IN THE SUPREME COURT OF THE UNITED KINGDOM **UKSC/2025/0047**

On Appeal from the Court of Appeal

BETWEEN

THE COMMISIONERS FOR HIS MAJESTY'S REVENUE AND CUSTOMS

Appellants

-and-

(1) SCOTTISHPOWER (SCPL) LIMITED

(2) SCOTTISHPOWER RENEWABLES (UK) LIMITED

(3) SCOTTISHPOWER (DCL) LIMITED

(4) SCOTTISHPOWER ENERGY RETAIL LIMITED ("SPERL")

Respondents

APPELLANTS' WRITTEN CASE

References to the FTT Decision are in the form FTTD - paragraph

References to the Bundle are not yet inserted

Introduction

1. The Respondents are energy companies in the ScottishPower group. This appeal concerns the deductibility for tax purposes of a series of payments ("the Redress Payments")[1] made by the Respondents under the terms of settlement agreements made between the Respondents and the Gas and Electricity Markets Authority ("GEMA"), acting through its executive arm, Ofgem. These payments were made because the Respondents were in serious breach of their regulatory obligations. Ofgem indicated to the Respondents that it intended to find they were in breach and impose substantial penalties (running into millions of pounds). Ofgem had a policy under which it could

[1] We use this term because it is used by the court and Tribunals below. "Redress" is also widely used in the Settlement Agreements and Notices of Decision: however, it is clear that the term "Redress" was used in a broad sense and did not generally imply compensation.

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settle an investigation on the basis that the energy provider admitted its breach (which if done promptly might entitle the energy provider to a discount on the indicated penalty) and also that Ofgem could agree that the sum that had been indicated as a penalty would instead be paid to third parties (typically charities or customers) and that a nominal £1 statutory penalty would be imposed.

2. HMRC deny that the Redress Payments are deductible from the Respondents' profits on the basis that they fell within the principle set out in *Commissioners of Inland Revenue v Von Glehn & Co Ltd* [1920] 2 KB 553; 12 TC 232 ("***Von Glehn***") as explained by Lord Hoffmann in *McKnight v Sheppard* [1999] 1 WLR 1333 ("***McKnight***").

3. The principle explained in *McKnight*, under which fines and penalties are not deductible from profits, has been recognised in the case law for over a century. It first appeared in a reported case in *Commissioners of Inland Revenue v EC Warnes & Co. Ltd* [1919] 2 KB 444; 12 TC 227 ("***Warnes***") and was then considered in more detail in *Von Glehn*.

4. In the present appeal, the Court of Appeal held that the principle is a freestanding judicial rule based on public policy which could only be applied in so far as its scope was clear. Accordingly, the principle was given a narrow scope and was only applied to the £1 statutory penalties.

5. This was an error: the principle in *McKnight* is (and always has been) an expression of the statutory restriction found in section 54(1)(a) of the Corporation Tax Act 2009 ("**CTA 2009**") that no deduction is allowed for expenses unless they are incurred wholly and exclusively for the purposes of the trade. The courts have articulated the reason for that in different ways. This appeal will require the Supreme Court to identify the basis for the principle described in *McKnight* so that its parameters can properly be set.

6. HMRC's Written Case is organised as follows:
    a. The framework under which Ofgem regulates and sanctions energy suppliers (7 - 15 below);
    b. The regulatory breaches in this case and how they were settled (16 - 17 below);
    c. The decisions of the FTT and its key findings (18- 39 below);
    d. The decisions of the Upper Tribunal and Court of Appeal (40 - 44 below);
    e. The errors in the approach of the Court of Appeal (45 - 75 below);
    f. The history of the principle preventing deduction of penalties and similar payments (76 - 106 below);
    g. The principle in *McKnight* expresses the requirement that expenses that are not wholly and exclusively for the purposes of the trade are not deductible, and this applies to the Redress Payments (108 - 126 below);
    h. The principle in *McKnight* expresses the general principle that sanctions and punishments cannot be shared with, or indemnified by, third parties, and this applies to the Redress Payments (127 - 160 below);
    i. The principle in *McKnight*, even if it is a freestanding judicial rule as suggested by the Court of Appeal, also applies to the Redress Payments (161 - 166 below).

The facts of this case

Ofgem's regulatory approach

7. GEMA is a body corporate established by section 1 of the Utilities Act 2000 as the regulator for gas and electricity. It was at the relevant times the regulator for the Respondents. Ofgem is the Executive arm of GEMA and operates under the direction and governance of GEMA. Ofgem is responsible for carrying out GEMA's regulatory duties on its behalf. In this Written Case HMRC generally refers to the actions taken by the regulator as taken by Ofgem but they can also be described as taken by GEMA.

8. Under the Gas Act 1986 and the Electricity Act 1989, GEMA has powers to ensure that persons licensed by GEMA to operate in the gas and electricity markets comply with licence conditions and other relevant requirements of the Acts. Sections 28 to 30F of the Gas Act and sections 25 to 28 of the Electricity Act provide for enforcement powers in respect of breaches of licence conditions and relevant requirements.

9. Where GEMA is satisfied that a licensee has contravened any licence condition or relevant requirement, it may impose a financial penalty pursuant to section 30A of the Gas Act and section 27A of the Electricity Act and/or (after amendments made with effect from January 2014) a consumer redress order pursuant to section 30G of the Gas Act and section 27G of the Electricity Act.

10. Where Ofgem considered that a supplier had committed a serious breach of one or more of its regulatory obligations, the sanctions open to Ofgem were: (i) to make a compliance order; (ii) to impose a penalty; (iii) (from 18 February 2014) to make a statutory Consumer Redress Order (this was not applied here); or (iv) to come to an agreement with the supplier to close the investigation imposing a nominal (typically £1) penalty on condition that the supplier agrees to make payments to or for the benefit of consumers in place of a substantial statutory penalty. In such cases, following the settlement agreement there would be a formal Notice of Decision from Ofgem, reciting the breaches which it had found (and which had been conceded by the supplier), recording the settlement payments that had been agreed, and imposing the nominal penalty.

11. It was option (iv) that was adopted in these investigations and resulted in the Redress Payments being made.

12. Ofgem's practice is explained by the FTT at FTTD paras [11] – [21]. As noted at FTTD para [16], Ofgem would indicate to a company in breach that it was intending to impose a penalty of a certain amount and offer to discount that as part of a settlement.

13. There was a standard process, set out in GEMA's 6 November 2014 Statement of Policy, whereby an energy provider would be given the opportunity to concede their breach in return for a discount to the penalty, that discount ranging from 30% to 10% depending on how early they settled with Ofgem (at 5.23-5.26). The 12 September 2014 Enforcement Guidelines explain in Section 5 at 5.4 that any settlement requires the company to admit its breaches.

14. Ofgem had a practice (explained in the Guidance of 14 December 2015) that a settlement could include an agreement to make payments to third parties instead of paying substantial penalties to the Treasury via the Consolidated Fund. It is clear from the way that the settlements were approached that the total cost was expected to be of a similar amount as the proposed penalty taking account of any discount for early settlement (see 24 - 27 and 33 - 37 below) and the payments had to be agreed with Ofgem. Otherwise Ofgem would impose the full amount as a penalty.

15. In this case, the latter two investigations (CESP and late billing / complaints handling) followed this procedure closely, with letters from Ofgem setting out the intended (pre-discount) penalty and offering set discounts for early settlement: see 33 - 37 below. Ofgem made clear that it might also agree to the vast majority of the intended penalty being paid to third parties rather than imposed as a statutory penalty which would go to the Consolidated Fund. This is not presented as being a further discount. It is clear from the correspondence between Ofgem and the Respondents for the first two investigations (Mis-selling and cost reflectivity), that a similar process was followed, if not in quite such a formal a manner: Ofgem and the Respondents negotiated over an overall amount that the Respondents would be expected to pay if they conceded breach of the regulations, and that was then paid to third parties (save as to a nominal statutory penalty).

The investigations into the Respondents

16. This appeal relates to four sets of regulatory breaches by the Respondents that Ofgem investigated in the 2011-2016 period.

17. Details of the investigations and negotiations are set out at FTTD [36] – [64]. In summary, the investigations leading to the agreements were as follows:
    (i) An investigation into mis-selling, which was settled by an agreement on 10 October 2013 under which the Fourth Respondent agreed to pay:
        a. a penalty of £1;
        b. £7,316,385 to vulnerable customers who were not necessarily affected by the mis-selling;
        c. £554,013 to customers directly affected; and
        d. £629,602 to the SP Energy People Trust (a charity).

(ii) An investigation into cost reflectivity (meaning that differences between terms and conditions for different payment methods should reflect the relative costs of those methods), which was settled by an agreement on 15 May 2014 under which the Fourth Respondent agreed to pay:

a. a penalty of £1; and
b. £750,000 to Energy Best Deal (accepted to be a charity).

(iii) An investigation into CESP targets, concerning reductions to CO_2 emissions, which had been missed by the Respondents, and which was settled by an agreement on 4 December 2014 under which the Fourth Respondent and ScottishPower Generation Ltd agreed to pay:

a. Two penalties each of £1; and
b. £2,399,998 to ScottishPower Energy Trust (which is a charity).

(iv) An investigation into complaints handling which was settled by an agreement of 25 April 2016 under which the Fourth Respondent agreed to pay:

a. a penalty of £1; and (as subsequently transpired)
b. £14,709,208 to certain Qualifying customers; and
c. £3,290,791 to Energy Action Scotland and National Energy Action (both of which are charities).

The decisions of the courts below

18. Before the FTT, HMRC had argued both that the Redress Payments were within the scope of the principle explained in *McKnight*, being in the nature of penalties, and alternatively that the regulatory failures of the Respondents fell outside the scope of their proper trading activities such that the consequences of those failures should not be taken into account as trading expenses. The Respondents had argued that, even if the Redress Payments were not deductible under general principles, those Redress Payments made to charities were eligible for charitable relief under s 189 Corporation Tax Act 2010.

19. The FTT held that:

    a. The Redress Payments were not compensation and were within the scope of the principle explained in *McKnight*, and so were not deductible, except for the £554,013 (see para 17(i)(c) above) in respect of mis-selling which was in the nature of compensation and so was deductible.
    b. The reason the £554,013 was treated differently was because, in the FTT's view, the status of a payment as compensation was objective and was inconsistent with its being a penalty (see [130] – [131]). Because those payments (unlike the others) were intended to match identified losses that customers had borne, they could not be penalties even if Ofgem intended to punish the Respondents by requiring them to pay that compensation (see the FTT at [135] and [149]).
    c. The behaviour of the Respondents was not so far outside the ordinary conduct of their trades that the costs incurred should be treated as arising from non-trading activities. If the Redress Payments had not been barred from deduction under the principle explained in *McKnight* they would have been incurred wholly and exclusively for the purposes of the trade.
    d. Charitable relief was not available.

