.

42. The second appellant also paid the £1 penalty but made no Compensation Arrangements. In the accounting period ended 30 April 2016, it paid £215,999 in Consumer Redress.

The Tax position

43. The appellants reduced their profits chargeable to corporation tax in their Corporation Tax Returns for the accounting periods ended 30 April 2016 by the total value of the payments relating to the Compensation Arrangements and the Consumer Redress.

44. HMRC timeously opened enquiries into each of those Corporation Tax Returns on 25 April 2018.

45. HMRC disallowed the £467,999 of Consumer Redress by the first appellant and disallowed £296,000 only of the Compensation Arrangements. In the case of the second appellant the £215,999 of Consumer Redress was disallowed. Of course the penalties of £2 were disallowed and that is not disputed. The total is £980,000.

46. HMRC's reasoning was that the entirety of the settlement agreed with Ofgem was a penalty, as the whole Settlement Agreement was punitive, so a total of £980,000 between the two appellants should not be deductible. They did, however, allow deductions for the payments in excess of that, and also in the following year, since they were not included in the Settlement Agreement.

47. On 26 June 2019, the partial Closure Notices were issued in relation to each of those Corporation Tax Returns making the following amendments:-

(a) In relation to the first appellant, HMRC increased the profits chargeable to corporation tax by £763,999, and

(b) In relation to the second appellant, HMRC increased the profits chargeable to corporation tax by £215,999.

48. The appellants appealed to HMRC on 23 July 2019 and HMRC upheld the partial Closure Notices by way of review conclusion letters dated 30 October 2019.

49. On 29 November 2019, the appellants notified their appeals to the Tribunal.

Legislation

50. Section 54 Corporation Tax Act 2009 ("CTA 2009") reads as follows:-

"54. Expenses not wholly and exclusively for trade and unconnected losses

(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.

51. Section 189 CTA 2010 provides that qualifying charitable donations made by a company are allowed as deductions in calculating corporation tax.

52. Section 190 CTA 2010 reads:-

"190 Qualifying charitable donations: meaning

(1) The following are qualifying charitable donations for corporation tax purposes—

(a) Payments which are qualifying payments for the purposes of Chapter 2 (certain payments to charity), and

(b) Amounts treated as qualifying charitable donations under Chapter 3 (certain disposals of investments to charity.

(2) However, no payment that is otherwise deductible from total profits, or in calculating any component of total profits, is a qualifying charitable donation.

53. Qualifying payments under Chapter 2 are defined by Section 191 CTA 2010 as follows:-

"191. Qualifying payments

(1) A payment made to a charity by a company is a qualifying payment for the purposes of this Chapter each of the conditions A to F is met.

(2) Condition A is that the payment is a payment of a sum of money.

(3) Condition B is a payment that is not subject to a condition as to repayment (but see Section 192).

(4) Condition C is that the company making the payment is not itself a charity.

(5) Condition D is that the payment is not disqualified under Section 193 (associated acquisition etc by the charity).

(6) Condition E is that the payment is not disqualified under Section 194 (certain distributions).

(7) Condition F is that the payment is not disqualified under Section 195 (associated benefits).

54. The relevant legislation on associated benefits is as follows:-

195 Associated benefits

(1) A payment is disqualified under this section if—

(a) benefits are associated with the payment, and

(b) the restrictions on benefits associated with a payment are breached.

(2) Sections 196 to 198 apply for these purposes.

196 Associated benefits: meaning

For the purposes of this Chapter a benefit is associated with a payment if—

(a) it is received by the company which made the payment or by a person associated with the company, and

(b) it is received in consequence of making the payment.

197 Restrictions on associated benefits

(1) For the purposes of this Chapter the restrictions on benefits associated with a payment are breached if condition A or B is met.

(2) Condition A is that the total value of the benefits associated with the payment exceeds the variable limit, which is—

(a) 25% of the amount of the payment, if the amount of the payment is 100 or less,

(b) 25, if the amount of the payment is more than 100 but not more than 1,000,

(c) 5% of the amount of the payment, if the amount of the payment is more than 1,000.