20. The FTT made specific findings as to the character of the Redress Payments that are central to this appeal. As set out below, the Court of Appeal did not take account of these findings.

The Redress Payments were penalties

21. At [130]-131] the FTT held that the Redress Payments were "penalties", save in respect of £554,013 which was compensation. This was because a penalty was "*some suffering, expense or loss which arises from the breach ... [which] is not simply compensation to a party injured by the breach…*". The Redress Payments were "*expenses occasioned by a breach of the rules…*"

22. The FTT was aware that the Redress Payments were not statutory penalties levied by Ofgem under s 27A of the Electricity Act: *those* penalties were £1. Rather, the FTT considered what "penalty" meant, in substance, and recognised that the Redress Payments were penalties, in addition to the £1 statutory penalties, save in so far as they

amounted to actual compensation for quantifiable loss (rather than compensation in some more general sense).

The Redress Payments were punishments

23. The Redress Payments (including the compensatory element) were punishments for the breach of regulations (FTTD [132] – [135]), that is, they were suffering, loss or expense caused by Ofgem for the purpose of ensuring future compliance with rules, and Ofgem intended them to be punishments. This was because it was clear from GEMA's public statements both that its enforcement objective was to deliver credible deterrence so that non-compliance would cost more than compliance (in order to ensure future compliance); and that any penalty or any amount paid in settlement where GEMA/Ofgem would have sought a penalty should remove any gain made and be in an amount reflecting the seriousness of the breach. These aims were fulfilled by the Redress Payments and statutory penalties in combination: obviously £1 in isolation did not reflect the seriousness of the breach or represent deterrence.

In place of a formal penalty

24. The FTT held that the Redress Payments were made in place of formal penalties, made the following important findings, at FTTD paras 137-8:

    "*[137] … it seems to us that in each case had a payment not been agreed it is likely that, even after any appeal, a penalty of the same order of magnitude as the settlement amount would have been borne because it seems unlikely, in view of Ofgem's attitude and the way the witnesses described SPERL's aims in settlement, that SPERL would have settled if it had been given robust advice that only a very much smaller sum would have been successfully imposed.*

    [138] In this sense we regard the settlements to have been made in place of what might have been imposed and so to have a avoided a penalty larger than £1."

25. There is no contradiction between the finding at [131] that the Redress Payments are in substance penalties and the finding at [138]. The FTT makes clear at [131] and [141] that from [132] onwards it is dealing with the suggestion that the Redress Payments could not have been penalties because they were not formally imposed: it rejected that at [130] – [131] but then finds that even if a "penalty" has to be formally imposed, the

Redress Payments still fell within the principle in *McKnight* (referred to as a rule of public policy) because they take the place of formal penalties and are the Respondents' punishment.

26. What was also being dealt with at [136] – [140] was an argument of the Respondents that the payments made as part of the settlements might have exceeded any penalty finally imposed if the Respondents had disputed their breach. This was part of the Respondents' argument that the Redress Payments were fundamentally voluntary and were not paid to avoid being exposed to comparable statutory penalties. That was rejected.

27. Crucially, as explained at [139], the reason the Redress Payments fell within the principle in *McKnight* was not simply because they replaced statutory penalties that would otherwise have been imposed, but because they (as well as the statutory £1 penalties) fell within the aims of that principle, considered purposively:

    "*It seems to us that the same public policy which denies a deduction for a punishing non-compensatory penalty also denies a deduction a deduction for punishing non-compensatory payments which arise from a breach of statutory conditions and which are made in avoiding a larger penalty under the aegis of the body which would have imposed such a penalty. The non-deduction policy inherent in the statutory provision which permits the Authority to punish must also be inherent in the ability of the Authority to extract other payments instead of, or under the threat of imposing, a penalty. Thus, even if it were the case that, because the Redress Payments were not imposed by law, they could not be penalties, the same public policy considerations - the concern over dilution of the deterred punishment by allowing deductibility* [would apply]*…"*

28. These findings have never been challenged on appeal. Indeed, there are no grounds for challenging them as there was ample evidence before the FTT to support the findings.

29. The FTT was clearly entitled to find that it was the entire package, of £1 formal penalties and much larger Redress Payments, that was intended and understood to be the Respondents' punishment for their breach. First, this was the way that the

Respondents agreed with Ofgem that they would explain the payments to the public: there were agreed Press Notices saying as follows,

a. For mis-selling, "*Scottishpower agrees to pay £8.5m package to benefit consumers following Ofgem sales investigation*" and continues to state that "*The size of the payment reflects the impact of the sales practices on consumers and it also recognises ScottishPowers cooperative engagement with Ofgem to put right their processes…*" "*Today's announcement is a clear signal to energy suppliers of the consequences of breaching licence obligations…*"
b. For costs reflectivity, "*Scottish Power agrees to pay £750,000 following Ofgem investigation into payment differences…*" … "*Scottish Power did not have a robust process in place when setting their prices to ensure that the difference between their tariffs complied with Ofgem's rules. We've held them to account for this and they will now pay £750,000 to benefit Energy Best Deal…*"
c. For CESP, "*Ofgem secures £2.4m from ScottishPower for failing to meet environmental obligations on time…*" "*The penalty would have been higher if ScottishPower had not continued to install efficiency measures following its missed deadline…*" "*Today's redress package sends a clear message to the energy industry that late delivery of obligations is unacceptable…*"
d. For complaints handling, "*ScottishPower to pay £18m for customer service failings*"… "*ScottishPower has agreed to pay £18m concluding an Ofgem investigation …*" "*The £18m payment sends a strong message to all energy companies about the importance of treating customers well at all times…*"

30. Second, the Notices of Decision explain the level of penalty specifically in terms of how much is being committed by way of Redress Payments. This was most explicit in the CESP Notice of Decision of 5 March 2015 which stated at 1.9, "*the aggregate of the penalty and the amount of consumer redress is larger than the detriment suffered by consumers and the gain made by ScottishPower…*" However, all the Notices of Decision make clear that it is only because of the Redress Payments that a £1 penalty is seen as adequate in light of the seriousness of the breach: see the Mis-Selling Notice of Decision of 4 December 2013 at section 6 (which also makes clear that it is the Redress Payments which fulfil Ofgem's aim of deterring future breach); the Costs Reflectivity Notice of Decision of 3 July 2014 at 1.9 and the Complaints Handling Notice of Decision of 8 June 2016 at 1.5 to 1.7.

31. Both the Press Releases and the Notices of Decision make clear that the overall quantum of the sanction, which is judged to be appropriate in light of the seriousness of the breach, is that of the Redress Payments, not the £1 formal penalties.

32. This fits with the 6 November 2014 Policy Statement: as is clear from the FTT at [13], the total penalty must take into account the removal of detriment and reversal of gain, but also the seriousness of breach: it is only by treating the Redress Payments as part of the penalty that this objective can be met. Further, the policies (and correspondence) of GEMA/Ofgem made clear that the discount for settlement was given by way of fixed reductions depending on the time that the breach was conceded: the maximum discount being 30% (see the 6 November 2014 Statement of Policy at 5.26). Settlement by way of Redress Payments did not involve a further discount of almost 100%.

33. In terms of the amount of the Redress Payments reflecting the amount of penalties that Ofgem had threatened to impose, the latter two investigations make this absolutely clear.

34. In the CESP Target (CO_2) investigation, Ofgem sent a Without Prejudice letter on 6 November 2014. Ofgem clearly spelt out, in the section of the letter headed "**Penalty policy on early resolution**", how an early settlement will attract discounts (at differing levels depending on date of settlement) from a penalty of £3,600,000 which would have been sought at a contested hearing. The letter shows in the table that settlement by the end of the earliest settlement window, closing on 4 December 2014, would result in the proposed penalty being discounted to £2,400,000. This letter is discussed in an internal email of 30 November 2014**,** copied also to Mr Orr: *"I will discuss it at the General Committee tomorrow and Alistair will raise with the DWR. We have a deadline from OFG of 4th December to ensure we keep the fine to the lowest amount of £2.4m."* This reflects the reality that, however it was satisfied, the £2.4m was a "fine" (or penalty).

35. That settlement was concluded with Ofgem on 4 December 2014**.** Under it the Respondents did make payments of £2.4m less £2 (the £2 being the formal penalties). This discount is also reflected in the terms of paragraph 6.1 of the Decision Notice of

5 March 2015**.** At the end of paragraph 6.2, the Notice records that "*…the aggregate of the penalty and the amount of consumer redress is a lower figure than would have been the case if ScottishPower had not taken the steps as set out in paragraphs (e) and (h) above* [taking mitigating action and settling the investigation]*, the aggregate of the penalty and the amount of consumer redress is larger than the detriment suffered by customers and the gains made by ScottishPower"* . The amount of the penalty and the consumer redress are together regarded as a composite figure which is compared to the detriment and gains (as a penalty would be) and is subject to mitigation (also as a penalty would be).

36. In the case of the Complaints Handling investigation, there was also a Without Prejudice letter of 23 March 2016 from Ofgem which, in a section under the heading "***Penalty policy on early resolution***", similarly set out an initial penalty figure of £23 million with discounts for early settlement This included a discount to £18 million if a settlement was reached by 5pm on 25 April 2016. The letter continues: "*You will note that the total proposed penalty in the early settlement window is £18m. At this stage of the process, we would be prepared to consider Scottish Power making redress payments to the value of £18 million (minus a £1 financial penalty) on a date to be notified to the Authority in the Final Penalty Notice, in lieu of a full £18 million financial penalty."* The letter then expressed a view as to the recipient of the payments.

37. The settlement agreement, which concluded the investigation, was made on 25 April 2016. Under it, payments totalling £17,999,999 were made in lieu of a penalty of £18 million. Paragraph 6.1 of the Notice of Decision of 8 June 2016 says (having noted at paragraph 5.22 that a discount for early settlement had been applied): *"Taking account of all these factors and also mindful of its principal objective to protect the interests of existing and future consumers, ScottishPower has agreed to pay £18 million (less £1) in lieu of a higher penalty".*

The "inevitability" of breach

38. The Respondents (as addressed below) had argued that the breaches in this case were almost unavoidable. The FTT made findings on that issue in FTTD at [112]:

"We find that the payments were a consequence of not meeting the standards required of energy suppliers (we express no opinion as to whether those standards are 'high'). We find that infraction of the standards is not uncommon but that serious breach, as was the case in relation to the Redress Payments, is less common. We consider that the breaches of the CO2 and complaints handling rules were practically almost unavoidable. We are not able on the evidence to say the same in relation to mis-selling or cost reflexivity."

39. The finding in relation to the CO2 and complaints handling rules was based on the particular way that the Respondents conducted their businesses (FTTD [52] – [54] and [57] – [58]. This was because, in relation to CO2, they relied on a third party provider and, in relation to complaints handling, they were engaged in a big IT project. The FTT was not suggesting that it was almost inevitable that any energy company would commit serious breaches of their regulatory obligations such as to expose them to fines in the millions. Rather, given the commercial decisions that the Respondents had made, it was very hard for them to avoid committing these breaches.

The Appeal to the UT

40. The Respondents appealed to the UT but did not renew the argument based on charitable relief. They challenged the findings of the FTT that the Redress Payments were not compensatory (apart from £554,013).

41. HMRC cross-appealed in respect of the sum of £554,013.

42. The UT dismissed the Respondents' appeal and allowed HMRC's cross-appeal. The whole amount of the Redress Payments was held to fall within the scope of the principle explained in *McKnight*. In doing so, the UT rejected an argument by the Respondents that, in *McKnight*, Lord Hoffmann was describing a judge-made rule (UTD para [54]). Rather, it was a decision on the proper construction of one of the material statutory provisions i.e., section 130 (a) which was a predecessor of CTA 2009 section 54(1)(a). The UT held at [98] – [99] that the total sum to be paid in respect of mis-selling, being £8.5 million, was all in lieu of a penalty and was arrived at "*under the regulatory auspices*" on the basis that a penalty of that level would otherwise have been imposed. This was a "*package of payments*" all of which shared the same nature:

the fact that part of that £8.5 million was used to compensate customers did not change the fact that it was a penal sanction.

43. The UT also rejected the Respondents' challenge to the FTT's findings that the Redress Payments were not compensatory.

44. The Respondents appealed to the Court of Appeal, which allowed the Respondents' appeal and held that:
    a. The principle in *McKnight v Sheppard* was not an application of the statutory rule against deductions not incurred wholly and exclusively for the purposes of the trade, but was a freestanding judge-made rule prohibiting the deduction of penalties (Falk LJ at [51] – [52]);
    b. That the principle had to be interpreted strictly because otherwise it would be unclear, and a judge-made rule would need to be clear in its scope ([59] – [61]);
    c. It was irrelevant whether the Redress Payments were or were not compensatory; and
    d. As only the £1 penalties were imposed under Ofgem's statutory power to impose penalties, only those £1 penalties were within the principle in *McKnight*.

Why the Court of Appeal was wrong

What the Court of Appeal decided

45. The Court of Appeal was wrong to regard the principle in *McKnight* against deducting fines and penalties as a freestanding judge-made rule. Rather, it arose from the proper construction and application of what is now CTA 2009 section 54(1)(a). This restriction should apply to all of the Redress Payments and not just to the £1 penalties.

46. Crucially, the Court of Appeal makes this principle a matter fundamentally of form over substance: if a sanction is imposed on a taxpayer which is described as a penalty it is not deductible, but if it is described as something else, or if it is effected in a certain manner for the sake of practicality, then it is deductible. This approach is at odds with the modern approach to the tax code. Indeed it makes the principle depend on little more than labelling.

47. It is important to start with what the FTT found in regards to the Redress Payments:
    a. The Redress Payments, except in so far as £554,013 of them represented compensation, were penalties (FTTD [130] – [131]).
    b. The Redress Payments (including the compensatory element) were punishments for the breach of regulations (FTTD [132] – [135]), that is, they were suffering, loss or expense caused by Ofgem for the purpose of ensuring future compliance with rules;
    c. The Redress Payments were agreed as part of the exercise of Ofgem's statutory powers (FTTD [115]);
    d. The Redress Payments were agreed in place of statutory penalties that might otherwise have been used to punish the Respondents: (FTTD [137] – [139]).

48. As set out above at 20 - 37, it is very clear from the contemporaneous documents and from the FTT's findings that the Respondents were being punished for their breaches by being required to pay over millions of pounds. There is no ambiguity about this. It is not the case that they were given £1 slaps on the wrist because their good conduct in compensating their customers and giving to charity made Ofgem feel that their behaviour could almost be overlooked. The punishment was the combination of the Redress Payments and the £1 statutory penalties: this combination was in substance the penalty or sanction the Respondents were faced with.

49. The reasoning of the Court of Appeal is broadly set out in five stages: first, at [49] – [57], the basis of the rule against deducting penalties; second, at [58] – [64], why payments that are made instead of penalties do not fall within that rule; third, at [65] – [71] that HMRC's approach made the scope of the rule unclear, and at [72] – [73] that HMRC (and the Tribunals) wrongly focused on the intentions of the regulator when only the intentions of the taxpayer matter. Finally at [74] to [78] Falk LJ addressed the question whether a penalty could be compensatory (which did not, however, arise as she had held that the Redress Payments, whether or not compensatory, were not within the principle in *McKnight*).

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50. In terms of the scope of the principle in *McKnight*,
    a. at [49] Falk LJ expresses the principle as being that "*a penalty or fine incurred under a statutory regime … is not deductible…*"
    b. At [55] and [56], she notes that her view, that this only applies to penalties imposed by a statutory regime, is inconsistent with both *McLaren Racing v HMRC* [2014] STC 2417 and *McKnight* itself (as neither involved statutory penalties), but states that this issue was not considered by Lord Hoffmann and that as this present case involves a statutory regime that problem does not need to be addressed;
    c. At [50] she explained that the restriction cannot be an expression of the wholly and exclusively rule in s 54(1)(a), because that rule is focused on the taxpayer's purpose and not the character or nature of the payment: she cites *Mallalieu v Drummond* [1983] 2 AC 861 for this although, as explained below at 70 and 118 - 126, it stands for almost the opposite proposition (that the nature of an expense can mean that the taxpayer is treated as having a non-trading purpose irrespective of their subjective beliefs);
    d. She therefore concludes at [51] that the principle in *Von Glehn / McKnight* must be an adjustment required by law, and at [52] that this means that as it is a judge-made rule it must be clear in its scope.

51. Falk LJ then moved on to why the Redress Payments did not fall within this principle. Her reasoning is as follows:
    a. At [59]: while there is a rule restricting deductions for "*fines and penalties, at least where they are imposed under a legislative regime*" "*there is no support in the authorities for that rule to extend to amounts which are not, in fact, fines or penalties… the scope of any such extension would be anything but clear*."
    b. In her view, at [60], "*HMRC's case, essentially accepted by the FTT and UT, is that [the Redress Payments] should be treated as having the same nature or character as penalties because that is what they replaced… no authority was citied 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…*" (emphasis original);

c. The rule of policy does not "*extend to payments which are not in fact fines or penalties, even if they can be seen as replacing them…*"
d. At [63] – [64] Falk LJ held that it would be legitimate for a regulator, in seeking alternatives to a fine, to take into account that the wrongdoer would obtain tax benefits by making other forms of redress, and that this is not something the law needs to avoid.

52. Falk LJ held that HMRC's approach (and that of the Tribunals) made the scope of the rule unclear: at [67] she noted that while Ofgem imposed a lower penalty because the Redress Payments were being made, Ofgem also agreed to a low penalty on the basis of commitments that were made by the Respondents to improve their level of compliance, and there was no suggestion that the costs of that improved compliance (e.g. the salaries of additional complaints handlers) would not be deductible.

53. Further, at [68], Falk LJ considered that there was no clear distinction between the Respondents voluntarily making payments of redress to their customers during the investigation in the hope Ofgem would give them credit for this, and making those payments as part of a settlement: in both cases this could reduce the formal penalty. At [69] she noted that it was not clear whether a Consumer Redress Order made under statute would fall within the scope of the rule or not, on HMRC's case.

54. While it appears late in the reasoning, a key part of the decision is the point made at [73] and [78], which is that, in Falk LJ's view, GEMA's "*only relevant statutory power was to levy a penalty which it was required to pay into the Consolidated Fund*" and that "*GEMA had no power to redirect a payment away from the Consolidated Fund, and it did not do so*."

Errors in the reasoning of the Court of Appeal

55. A key feature of Falk LJ's reasoning is that the statutory penalties raised by Ofgem, of £1, are the only payments that can be properly described as a penalty within the scope of this principle: that is never explicitly stated but it runs through her analysis.

56. This is what allowed Falk LJ to make the statement at [73] that "*GEMA (correctly) considered that the disputed amounts were <u>not</u> penalties*", which simply contradicts

the findings of the FTT, which found both that the sums were penalties and that GEMA perceived them to be punishments. As noted below, the Court of Appeal does not acknowledge that it is rejecting the FTT's findings:

57. The Court of Appeal's limitation of the principle in *McKnight* to explicit statutory penalties appears to be based on the idea that the rule only applies to "*a penalty or fine incurred under a statutory regime*" (Falk LJ at [49]). While Falk LJ states that this is the principle Lord Hoffmann explained in *McKnight*, it is, in fact, inconsistent with that case. *McKnight* did not concern a statutory regime: that case concerned the pre-Financial Service Act Stock Exchange Rules.

58. Further, if that is the rule, it would be a rule of tax based entirely on labels rather than substance, which would be very unusual in the modern law. The FTT held that the Redress Payments were made under the exercise of Ofgem's statutory powers, and were intended to punish the Respondents: that meant they were penalties within the meaning of the rule. The application of the principle in *McKnight* does not depend on who receives a payment exacted by a regulatory authority as a punishment, so that it would cover payments to the Consolidated Fund but not payments to charities or consumers: rather, it depends on the reason for the payment.

59. Crucially, Falk LJ's view at [73] and [78] that GEMA/Ofgem's only power was to levy a penalty that would be paid into the Consolidated Fund is incorrect. As the FTT explained at [134] – [135] (supported by its findings on the practice of Ofgem at [30]), Ofgem used settlements that included Redress Payments to carry out its proper purposes of deterrence and punishment. Under its own Guidance it was required to impose penalties that exceeded the gain obtained and the harm done by a breach, and which discouraged further breaches. The FTT found that this was done by the Redress Payments together with the £1 statutory penalties. The combination was the punishment. Neither party has ever suggested that Ofgem acted outside its statutory powers in doing this.