(3) Condition B is that the sum of the following total values is more than 2,500—

(a) the total value of the benefits associated with the payment, and

(b) the total value of the benefits (if any) associated with each relevant prior payment.

(4) A relevant prior payment is a payment—

(a) which has already been made by the company to the charity in the accounting period, and

(b) which is a qualifying payment."

Summary of the appellants' arguments

55. The appellants' primary case is that the Payments are not fines or penalties and they were incurred wholly and exclusively for the purposes of their trades and therefore they are deductible from their trading profits in the normal way.

56. The appellants argue that the Payments are compensatory rather than punitive in nature.

57. If contrary to the appellants' primary case, the Consumer Redress was held not to be deductible from the profits of the trade, then that element would nevertheless qualify for relief as a charitable donation.

Summary of HMRC's arguments

58. The payments were not made wholly and exclusively for the purposes of the appellants trade because they were paid pursuant to the Settlement Agreement which was entered into because of the regulatory breaches identified by Ofgem.

59. The Settlement Agreement was entered into to avoid higher penalties being levied by Ofgem and therefore the payments have the nature of penal sanctions from Ofgem and the principle in *McNight* applies to them.

60. Condition F in section 191 CTA 2010 is not met because the appellants received an associated benefit whereby the investigation was discontinued and the risk of higher penalties was avoided.

Discussion

Issue 1

61. The one issue on which both parties were agreed was that the leading authority on the scope of the entitlement to deduct expenses relating to disciplinary or regulatory proceedings is the House of Lords judgment given by Lord Hoffman in *McNight*. In his judgment Lord Hoffman considered the case of *IRC v von Glehn*[2] ("von Glehn") where Lord Sterndale M.R. said that although the incurring of the penalty was connected with the trade, in the sense that it would not have happened unless the trade had been carried on, it was not for the purposes of the trade but because of a wrongful act on the part of the company. He said:-

> "… were these penalties an expenditure necessary to earn the profits? Were they paid for the purpose of earning the profit? The answer seems to me to be obvious, that they were not; they were unfortunate incidents which followed after the profits had been earned".

62. Undoubtedly, in this case the Payments were made after the profits had been earned.

63. Both parties relied on Lord Hoffman where he had explained *von Glehn* as being based, not on the ordinary meaning of "wholly and exclusively" but on a public policy restriction, saying of the Court of Appeal that:-

> "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'."

64. Lord Hoffman went on to say, and in our view it is applicable here, that:-

> "Once it is appreciated that, in a case like this, non-deductibility depends upon the nature of the expenditure and the specific policy of the rule under which it became payable, it can be seen that the relevant considerations may be quite different … The question is

[2] 1920 [2 K.B.553]

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".

65. What is the nature of the Payments? They are made in terms of the Settlement Agreement and the very fact that the settlement process is set out in Ofgem's Enforcement Guidelines points to the payments being punitive in nature. That is reinforced by the fact that the settlement discount is described in the Enforcement Guidelines and in the 23 October letter as being applied to the penalty and the penalty is £980,000 which is the amount of the Payments plus the £2.

66. The Notice of Decision is headed "Notice of decision to impose a financial penalty" and is the final version of the Notice of Intention which was annexed to the Settlement Agreement and throughout all of that documentation there is frequent mention of the seriousness of the breaches and the need for deterrents. There is also mention of the fact that the appellants profited financially from the contraventions.

67. The stringent conditions imposed upon the appellants in connection with the Consumer Arrangements point to that being punitive. We use the word "imposed" deliberately. Mr Chapman argued that they did not agree with all that Ofgem had stated in relation to the breaches but they had not contested the matter since it was a pragmatic decision to settle the issue as soon as possible. As can be seen from paragraph 14 above, Ofgem make it explicit that where a party enters into a settlement agreement the terms must be accepted by the company under investigation. The appellants had no choice. Furthermore, the Compensation Arrangements had to be audited and the Consumer Redress paid before the Penalty Notice was issued.