60. As is clear from the FTT at [135], Redress Payments were a way of carrying out the purpose of punishment while also benefiting consumers in a way that a payment into the Consolidated Fund would not do: in that sense, Ofgem clearly did have the power to redirect penalties away from the Consolidated Fund and that is exactly what they did and is what their polices, and the correspondence leading up to settlement, makes clear that they did.

61. The Court of Appeal does not mention that the FTT found that the Redress Payments were (save for a small fraction) actually penalties, and that they were, in their entirety, punishment.

62. Falk LJ proceeded on the basis that HMRC's case rested entirely on the idea that a payment in lieu of a penalty is not deductible: see her judgment at [60].

63. Neither HMRC nor the Tribunals were relying on a general proposition that the deductibility of a payment is determined by the payment it replaces. The relevance of the Redress Payments being agreed in place of formal penalties that Ofgem had indicated it would otherwise seek is that it supported the conclusion that they were punishments and were within the scope of the principle in *McKnight*, applied purposively, just as much as formal penalties would have been: that is what the FTT decided in [139].

64. As set out below at 107 onwards, it is important to identify the basis for the rule in *Von Glehn* / *McKnight* so as to work out what its parameters are. HMRC submits that on any principled basis identified for this rule, it would apply to the Redress Payments (which also formed part of the Respondents' punishment) as well as the formal £1 penalties. It is a rule that prevents a taxpayer, who is being punished for their misconduct, from claiming the costs of that punishment as a deduction: it does not depend on the precise form of the punishment.

No lack of conceptual clarity

65. It may sometimes be difficult to decide whether a payment is a punishment or not. That does not mean that the rule is unclear, and in this case the FTT held that the payments were the Respondents' punishment.

66. Falk LJ raised the problem at [68] to [69] that Ofgem had taken into account not only the redress payments, but also various behavioural improvements when reducing the formal penalty to £1: HMRC were (and are) not arguing that the cost of steps taken to improve systems and processes should not be deductible. However, those improvements, required though they were by Ofgem, cannot sensibly be described as part of the sanction or punishment imposed by Ofgem. Being required to pay away millions of pounds is a punishment: being told what level of service would count as compliance (and so be likely to avoid further punishment) in future is not. The fact that the settlement was agreed (and that the Respondents were free not to settle) does not mean that this is not how they were being punished: that is what the FTT found at [137] – [139] when they held that the Redress Payments were made in place of the penalties of similar amounts that might otherwise have been imposed.

67. Similarly, if the Respondents had (as Falk LJ asked at [69]) voluntarily made redress payments to customers without receiving a penalty, those would not be in the nature of a regulatory sanction or punishment and no question of that punishment being diluted could arise. The difference is as stark as between someone whose voluntary work is put forward in a plea in mitigation and someone who is sentenced to unpaid work. The work may be the same but the reason is unambiguously different. The reason the FTT found the Redress Payments were not deductible is not that Ofgem took them into account when setting its statutory penalty: it is that they were (together with the £1 penalties) the way Ofgem punished the Respondents and they took the place of the statutory penalty (save as to £1).

68. Moreover, the rule as set out by the Court of Appeal (at [59]), that the principle in *McKnight* only applies to "fines and penalties, would be equally unclear without a definition of "fines" and of "penalties". Falk LJ solves this by relying almost entirely on labelling: something is a penalty only if the statute calls it a penalty. Such a rule would then be capricious, depending on the precise form in which a regulator decided to carry out a taxpayer's punishment.

69. More generally, the principle must be applied to the facts before the court. The fact that it is possible to suggest situations that have not been fully explored (such as the use of a statutory Consumer Redress Order under s 27G of the Electricity Act,

mentioned by the Court of Appeal at [70]) and that the proper treatment of them is not immediately obvious, does not mean that the principle is unclear. The proper treatment of the payments in *Mallalieu v Drummond* was argued about up to the House of Lords, but the rule against deducting expenses not wholly and exclusively for the purposes of the trade is not ambiguous. The fact that it might, in some cases, be difficult to decide whether a payment is in the nature of a punishment does not make the rule unclear.

Is this a judge-made rule?

70. Falk LJ held that the principle in *McKnight* was not an application of the statutory rule in s 54(1)(a) against expenses not incurred wholly and exclusively for the purposes of the trade, as the principle concerns the nature of the payment, not the intentions of the trader, and the focus of s 54(1)(a) is the intentions of the trader. This is incorrect: as explained at 108 - 126 below, it is perfectly possible for the nature of a payment to mean that a trader will not be treated as having incurred that expense wholly and exclusively for the purposes of the trade. The question does not depend solely on the subjective beliefs of the person incurring the expenditure. Indeed, *Mallalieu v Drummond* is the principal authority for this, as it held that a barrister could not claim a deduction for the costs of a suit even if she genuinely believed that she only acquired it for work purposes, because clothing necessarily fulfilled the private (non-trading) object of providing warmth and decency whether or not the taxpayer had it consciously in mind.

71. With respect, the reasoning of the Court of Appeal in paragraphs [51]-[57] is unsound. The Court of appeal accepts (correctly) that a reference to a "judge-made rule" does not 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.*" However, it went on to say that " *..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*." It is difficult to understand the difference between the recognition of that principle and the creation of new restrictions which is said to be impermissible. Any restrictions which are recognised by case law would be "new" the first time that they are recognised although the judge would be recognising a restriction which always existed.

Put another way, no restriction is new because even the first time it is recognised it will always have existed.

72. The Court of appeal go on to say:

"*In this case the principle established by* <u>*von Glehn*</u>*, 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.*"

73. With respect, that is wrong for at least two reasons. First, the decision in *Von Glehn* was based on the application of an express statutory provision (a predecessor to section 54(1)(a)) and not a judge-made rule. Secondly, it is directly contrary to the decision of the Court of Appeal in *Gallagher v Jones (HMIT)* [1994] Ch 107; 66 TC 77. In that case, Lord Bingham MR said:

"*Subject to any express or implied statutory rule, of which there is none here, the ordinary way to obtain the profits or losses of a business is to apply accepted principles of commercial accounting. That is the very purpose for which such principles are formulated.*

…

The authorities do not persuade me that there is any rule of law such as that for which the taxpayers contend and the judge found. Indeed, given the plain language of the legislation, I find it hard to understand how any judge-made rule could override the application of a generally accepted rule of commercial accountancy which (a) applied to the situation in question , (b) was not one of two or more rules applicable to the situation in question and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business."

74. In enacting FA 1998 section 42, Parliament put the principles enunciated in *Gallagher v Jones* in express statutory form.

75. It is clear from the history and development of the rule against deducting penalties that it is an application of the statutory restriction on expenses not incurred wholly and exclusively for the purposes of the trade. However, even if it were a judge-made rule, the Court of Appeal was wrong to restrict it so narrowly: this is dealt with in 161 - 166 below.

History of the restriction

76. The first case dealing with this issue was *Warnes,* in which Rowlatt J decided that no deduction could be allowed for a penalty imposed under the Customs (War Powers) Act 1915 which applied where an exporter had not taken sufficient care to secure that the ultimate destination of goods was not an enemy territory. Rowlatt J dealt with the point very briefly stating that "*a penal liability of this kind cannot be regarded as a loss connected with or arising out of the trade…"* and described it as a fine "*inflicted upon a trading body…"*. This was an application of what is now CTA 2009 section 54(1)(b).

77. In *Von Glehn*, the Court of Appeal came to the same conclusion as Rowlatt J in *Warnes* but explained their reasoning in much more detail. They based their decision on the predecessor to CTA 2009 section 54(1)(a).

78. All three judges in the Court of Appeal addressed the question in light of the comments of Lord Davey in *Strong & Co. of Romsey Ltd v Woodifield* [1906] AC 448; 5 TC 220 ("**Strong v Woodifield**"), which dealt with the question of whether damages incurred due the fall of a chimney were deductible. Lord Davey had described the issue as whether the disbursement was made "*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*"

79. In *Von Glehn*, Lord Sterndale MR explained why no deduction could be claimed at page 565, saying "*This business could perfectly well be carried on without any infraction of the law. This penalty was imposed because of an infraction of the law, and that does not seem to me to be … a disbursement or expense which was laid out or expended for the purpose of [the trade]…"* He observed that in a sense the expense

was connected with the trade, "*because if the trade had not been carried on the penalty would not have been imposed*… but that it was not incurred for the purposes of the trade: "*[d]uring the course of the trading this company committed a breach of the law. As I say, it has been agreed that they did not intend to do anything wrong ... but they committed a breach of the law, and for that breach of the law they were fined. That, as it seems to me, was not a loss connected with the business, but was a fine imposed upon the company personally, so far as a company can be considered to be a person, for a breach of the law which it had committed."*

80. Warrington LJ agreed, saying at 569-570 first that this was not "*a loss connected with or arising out of the trade*" because "*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…"* and then, "*... it cannot be said that this disbursement was made in any way for the purpose of the trade or for the purpose of earning the profits of the trade. It was made ... because the individuals who were conducting the trade had ... unfortunately been guilty of an infraction of the law…"*

81. Scrutton LJ explained the position at 572, saying *"... were these penalties an expenditure necessary to earn the profits? Were they paid for the purpose of earning the profits? The answer seems to me to be obvious, that they were not; they were unfortunate incidents which followed after the profits had been earned…"*

82. The reasoning in *Von Glehn* is that the penalties in that case were something imposed on the taxpayer by the law because their profit-making practices were found to be unlawful. The taxpayer's expense of paying that penalty was for the purposes of complying with the legal obligation to do so. That expense was not incurred for the purpose of earning the profits which had already been made or any future profits.

83. This was also the approach taken by the majority of the House of Lords (Lords Porter, Simonds and Normand) in *Smith's Potato Estates Ltd v Bolland* [1948] AC 508; 30 TC 290, when explaining why the costs of contesting the denial of a relief from tax were not deductible expenses. Lord Porter expressed the question at 523 as "*whether the expense is incurred in order to earn gain or is the application or distribution of that gain when earned…"* and that money spent *"to determine the correct amount of*

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income tax …" is "*laid out in order to discover what sum is to be paid to the Crown out of the profits or gains, which have already been earned and computed."*

84. Lord Simonds put it as follows at 527: *"neither the cost of ascertaining taxable profit nor the cost of disputing it with the Revenue authorities is money spent to enable the trader to earn profit in his trade. What profit he has earned, he has earned before ever the voice of the tax gatherer is heard. He would have earned no more and no less if there was no such thing as income tax…"* He approved the comments of Lord Greene MR in *Rushden Heel Co v IRC* [1947] 1 All ER 699: "*his obligation… to pay it is his obligation as a subject and a taxpayer, and in ascertaining the amount of his liability he is putting himself in a position to discharge his duty to the Crown…",* observing *"It is as little a part of his trade to find out how much tax he must pay as it is a part to pay it when he has found out…"*

85. Lord Normand's reasoning at 530 is very close to the approach in *Von Glehn*: "... *income tax is an impost made upon profits after they have been earned… a payment out of profits after they have been earned is not within the purposes of the trade carried on by the taxpayer…"*.

86. There is, therefore, a principle of taxation that payments made out of the profits, or expenses imposed on the taxpayer after the profits have been earned, are not deductible in calculating the profits: they cannot have been incurred for the purpose of earning the profits (because the profits have already been earned) and so are not incurred wholly and exclusively for the purposes of the trade.

87. In *Von Glehn* at 572, Scrutton LJ observed that this threw up the question as to whether damages paid in civil proceedings were deductible from profits. There have in fact been very few cases on this subject: but it appears that damages, both for tort and breach of contract, can at least sometimes be deductible in computing profits.

88. In *Strong v Woodifield*, the taxpayer was a brewery company which owned an inn. A chimney fell on a customer sleeping in the inn: the damages were held not to be deductible from the profits of the trade of brewing and innkeeping. Lord Loreburn LC said that deductibility would depend on the relationship between the injury and the

trade: at 452, *"losses sustained by a railway company in compensating passengers for accidents in travelling might be deducted. On the other hand, if a man kept a grocer's shop, for keeping which a house is necessary, and one of the window shutters fell upon and injured a man walking in the street, the loss arising thereby to the grocer ought not to be deducted…"*

89. The Australian case of *The Herald and Weekly Times v Federal Commissioner of Taxation* [1932] 48 CLR 113 (HCA) was approved by Lord Hoffmann in *McKnight*. In that case the court held that damages for defamation paid by a newspaper were deductible: as it said at 119, being sued for defamation was a "*regular and almost unavoidable incident of publishing*" and "*the thing which produced the assessable income was the thing which exposed the taxpayer to the liability*."

90. In this sense, torts committed (innocently) in the carrying on of the business can produce expenses incurred for the purposes of the trade. In the same way, contracts entered into for the purposes of the trade which are then breached, or which include contingent payments when trading ceases, can produce deductible expenses. This was the basis of the decision of the Privy Council in *CIR v Cosmotron* [1997] 1 WLR 1288 that severance payments made when a business was being shut down were deductible.

91. The Respondents have emphasised the use of the language of "almost unavoidable" in *Herald and Weekly Times* to suggest that regulatory breaches are also, in practice, almost unavoidable so that sanctions for those breaches should be deducted. This has also been put in terms of the loss being "contemplable" (see for example the Court of Appeal in the present appeal at [42]), a word used by Rowlatt J in *Warnes*. This is wrong: the difference between tortious damages and regulatory sanctions is not the degree to which the expense can be avoided but the reason why it is incurred. Tortious damages, like contractual damages (see *Cosmotron*, cited above), are the direct consequence of the trader's activities in the course of the trade: by imposing damage on third parties, those activities are rendered more expensive. Regulatory sanctions are imposed by a regulator. The High Court of Australia referred to the unavoidability of libel claims against newspapers to make clear that this was an ordinary cost of publishing: it is not part of the test. If it were, it would suggest that damages incurred

by large enterprises were more likely to be deductible (because a very large enterprise is overall more likely to make mistakes) than those incurred by small ones.

McKnight v Sheppard

92. In *McKnight*, the taxpayer was a stockbroker who had incurred significant legal costs defending himself in disciplinary proceedings before committees of the Stock Exchange Council. As a result of these proceedings, he had to pay fines.

93. The Special Commissioner dealt with the fines differently from the legal costs. As regards the fines, he said, at para 63: "*Furthermore, I hold that payment of such a fine is not an ordinary commercial loss, see per Lord Reid 35 TC 367, at 419, [1955] AC 21, at 52, in Morgan v Tate and Lyle Ltd citing Warnes. There is a difference between a commercial loss in trading and a penalty imposed for breach of the rules which was committed in that trading, see per Lord Sterndale MR in Von Glehn 12 TC 232, [1920] 2 KB 553, at pages 565-566.*" His conclusion was that the fines were not deductible.

94. However, the Special Commissioner considered the deductibility of the legal costs on conventional "duality" grounds: see paragraph 70. It was accepted that saving the taxpayer's business was a purpose of the taxpayer in incurring the legal costs. Further, if that were the only purpose then the expenditure would be deductible: *Morgan v Tate & Lyle Ltd* [1921] AC 21; 35 TC 367. The Revenue argued that the expenditure on legal costs was also incurred for the purpose of protecting the taxpayer's personal reputation. The Special Commissioner rejected that argument on the facts: see paragraph 97.

95. On appeal and cross appeal to the High Court in relation to both the fines and the legal costs, Lightman J identified three hurdles which a trader had to overcome in order to obtain a deduction:

"*(1) Whether the item constitutes a disbursement or an expense. If it does not, that is the end of the exercise;*

(2) What was the purpose of the disbursement or expenditure. Unless it was wholly and exclusively incurred for the purpose of enabling the trader to carry on and earn profits in his trade, eg if there was some other extraneous purpose, it is not deductible; and

(3) Whether the disbursement or expenditure was in fact sufficiently connected with the carrying on or earning of profits in the trade. This hurdle to deductibility has particular relevance and application when the disbursement or expenditure is made (as in this case) to meet liabilities to which the trader is exposed, and which have been occasioned, by reason of his trading."

96. Lightman J accepted that the taxpayer had overcome the first and second hurdles on the basis of the findings of the Special Commissioner. He then considered the third hurdle and concluded:

    "*Whether the costs of defending the trader against the complaints are deductible must depend on whether the act or omission which occasioned the complaint occurred in the ordinary course of the trade. If it involves some serious departure from the ordinary course of his trade. If it involves some serious departure from the standards, procedure and rules of conduct required of the trader, the expenses are likely to be disallowed. If the trader has deliberately committed a serious breach of the rules, and in particular if he has been dishonest, then no question of deduction can arise. He has stepped outside the ordinary course of the trade; the risk of disciplinary proceedings is not a normal trade risk, an incident of trading, but an extraneous risk deliberately, unnecessarily and improperly assumed; and it is accordingly not sufficiently connected with the profit earning activity to qualify the disbursements and expenses flowing from it as allowable deductions.*"

97. Lightman J considered the taxpayer had stepped outside the ordinary course of his trade in the way described above. As a result, neither the fines nor the legal expenses were deductible.

98. The taxpayer appealed the deductibility of the legal expenses to the Court of Appeal which allowed the appeal. Nourse LJ commented:

    "*As I understand the authorities, they all adopt the single test which the words of s 130(a) require to be adopted. The second requirement suggested by the Judge is only an aid to deciding whether the first has been satisfied or not; cf,* Strong and Co. of Romsey Ltd v Woodifield *[1906] AC 448; 5 TC 215.*

    The decisive objection to the basis of the Judge's decision is that the Commissioner was not asked to determine, and did not determine, whether contrary to the treatment

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accorded to them in the accounts of the taxpayer's firm, the legal expenses were incurred outside the ordinary course of their trade."

99. The Court of Appeal, therefore, decided that it had not been open to the Judge to overturn the Special Commissioner's finding that the taxpayer only had a trading purpose in incurring the legal expenses and so allowed the appeal.

100. The Revenue appealed to the House of Lords on two grounds. The first was that the facts found by the Special Commissioner led inescapably to the conclusion that the taxpayer had two purposes in paying the legal expenses: the preservation of the business and of his personal reputation. Lord Hoffmann rejected that ground on conventional duality principles.

101. The Revenue's second ground was that the words "*for the purposes of the trade*" meant that the expenditure had to be "*in furtherance of the relevant commercial activity*". There must be a sufficient connection with the earning of profits in the trade. The expenditure in question resulted from the taxpayer's own misconduct, that is to say, from behaviour outside the proper scope of his trade. Although the appeal to the House of Lords only concerned the deductibility of the legal expenses, Lord Hoffmann felt it necessary to consider the correct basis on which deductibility of the fines was denied.

102. This led him to an examination of the reasoning in *Von Glehn*. Lord Hoffmann considered the explanation given in *Von Glehn* by Scrutton LJ that the payments "*followed after the profits had been earned*" to be circular:

"*It restates the question rather than explaining the answer. Von Glehn was not a case like Smith's Potato Estates … in which it would have involved an illogical circularity to treat the expenditure as a trade expense. In that case, the taxpayer claimed to deduct the legal costs of contesting an assessment to tax. The dispute was about the computation of the taxpayer's profits. It assumed that those profits were ascertainable, one way or another, at the time when the dispute arose. The costs of the dispute could not therefore have been an element in the computation. They were logically as well as temporally subsequent to the profits being earned."*

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103. Lord Hoffmann then gave his rationalisation for the decision in *Von Glehn*: *"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…"*

104. Notably, while Lord Hoffmann refers to "legislative policy", the penalties in *McKnight* were imposed by the Stock Exchange disciplinary committee in 1986-7, before the Financial Services Act 1986 had come into effect and put the disciplinary system on a statutory footing.[2] Indeed, before the Special Commissioner it was recorded that Mr Sheppard did not believe the fines were legally enforceable (para 57).

105. Similarly, in *HMRC v McLaren Racing* [2014] STC 2417; the Upper Tribunal held (though also deciding the case on another ground) that the *McKnight* principle could apply in that case despite the fine in question being imposed by the governing body of a sport which had only contractual relations with the taxpayer. In that case McLaren were fined after one of their engineers obtained Ferrari's plans.