68. The specific policy of the rule under which the Payments were made is to enforce compliance with the licence conditions and the relevant legislative provisions.

69. The legislative policy that Ofgem are enforcing would be diluted if tax deductions were allowed for payments made. By entering into enforcement action Ofgem's aim is to balance the energy market and ensure that customers are treated equally and fairly in accordance with the licence conditions. If tax deductions for the Payments were allowed in a situation where the Payments are settling the enforcement action, that would treat the Payments as if they were the same as the costs of complying with the relevant requirements. That would dilute the legislative policy by significantly reducing the deterrent effect of failing to meet requirements. It is even more inequitable in this case where Ofgem have found that the appellants benefited financially from their contraventions.

70. The Upper Tribunal in *McLaren Racing Limited v HMRC* [3] ("McLaren") reviewed the extensive case law in this field and there is no requirement for us to do so again here. We observe that at paragraph 77, the Tribunal said:-

> "Even if the sole purpose of the payment had been to preserve McLaren's trade, it still would not satisfy the statutory requirement because the nature of the payment was such as to prevent its deductibility, namely that it was designed to punish McLaren for an egregious breach of the ISC."

[3] 2014 UKUT 269 (TCC)

That is precisely the position here and the situation is all the more grave because in this instance we are dealing with an external regulator.

71. We do not accept the appellants' argument that the fact that Ofgem chose not to impose a Consumer Redress Order is telling. It is not. They chose to apply the 2003 policy and there is no provision for such Orders in that policy (see paragraphs 12 and 13 above).

72. The sum of £2 does not sit easily with the repeated assertions that the breaches were serious and the penalty had to act as a deterrence not only to the appellants but also to others.

73. In summary, we find that the "package" of the Payments was a penalty. Ofgem simply directed the appellants to pay third parties rather than the Treasury. An analogy would be with the disposal of a criminal offence whereby the court has the option of a custodial sentence, a fine, a Compensation Order (payment to the victim) or community service all of which are punitive, albeit third parties might benefit. We find that the Compensation Arrangements are the equivalent of such a Compensation Order.

74. We agree with HMRC that the test of deductibility does not depend on the effects of the payments or to whom they are paid, but depends rather on the reason for the Payments, and the reason for the Payments was that Ofgem required it as an alternative to levying a more substantial penalty.

75. Accordingly applying the principle in *McKnight* the payments are not deductible.

Issue 2

76. The next issue is whether or not the Payments were incurred wholly and exclusively for the purposes of the appellants' trades and Section 54 CTA 2009 applies.

77. The basic principles of whether a payment is "wholly and exclusively" made for the purposes of the taxpayers trade are still those set out in *Strong & Company of Romsey Ltd v Woodifield* [4] where Lord Davey said:

> "These words … appear to me to mean for the purpose of enabling a person to carry on and earn profits in the trade… 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 profits of the trade. It must be made for the purpose of earning the profits."

78. It is not disputed that it is connected with the trade.

79. HMRC relied on Millett LJ in *Vodafone Cellular Limited and Others v Shaw*[5] where having reviewed more modern case law he stated:-

> "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 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 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

[4] 1906 AC 448

[5] [1997] STC 734 at page 742

> secured 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 enquiry of the taxpayer whether he consciously intended to obtain a trade or personal advantage by the payment. The primary enquiry is to ascertain what was the particular object of the taxpayer in making the payment."

80. We agree with HMRC that it is the reason for which the payment is made that matters. In this case undoubtedly payment was made to reduce the total amount of the financial burden likely to be imposed on the appellants and to settle the ongoing enquiry.

81. We have already referred to *McLaren* but we also rely on paragraph 61 where the Upper Tribunal stated: "In our view, a deliberate activity which is contrary to … the rules and regulations governing the conduct of the trade, which is not an unavoidable consequence of carrying on a trade and which could lead to the destruction of the trade is not an activity carried on in the course of that trade …".

82. The appellants argue that regulatory infractions are a common feature of trading in a heavily regulated industry such as their own, that they had not acted deliberately and by reference to *Herald & Weekly Times Ltd v Federal Commissioner of Taxation*[6], where what was described as an "almost unavoidable incident" of the trade was deductible.