106. In *G4S Cash Solutions (UK) Ltd v HMRC* [2016] UKFTT 239 the taxpayer argued that they could deduct parking fines on the basis that their trade (delivering cash to banks) effectively required them to park illegally and incur civil penalty fines. This was rejected. The FTT explained at [238] that a penalty charge notice (a PCN) was not paid "*for the purpose of the trade*" because "*It is paid because the appellant has a statutory liability to pay it*…" and at [241] that even if there were trade purposes for parking illegally, the fines were not paid wholly and exclusively for the purposes of the trade because "*The trade is not that of breaking the law*" even if the law has been broken deliberately for commercial gain. At [242] the FTT applied *Von Glehn* saying

[2] Section 3 of the FSA 1986, prohibiting unauthorised persons from carrying on investment business, did not come into effect until 29 April 1988 (The Financial Services Act 1986 (Commencement) (No. 8) Order 1988, Article 3 and Schedule), The relevant self-regulating organisation was not in a position to apply for recognition until 4th June 1987 (The Financial Services Act 1986 (Commencement) (No. 5) Order 1987, Article 3 and Schedule). Prior to that time it was an offence to deal in securities unless licensed or exempt under the Prevention of Fraud (Investments) Act 1958, but members of The Stock Exchange were exempt.

that while the penalty was incurred as a consequence of how the trade was carried on, the penalty is imposed for the breach of the law.

THE BASIS FOR THE PRINCIPLE IN MCKNIGHT

107. It is impossible to answer the question whether the Redress Payments fall within the principle in *McKnight* without understanding what the basis for that principle is, as that will determine its scope. As set out below (reflecting the Grounds on which HMRC obtained permission to appeal), there are two well established principles that represent the underlying rationale for refusing tax deductions for penalties and similar payments. These are both represented in the historic authorities. One is the statutory rule against deducting expenses which are not wholly and exclusively incurred for the purposes of the trade (108 - 126 below); the other is the principle against indemnifying or sharing the burden of a punishment (127 - 160 below). These may both apply and to an extent they support each other: see 131 below for why the authorities on the nature of punishment (dealt with at 127 - 160) are relevant to the argument on duality of purpose, set out at 118 - 126. A punishment should not be shared, because it is personal to the entity being punished, and that is why the cost of the punishment is a personal expense of the trader and so cannot be wholly and exclusively incurred for the purposes of the trade. Finally, if (as HMRC consider to be wrong) the principle in *McKnight* is not an application of a more general rule of law, and is a freestanding judicial rule against deducting penalties, it is still necessary to understand what "penalties" means for those purposes (161 - 166 below).

Wholly and exclusively for the purposes of the trade

108. Both *Von Glehn* and *McKnight* present the restriction against deducting penalties as an application of the rule against deducting expenses which are not incurred wholly and exclusively for the purposes of the trade.

109. There are essentially two reasons why this is correct: all are present in the authorities and to a certain extent they overlap. First, it is an application of the rule (dating back to *Strong v Woodifield*) that an expense must be incurred in order to make profits, and not merely be paid out of the profits that the trader would otherwise be able to retain. Second, it is an application of the rule against duality of purpose: the

payment of a penalty or similar sanction is inherently a private purpose of the taxpayer, whether or not it also confers benefits in the trade.

For the purpose of earning profits

110. To understand the scope of this rule, it is important to look back at *von Glehn* and at *Smith's Potato*. Lord Hoffmann found the reasoning in those cases unclear but they in fact express a longstanding and well-established principle which is that the tax code distinguishes between sums paid to earn profits and sums paid out of the profits when they have been earned. This is also sometimes expressed in terms of whether the cost is incurred in the capacity of a trader (making profits) or in another capacity.

111. Lord Hoffmann distinguished *Smith's Potato* on the basis that it concerned the costs of disputing a tax assessment, and so allowing those costs in calculating profits would have involved an "*illogical circularity*". In fact, Lord Hoffmann was wrong about that. When Lord Normand spoke of "*a logical difficulty*", in *Smith's Potato* at 530, he was referring to the deduction of Income Tax itself in computing profits for Income Tax. In any event, he went on to set out the "*more substantial reason*" for the non-deductibility of Income Tax, which was that "*Income tax is an impost made upon profits after they have been earned.*" The same principle was applied to refuse a deduction for foreign tax in *IRC v Dowdall, O'Mahoney and Co* [1952] AC 401; 33 TC 259. In that case it was pointed out that, from the point of view of the calculation of profits for UK taxation, there would be no illogical circularity in allowing such a deduction, but, as Lord Oaksey said at 409, "*Taxes such as these are not paid for the purpose of earning the profits of the trade: they are the application of those profits when made and not the less so that they are exacted by a dominion or foreign government…*".

112. On this approach, which the authorities have treated as the same as that in *Von Glehn* and *Strong v Woodifield*, the point about a fine or regulatory sanction is that it is imposed on the trader "personally" for what they have done and is not a component in how they make profits.

113. The key distinction is that a sanction for regulatory breach, like a charge to tax, is imposed on the business after the profits have been earned: it is conceptually posterior to the carrying on of the business as inevitably a regulator is looking at how the business has been carried on and is punishing the person who carried it on for what they did. This is fundamentally different to a payment of tortious or contractual damages. A breach of contract, or a wrongful injury, done in the course of the trade imposes a cost on the trader immediately, even if it may take a long period of time for the injured party to identify their damage, bring a claim and succeed: the court awards damages on an essentially declaratory basis, identifying the amount by which the defendant business has injured the claimant. Conversely, a trader who breaches regulations (or the criminal law) only suffers loss as and when the relevant authorities decide that it is appropriate to punish them.

114. This approach was adopted by the FTT in *G4S Cash Solutions v HMRC* [2016] UKFTT 239, where the taxpayer argued that it needed to carry on its business in such a way that it would be exposed to large numbers of parking fines, and so those fines were deductible: see that decision at [218] citing *von Glehn* and [238], "*Is the PCN paid for the purposes of the trade? No. It is paid because the appellant has a statutory liability to pay it…*" It was not the fact that the van parked illegally that exposed the business to liability, but the decision of the traffic warden to place a parking ticket on the van.

115. Lord Simonds observed in *Smith's Potato* at 527 that a trader who successfully argues for a lower tax figure has not, in any real sense, earned additional profit. Similarly, it seems wrong to say that if the business in *Von Glehn* had suffered a lower fine, it would have been more profitable.

116. This is different from the costs of disputing liability: as Lord Hoffmann explained in *McKnight*, it can be a cost of doing business to try to persuade a regulator that you are not in breach and to try to minimise the sanction imposed on you.

117. The case here, though, is different. As is clear from the policies of Ofgem and the correspondence in the lead up to each settlement, the Redress Payments were not paid to avoid being punished, or in order to seek a less onerous punishment. Rather

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they were the punishment. Agreeing with the regulator how that punishment will be effected, i.e. by paying an amount to a third party rather than into the consolidated fund is not avoiding the penalty, it is paying it in a different way.

Duality of purpose

118. In *McKnight,* Lord Hoffmann identified an alternative basis on which section 54(1)(a) might apply to deny deductibility. This basis focused on the nature and purpose of a penalty: being to punish a wrongdoer. It is in the nature of a penalty that it should be suffered in its entirety by the wrongdoer. It is inevitable therefore that the object or purpose of paying a penalty is punishment.

119. In this case, Falk LJ saw this as taking the principle outside the wholly and exclusively restriction in s 54(a), as she considered that s 54(a) could only take account of the purposes of the taxpayer, not the nature of the expense.

120. Lord Hoffmann did not explain how what he said in his speech fitted in with what was then section 130(a) of the Income and Corporation Taxes Act 1970 and is now s 54(a) CTA 2009. However, there are two reasons why his explanation is an orthodox interpretation of the tax legislation (and is not some form of judicial invention). First, that the payment of a penalty inevitably has a non-trading purpose (which is dealt with here). Secondly, it refers to an implied limitation (within the statute) based on public policy, which is that punishments should not be subsidised or shared with third parties, which is dealt with at 127 - 160.

121. Turning first to non-trading purpose, the starting point is what Lord Oliver said in *MacKinlay v Arthur Young* [1990] 2 AC 239 at 255; 62 TC 704 at 757:

"*... much argument has been addressed to the question whether the purpose of the particular payment falls to be ascertained objectively or by reference only to the subjective attention of the payer. For my part, I think that the difficulties suggested here are more illusory than real. The question in each case is what was the object to be served by the disbursement or expense? As was pointed out by Lord Brightman in* Mallalieu's *case, this cannot be answered simply by evidence of what the payer said he intended to achieve. Some results are so inevitably and inextricably involved in particular activities they cannot but be said to be a purpose of the activity.*"

122. *Mallalieu v Drummond* explained that the question of whether an expense was wholly and exclusively for the purposes of the trade did not depend simply on the subjective intention of the taxpayer: in that case a barrister argued that she only purchased suits to appear in court and would not wear them otherwise. The House of Lords explained that a suit fulfilled basic requirements of all clothing, being warmth and decency, and that this was necessarily a (non-trading) purpose whether or not the taxpayer had it in mind. The issue in *MacKinlay* was whether a partnership, which had clear commercial reasons to want its partners (and other senior employees) to move to different offices as the business required, could deduct the cost of arranging and furnishing their houses when they moved. The House of Lords held that the cost could not be deducted in so far as it represented a benefit to a partner (rather than an employee) because a benefit to a partner represented an inherently mixed purpose, whether or not the partnership as a whole had business reasons for wanting that partner to move house.

123. In *G4S* the FTT presented the reason for refusing a deduction for parking fines to be an application of *Mallalieu* at [237] – [238]: in the same way that there is a necessary private (as opposed to trading) purpose when buying clothes or making a payment for the personal benefit of a partner, there is such a private purpose in discharging a penal liability. The trader must discharge that liability because it is their punishment: they do not choose to do so to advance their business. That is what was meant by Lord Sterndale MR in *Von Glehn* at 565 when he said the fine was "*imposed upon the company personally…*" This is also what Lord Hoffmann is referring to when he identified that the penalty should not be diluted by its being subsidised by the general public (that being the effect of allowing a tax deduction): it is inherently a liability personal to the one being penalised, and the expense incurred in bearing that punishment fulfils that private purpose.

124. This is the reason that a penalty is not deductible. It does not satisfy section 54(1)(a). Falk LJ complains that this is focusing on the purpose of the Regulator. That is not so. It is identifying the purpose of the expense incurred in paying the penalty.

125. The Payments in issue in this appeal had the same purpose as a substantial penalty would have had: to punish. The FTT rightly concluded that it was relevant in

determining the nature of the payments to consider the object of GEMA (through Ofgem) in agreeing to those payments being made in the place of a substantial penalty (FTTD paras 132-134).

126. That purpose did not change because the Respondents agreed with Ofgem that they would make the Redress Payments instead of paying a similar penalty: indeed the purpose did not change because they settled the investigation instead of disputing it and being fined. This was still something that the regulator did to them because of their conduct while trading: it was not a cost of that trading. That is very clear from the FTT's findings at [134] – [135].

Sharing the burden of a sanction

127. Lord Hoffmann expressed the basis for the rule as following from 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…"*

128. The concern here that the taxpayer is being punished, that they are supposed to bear the sanction in its entirety, and that it should not be passed on to or shared with third parties, suggests that this is a special case of the principle described by Lord Hoffmann in *Gray v Thames Trains* [2009] UKHL 33, [2009] 1 AC 1339 at [29] as the "narrow" rule against illegality / *ex turpi causa*. The wider rule is that a claim cannot be founded on an illegal act: the narrow is that someone subject to some form of penal sanction cannot seem an indemnity against that by way of insurance or damages claim: "*you cannot recover for damage which flows from loss of liberty, a fine or other punishment lawfully imposed upon you…"*. While the law on illegality / *ex turpi causa* has been clarified since *Gray*, Lord Hoffmann's expression of wide and narrow rules remains the law: see *Lewis-Ranwell v G4S Health Services (UK) Ltd* [2026] UKSC 2, [2026] 2 WLR 187 at [145], [166].

129. The principle against illegality (in that no-one should be allowed to profit from his own wrong) also applies to claims to rely on a statute: *Welwyn Hatfield Borough Council v Secretary of State for Communities and Local Government and Beesley*

[2011] UKSC 15, [2011] 2 AC 304 per Lord Mance at [50]. In that case Mr Beesley obtained planning permission to build a barn, and inside the frame of a barn built a dwelling house, for which he did not have planning permission. He then sought, after four years, a certificate of lawfulness on the basis that the period for taking enforcement action in respect of a change of use to a dwellinghouse was four years. This was refused both as a matter of the interpretation of the time limit in s 171B of the Town and Country Planning Act 1990 and on the basis that it would allow him to profit from his own wrong, with full discussion of the issue per Lord Mance at [43] – [57] and Lord Brown at [69] – [81].[3]

130. Lord Mance made clear at [50] that this principle could apply even though planning law "*is the creature of statute*" and "*a comprehensive code*". It had been applied to prevent claims to housing benefit (*R v South Ribble Borough Council ex p Hamilton* [2000] EWCA Civ 518) and to citizenship (*R v Home Secretary ex p Puddick* [1981] QB 767). There is nothing surprising about applying such general principles to the application of the tax code: indeed it is what was done in *UBS AG v HMRC* [2016] UKSC 13, [2016] 1 WLR 1005 at [85], where reading the legislation purposively required implying unstated limitations into the word "*any*".

131. There are three reasons this is important. First, this explains why a sanction or penalty for wrongdoing is inherently personal and so the expense of meeting it cannot be solely for the purposes of the trade. The second is that any other approach would allow the taxpayer to benefit from their wrong: it is clear from Ofgem's guidance and the FTT's findings that the total quantum, including the Redress Payments, was calculated to prevent the Respondents retaining any benefit from their breaches. If this was subsidised by the taxpayer the calculation would be wrong and they could still benefit. Thirdly, (and this would apply even if Falk LJ were right to say this is not an application of the wholly and exclusively principle), this shows that the principle in *McKnight* is an instance of the well established principle that nobody should be able to claim indemnities or contributions to the cost of their punishment.

[3] The passage in Halsbury referred to by Lord Mance at [45] is now paragraph 1155 of "Statutes and Legislative Process" in volume 96, 5 Ed., 2012.

132. The law on illegality was restated in *Patel v Mirza* [2016] UKSC 42, [2017] AC 467, where the Supreme Court by majority rejected the "reliance" approach, which was that a claim could not succeed if the claimant had to rely on their own illegality to make their claim good, in favour of a more flexible approach outlined by Lord Toulson at [101]:

"So how is the court to determine the matter if not by some mechanistic process? In answer to that question I would say that one cannot judge whether allowing a claim which is in some way tainted by illegality would be contrary to the public interest, because it would be harmful to the integrity of the legal system, without a) considering the underlying purpose of the prohibition which has been transgressed, b) considering conversely any other relevant public policies which may be rendered ineffective or less effective by denial of the claim, and c) keeping in mind the possibility of overkill unless the law is applied with a due sense of proportionality. We are, after all, in the area of public policy. That trio of necessary considerations can be found in the case law…"

133. Although many of the cases that have reached the higher courts have concerned criminal conduct (such as claims for damages for loss of earnings while imprisoned) the rule does not only apply to crimes. As Lord Sumption explained in *Les Laboratoires Servier v Apotex Inc* [2014] UKSC 55, [2015] AC 430 at [25],

"The ex turpi causa principle is concerned with claims founded on acts which are contrary to the public law of the state and engage the public interest. The paradigm case is, as I have said, a criminal act. In addition, it is concerned with a limited category of acts which, while not necessarily criminal, can conveniently be described as "quasi-criminal" because they engage the public interest in the same way. Leaving aside the rather special case of contracts prohibited by law, which can give rise to no enforceable rights, this additional category of non-criminal acts giving rise to the defence includes cases of dishonesty or corruption, which have always been regarded as engaging the public interest even in the context of purely civil disputes; some anomalous categories of misconduct, such as prostitution, which without itself being criminal are contrary to public policy and involve criminal liability on the part of secondary parties; <u>and the infringement of statutory rules enacted for the protection of the public interest and attracting civil sanctions of a penal character</u>, such as the

competition law considered by Flaux J in Safeway Stores Ltd v Twigger *[2010] 3 All ER 577."* (Emphasis supplied.) This passage is endorsed as representative by the editors of Chitty (36 Ed. 2025) at **19-015**.

134. Lord Sumption went on to say in *Apotex* at [28] that actions leading to claims in contract or tort do not raise the illegality defence as they "*offend against interests which are essentially private, not public…*" repeating this observation in *Bilta (UK) Ltd v Nazir (No 2)* [2015] UKSC 23, [2016] AC 1 at [100]. This is also a notable similarity with the approach of the courts to the non-deductibility of penalties.

135. There are two cases that apply the illegality defence to regulatory penalties: *Safeway Stores v Twigger* [2010] EWCA Civ 1472, [2011] 2 All ER 841, dealing with fines for anti-competitive behaviour, and *Khan v Hussein* [2019] CSOH 11, 2019 SC 322, dealing with sanctions from the Financial Services Authority.

Safeway Stores v Twigger

136. In this case Safeway was investigated by the Office of Fair Trading for anti-competitive practices to raise the price of milk (Longmore LJ at [5] – [6]). The OFT having given notice of their intention to make a decision against Safeway, Safeway chose not to proceed to a formal hearing but to come to an agreement which exposed them to a penalty (paragraphs [8] – [12]). They sought to claim an indemnity against that penalty (it not yet having been fixed) against their directors.

137. The directors argued that the illegality rule prevented Safeway's claim, as Safeway needed to rely on its anti-competitive practices to show that the directors had exposed it to liability. The Court of Appeal agreed.

138. Longmore LJ (with whom Lloyd LJ agreed) explained his conclusion on the basis that the liability to the penalty was "*personal*" to the company, saying at [23],

139. *"No one is liable for the penalty imposed by the Competition Act except the relevant undertaking. The liability is, therefore, personal to the undertaking. If there is a liability it cannot be imposed on any person other than the undertaking and the undertaking is personally liable for the infringement. If a penalty is imposed, it will*

only be because the undertaking itself has intentionally or negligently committed the infringement. In those circumstances it is the undertaking which is personally at fault (there can be no one else who is) and, once the maxim is engaged, the undertaking cannot say that it was not personally at fault in order to defeat the application of the maxim. The whole hypothesis of the undertaking's liability is that it is personally at fault…"

140. Lloyd LJ similarly stated at [37] that "*the ... liability to a penalty is, as Longmore LJ says, a personal liability of that claimant…"*.

141. The language used here, of the penalty being imposed "personally" on the company, so that it cannot be shared with the directors, is very close to the reasoning in *von Glehn*.

142. While Pill LJ concurred in the result his explanation was slightly different, saying at [44],

"… The policy of the 1998 Act is to protect the public and to do so by imposing obligations on the undertaking specifically. The policy of the statute would be undermined if undertakings were able to pass on the liability to their employees, or the employees' D & O insurers. Only if the undertaking itself bears the responsibilities, and meets the consequences of their non-observance, are the public protected. A deterrent effect is contemplated and the obligation to provide effective preventative measures is upon the undertaking itself."

143. *Safeway* was discussed, and to some extent criticised, in *Bilta v Nazir*. That case similarly concerned the ability of a company to sue its directors where the directors had caused the company to be involved in fraud, and the Supreme Court made clear that the illegality rule would rarely prevent such actions.

144. Lord Toulson and Hodge considered *Safeway* to be doubtful and the reasoning of Longmore LJ to be incorrect (at [159]). However, they went on to say at [162],

"Reference to public policy takes us to the only basis on which we consider that the decision of the Court of Appeal in Safeway may have been justified. Pill LJ considered that the policy of the Competition Act would be undermined if undertakings were able to pass on their liability to their employees. That may have been a sound reason for striking out Safeway's claims, and we express no view as to the merits of the decision. We accept that there may be circumstances where the nature of a statutory code, and the need to ensure its effectiveness, may provide a policy reason for not permitting a company to pursue a claim of the kind brought in Safeway."

145. Lord Sumption explained *Safeway* at [83], saying

"Safeway was not a one-man company, but the statutory scheme had the peculiarity, which was critical to the reasoning of the Court of Appeal, that the offence was not capable of being committed by the individuals directly responsible. The Act imposed the prohibition and the resulting penalty only on the company. It was held that this required the attribution of the infringement to the company and its non-attribution to the defendants. On that ground, it was held that to apply the breach of duty exception so as to allow recovery of the penalty from the defendants would be inconsistent with the statutory scheme. The decision is not authority for any proposition applying more generally."

146. Lord Neuberger (with whom Lords Clarke and Carnwath agreed) said at [31] that "*I would take a great deal of persuading that the Court of Appeal did not arrive at the correct conclusion in that case. However, I do not believe that it would be right on this appeal to express a concluded opinion as to whether the case was rightly decided, and, if so, whether the reasoning of the majority or of Pill LJ was correct…*" Lord Mance stated at [52] that he was sympathetic to the views of Lords Hodge and Toulson but that it should be considered at another time.