83. Destruction of the trade was a particular issue in *McLaren* but is not relevant in other cases on this topic or indeed in this case.

84. We were not persuaded by Mr Chapman's arguments that the appellants had not acted deliberately. He attempted to persuade us that the breaches were inadvertent. We do not accept that. For example, in regard to Breach 6 the breach was drawn to the appellants' attention on 11 April 2013 and no action was taken to remedy the matter until June 2014 after Ofgem became involved. Ofgem found that the impact of that was that 108 customers on deemed contracts were wrongly blocked from transferring and therefore the appellants kept customers and gained revenue that they should not have done.

85. The appellants did not react to the consistent customer complaints and the complaints from MPs.

86. As we have indicated at paragraph 38(l) above, the appellants had made a deliberate decision not to invest appropriately in regard to complaints handling despite all of the complaints. In the period since settlement of the investigation there have been no further breaches. It is not unavoidable or almost so. The appellants made a choice to conduct the business in the way that they did and to ignore a significant number of complaints over a period of years.

87. Accordingly, the Payments were not wholly and exclusively laid out or expended for the purposes of the appellants' trades and therefore are not an allowable deduction for tax.

[6] (1932) 48 CLR 113 AUST HC

Issue 3

88. As far as charitable donations are concerned, firstly, we observe that Ofgem stipulated that the appellants could not characterise the Consumer Redress as a charitable donation for marketing purposes. Of course, that does not impact on the tax position.

89. "Qualifying charitable donations" are defined by Section 190(1)(a) CTA 2010 as "payments which are qualifying payments for the purposes of Chapter 2". They can only qualify if Conditions A to F set out in Section 191 CTA 2010 are met. HMRC agree that Conditions A-E are met. HMRC argue that there are benefits associated with the Payments, namely, the settlement of the investigation and the payment of a lower amount of the penalty. Agreeing to make the Consumer Redress gave the appellants the right to pay a lower sum overall which is a valuable benefit.

90. The appellants argue that the Settlement Agreement was not the qualifying payment and the subsequent Consumer Redress payments were in consequence of the settlement, not the other way round. We disagree. As can be seen, in fact, the Consumer Redress payments were paid on 17 December 2015 before the Penalty Decision Notice was issued. The Settlement Agreement simply agreed the terms and made it explicit that if the Consumer Redress was not paid, the penalty would be substantially higher.

91. We find that it is a very tenuous argument to say that the Consumer Redress did not discharge a sizeable liability to a penalty and that for the reasons given. As can be seen, as early as August 2015, Mr Chapman was conceding that many key aspects of the SSIF were not in dispute. There was an inevitable liability to a penalty. The only issue was one of quantum. That liability was extinguished by *inter alia* the Consumer Redress. The appellants rightly cited *Harris v HMRC*[7] where the Tribunal found at paragraph 58:

> "[Counsel for HMRC] sought to argue that a benefit would be in consequence of the making of a gift if it would not have arisen but for the gift. We do not accept this. The test is one of consequence which requires a different causal connection to a 'but for' test. It is not in our view sufficient that a benefit would not have been received but for the making of the gift. The making of the gift (including, as we have found, the underlying arrangements whereby the gift is made) must be the reason why the benefit is received; it must in short be the cause of the benefit."

However, we disagree with the appellants' analysis. The Settlement Agreement did not remove the liability to a penalty as it was contingent on the Payments and the Consumer Redress was paid before the Penalty Notice was issued.

92. In this instance the Consumer Redress provided the benefit of a lesser outlay by the appellants.

93. The Consumer Redress does not qualify for Charitable Donations Relief and is not deductible.

Decision

94. For all these reasons the appeals are dismissed.

RIGHT TO APPLY FOR PERMISSION TO APPEAL

95. 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

[7] 2010 UKFTT 385

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.

ANNE SCOTT
TRIBUNAL JUDGE

Release date: 03 DECEMBER 2021