147. In so far as *Safeway* was wrongly decided, this was not because the illegality principle did not apply to regulatory penalties but because the defence there was being raised by the directors who had caused the company to incur those penalties, to defend a claim in respect of their breach of duty. Even so, the Justices who doubted *Safeway* noted that it could be justified in order to avoid undermining the regulatory regime,

which assumed that companies could not pass on penalties to others (even their own directors).

148. In *Khan v Hussein* the pursuer, Mr Khan, had been sanctioned by the FSA for making false statements about his income to obtain a mortgage (see the Court of Session at [8] – [17]). He was fined £80,000 but this was later withdrawn: he was, however, prohibited from performing regulated functions, which caused him loss of earnings.

149. Mr Khan sued his accountant for breach of contract and professional negligence, on the basis that the accountant had encouraged him to exaggerate his earnings and had provided him with false payslips to show to the bank.

150. The Court of Session held that this claim was barred by the *ex turpi causa* rule, which did apply to sanctions applied by a regulator (para [32]). *Khan v Hussein* was referred to without criticism by the Supreme Court in *Lewis-Ranwell* at [48].

Insurance

151. It is well established that insurance policies will not pay out to indemnify either criminal punishments or regulatory sanctions: see *Collingvaux's Law of Insurance* 14 Ed. (2025) at **5-144**, **5-151**, **5-158** and **21-280**;[4] and *Lancashire County Council v Municipal Mutual Insurance* [1997] QB 897, where Simon Brown LJ (having reviewed *Haseldine v Hosken* [1933] 1 KB 822*, Hardy v Motor Insurers' Bureau* [1964] 2 QB 745 and *Gray v Barr* [1971] 2 QB 554) stated at 907, "*I unhesitatingly accept the principle that a person cannot insure against a liability consequent on the commission of a crime…"*

152. While the cases have tended to deal with criminal liability, several of them represent offences that we would tend to see as more in the nature of regulation: *Haseldine v Hosken*, where the Court of Appeal held that a solicitor could not claim under his insurance policy in respect of losses arising from his committing champerty

[4] Following Patel v Mirza it is recognized that this is not entirely black and white: it is possible that if the three factors indicate that the public interest is not served by prohibiting a claim, for example where the offence is of strict liability, a claim might now be allowed.

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(Scrutton LJ at 833, Greer LJ at 837. Similarly, while it was not an insurance case, *Leslie v Reliable Advertising* [1915] 1 KB 652 concerned fines for sending money-lending advertisements to minors, in contravention of the Bettings and Loans (Infants) Act 1892 and the Money-lenders Act 1900: the money lender could not recover damages for breach of contract from their advertisers.

153. In summary, there is a well-established principle that punishments and sanctions imposed in the public interest (typically by regulators or the criminal justice system) cannot have their impact reduced by sharing them with other persons, either by seeking damages or by claiming indemnity. That would undermine the regime that has imposed the sanction and cause inconsistency in the law.

154. As Lord Hoffmann observed in *McKnight*, the same applies if a taxpayer seeks to claim a tax deduction for a regulatory sanction: effectively the punishment that the taxpayer was supposed to bear has been reduced, because they only bear a part of it.

155. The *Patel v Mirza* factors mean that in some cases a claim that relies on the illegal conduct (including regulatory breach) may still succeed, if there are countervailing factors suggesting that the claim should be permitted: this would rarely apply to a case within Lord Hoffmann's "narrow rule" as it would be very surprising for the public interest to support allowing a claimant to ask someone else to bear the burden of the punishment imposed on them. That would tend to suggest that the punishment was itself inappropriate, making the law inconsistent in the way these cases warn against. It might conceivably be the case that where a third party has caused the claimant to be in breach, it might be appropriate for that third party to pay the cost: that was the reason for the doubts expressed in *Bilta v Nazir* regarding *Safeway*.

156. In this context, however, it is never going to be appropriate, in the *Patel v Mirza* sense, for a regulatory punishment to be borne in part by the general taxpayer instead of the person who has been punished. The public at large are not to blame for the Respondents' regulatory breaches.

157. In this matter, Ofgem had statutory authority to investigate regulatory breaches and to impose penalties for those breaches. It also had power to order redress payments but it did not use that power. Rather, in accordance with its published policies, it indicated a level of penalty it would impose, which could be discounted if the business under investigation admitted its breaches, and which could also be paid to third parties rather than to the consolidated fund, by agreement. It was a crucial part of this though that the settlement would be an exercise of Ofgem's power to sanction and would include a penalty, so that it would trigger the rules as to publication of the breach that formal penalties involved. As the FTT said at [115], the settlements were made in exercise of Ofgem's power to issue penal sanctions.

158. As the FTT said at 135, the purpose of the indicated penalty was to punish the company in breach: "*the direction of payments to benefit consumers did not remove that object but added to it the benefit which redress payments could bestow on consumers generally…*" Accordingly the FTT held (at 134) that "*GEMA intended the obligations to make the Redress payments to be punishments…*"

159. It was clear from Ofgem's policies (and the findings of the FTT), the level of penalty would be set based on the seriousness of the breach (FTT at [13]). It would then be discounted for early settlement (FTT at [16]). This is made explicit in the settlement invitation letters for the later two breaches in this case. What is not being offered is a *further* discount, to a much lower level of punishment, if the company in breach agrees to pay the indicated sum to charity and to its customers. As the FTT recognised, these were penalties (see the FTT at [130]-[131]). The Redress Payments were a way of paying the amount Ofgem had decided on as a sanction, not an alternative to paying it or a reduction in that sum: it was also in place of paying a formal, statutory penalty as explained by the FTT at 137-8, "*we regard the settlements to have been made in place of what might have been imposed and so to have avoided a penalty larger than £1…*"

160. On the basis of the FTT's findings, the redress payments were the sanction imposed by Ofgem for the Respondents' regulatory breaches: the sanction was not merely the nominal £1 statutory penalties. Accordingly, the principle that sanctions cannot be passed on to third parties so as to reduce or avoid their punitive effect applies

equally to the redress payments: as the FTT said at [139], when explaining why the principle in *von Glehn* and *McKnight* applied, "*The non-deduction policy inherent in the statutory provision which permits the Authority to punish must also be inherent in the ability of the Authority to extract other payments instead of, or under the threat of imposing a penalty…"* The effect of the sanction would be diluted, and the punishment undermined, if the general body of taxpayers subsidised it.

Even if judge-made, the principle is not as narrow as the Court of Appeal suggested

161. Even if the Court of Appeal was correct to hold that the restriction on deductions for penalties and fines is a judge made rule of law, and is not an expression of a general rule which is implied into the legislation, the Court of Appeal interpreted the scope of the rule too narrowly. The principle laid down in *McKnight* is not restricted to formal statutory penalties (the penalty in that case was not imposed under statute). Rather, the rule applies to sanctions of a penal nature imposed by regulatory authorities as much as it applies to statutory fines.

162. Here, although the Redress Payments were not formally imposed as penalties, they were sanctions imposed on the Respondents by the regulator for the purpose of punishing their wrongdoing and so fall within the rule: see FTTD [134].

163. The Court of Appeal noted the difficulty in ascertaining whether or not a sum was imposed as a punishment in place of a penalty. However, that is a factual assessment to be made by the fact-finding tribunal. In this case the FTT held at [137]-138] that the Redress Payments were imposed as punishments in place of penalties.

164. At [61], Falk LJ cited the warnings "*against making decisions based on vague concepts of "public policy"*" from Lord Atkin in *Fender v St John-Mildmay* [1938] AC 1 at 10-12. That was a case on breach of promise of marriage and whether public policy meant that a promise made to marry after the defendant divorced his wife should be upheld. Lord Atkin cited older authority criticising the idea that "*it might, in any case, be proper for a judge to prevent a party from availing himself of an indisputable principle of law, in a Court of justice, upon the ground of some notion of fancied policy*

or expedience" and warned against extending rules based on *"the idiosyncratic inferences of a few judicial minds*."

165. This is clearly inapposite here. The rule in *Von Glehn* and *McKnight* is very well-established, whatever its underlying rationale, and (as all tax law must be) applied coherently and purposively. It is not sufficient to say: the rule exists, it clearly applies to statutory penalties, but to apply it to anything else would be judicial innovation. Indeed such an approach must be overly reductive, as *McKnight* itself did not concern statutory penalties. The scope of the rule has to be elucidated and then it should be applied.

166. Whatever the basis of the principle in *McKnight* is, the limited scope given to it by the Court of Appeal renders it capricious: in this case we have clear sanctions for breach, which have been quantified by agreement. The regulator and the wrongdoer agreed how those sanctions would be applied: to then say that £1 of that falls within the principle in *McKnight* because it is called a penalty and the rest does not makes the rule irrational.

Conclusion: summary of reasons upon which HMRC's argument is founded

(1) The issue before this Court is whether the Redress Payments, which were agreed by the Respondents in order to settle investigations into their regulatory breaches, fall within the principle in *McKnight* against deducting penalties and similar payments.

(2) The FTT held that the Redress Payments were part of the punishment imposed on the Respondents by Ofgem/GEMA in consequence of their breaches, and took the place of statutory penalties of similar sums that Ofgem might otherwise have sought.

(3) To answer this question, the scope of the principle in *McKnight* must be identified and this involves addressing the basis for that principle.

(4) The principle in *McKnight* is an application of the statutory rule against deducting expenses which are not incurred wholly and exclusively for the purposes of the trade. This is true for two reasons.

(5) The first reason is that a regulatory sanction or punishment for misconduct is something that is done to the trader after their profits have been earned: it is not something the trader incurs in order to earn profits.

(6) The second reason is that a punishment is inherently personal to the entity being punished, and therefore the expense of meeting that punishment fulfils a private, rather than a trading purpose, and this is an inherent mixed purpose (as in *Mallalieu*).

(7) Both these reasons apply to the Redress Payments, which were part of the punishment of the Respondents for their breaches, in the same way as they apply to the £1 statutory penalties.

(8) The principle in *McKnight* also expresses the general legal principle that no-one can seek an indemnity against or contribution towards the cost of their punishment. This is related to the point above that a punishment is inherently personal. This also applies to the Redress Payments just as clearly as to the statutory penalties.

(9) Finally, even if the principle in *McKnight* is not an example of a wider rule of law, its scope must be applied purposively and on that basis it applies to the Redress Payments.

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23 March 2026

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