Legal expenses webinar notes: 12 February 2015

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1. Introduction

1.1 Legal and Professional Fees are a risk area in any tax return computation

The annual requirement to prepare a tax computations highlights that the taxation treatment of legal expenses is a difficult area. Members in practice have been reporting that HMRC challenge frequently whether or not legal and professional fees are allowable. They seek an analysis of the debit and then an explanation of why and for what the expenditure was incurred. HMRC also challenge the input tax recoverability of legal and professional fees.

Legal expenses raise issues about the purpose and the capacity in which the expense has been incurred. In tax it is sometimes possible to achieve the outcome wished in a tax efficient manner whereas the poorly advised may face a disallowance of the expense for tax purposes. In other words "It ain't what you do but the way that you do it".

For returns lodged after March 2009, a new penalty regime applies (Schedule 24 FA 2007). Mistakes may not suffer a penalty but a failure to take reasonable care faces a penalty of up to 30% of the tax lost. It is important that taxpayers appreciate that legal expenses is a known risk area and the taxation treatment deserves reasonable care to be taken.. Litigation can be expensive and often the amounts involved are material.

This may be an appropriate point to remind readers and listeners that the views expressed are the author's only and should not be taken as representative of the AAT. In the author's view, it is sensible and prudent to ensure that the expenses of legal advice is treated properly obtaining relief whenever possible for the costs incurred. This paper contains advice as to how to achieve a commercial outcome in the desired way. That is sensible tax mitigation and a failure to structure a transaction in the right way might place a tax adviser at risk of being sued for damages. (see Slattery v Moore Stephens)

The article has also been written using the law in force as at 31 December 2015. There have been several decisions before the courts which reinforce the fact that the taxation treatment of legal expenses remains a difficult area. However, the issues remain contentious and the Tribunal has considered arguments in cases like Mr Paul Duckmanton v Revenue & Customs [2011] UKFTT 664, Chain Telecommunications Ltd v Revenue & Customs [2012] UKFTT 330 and Linslade Post Office & General Store (a firm) v Revenue & Customs [2012] UKFTT 457 which are considered later in this paper.

1.2 Taking Reasonable care

Case law establishes persuasive authority in many cases at tribunal level but decisions of the Court of Session and Court of Appeal, the Supreme Court and The House of Lords establish legal precedent and may establish the interpretation of the law. The taxation treatment of legal expenses remains a frequent area of contention. It is a difficult and grey area where it is important that reasonable care is taken and documented when considering the taxation treatment.

There are numerous reasons why a deduction may be denied for legal, accounting and other professional expenses: an expense may be regarded as attributable to capital; it may be regarded as not wholly and exclusively laid out for business purposes; or it may be seen as an application of profits already earned rather than as an expense in calculating those

In the real world, decisions are seldom binary. There is a risk that if there is a duality of purpose, that duality of purpose may disallow the expense. The reason for incurring the expense may be wholly

and exclusively for the purposes of the trade and therefore allowable. The fact that the expense results in an incidental benefit is irrelevant if that was not the motive and purpose for incurring the expenditure.

In areas of doubt, I recommend full disclosure of the position adopted and that the reasons leading to the decision are well documented if a tax deduction is being claimed. A failure to take reasonable care that is discovered by HMRC leads to a penalty regime of up to 30% if the new penalty regime found in Schedule 24 of FA 2007 is applied. In areas of tax law which are complex, a mistaken but tenable view of the law will not produce a penalty. So it is important to document that reasonable care has been taken in deciding the taxation treatment of known risk areas which include legal and professional fees.

1.3 Consider all the tax (and tax credit implications)

Legal (and other professional) fees often involve material amounts. It is important to consider not only the taxation treatment in the computation of the business profit but also the VAT treatment (whether and how much input VAT can be recovered) and possibly, if the risk is high and the amounts material the possibility of tax credit adjustments and possible discovery (see s20 TCA 2002).

2. VAT

2.1 General Rules for input tax recovery

Generally, VAT is only reclaimable if it is charged on a supply to the claimant (VATA 1994, s. 24(1)) and the expense has been incurred with a view to making taxable supplies.

Care is needed when deciding to whom and for what legal fees have been incurred. The risk areas are too many to mention but I am going to select a few of the more common difficult areas for this webinar.

Input tax is defined as VAT incurred on goods or services which are used or to be used for the purposes of the business (VATA 1994, s. 24(1) and Directive 2006/112, art. 168). Thus, VAT incurred on expenditure which is not for the purposes of the business is not input tax and is not recoverable.

Whether goods or services are obtained for the purposes of the businesses is sometimes open to doubt. In determining whether input tax is recoverable, it is not sufficient that the business has funded the expenditure; it must also have been incurred for the purpose of the business and the making of taxable supplies.

There is no comprehensive definition of 'business purpose' because of the wide variety of circumstances in which businesses operate.

The question of 'business purpose' was considered in Ian Flockton Developments Ltd v C & E Commrs (1987) 3 BVC 23. The company manufactured mouldings and plastic storage tanks. A racehorse was purchased in order to promote the company's image and to provide a talking point during discussions with potential customers.

The company was successful in recovering the input VAT. In the judgement which is often cited, Stuart-Smith J stated at p. 28:

'The test is, were the goods or services which were supplied to the taxpayer used or to be used for the purpose of any business carried on by him? The test is a subjective one: that is to say, the fact-finding tribunal must look into the taxpayer's mind as it was at the relevant time to discover his object. Where the taxpayer is a company, the relevant mind or minds are those of the person or persons who control the company or are entitled to and do act for the company.

In a case such as this, where there is no obvious and clear association between the company's business and the expenditure concerned, the tribunal should approach any assertion that it is for the company's business with circumspection and care, and must bear in mind that it is for the

applicant to establish its case and the tribunal should not simply accept the word of the witness, however respectable. It is both permissible and essential to test such evidence against the standards and thinking of the ordinary businessman in the position of the applicant. If they consider that no ordinary businessman would have incurred such an expenditure for business purposes that may be grounds for rejecting the applicant's evidence, but they must not substitute that as the test. It is only a guide or factor to take into account when considering the credibility of the witness, and no doubt there will be many other factors which bear upon that question which the tribunal should well understand.

The tribunal must look at all the circumstances of the case and draw such inferences as they think fit. In the end it is a question of fact for them whether they were satisfied on the balance of probability that the object in the taxpayer's mind at the time the expenditure was incurred was that the goods and services in question were to be used for the purposes of the business.'

In Chain Telecommunications Ltd v Revenue & Customs [2012] UKFTT 330, the company paid the invoices for legal services which had been supplied to a predecessor company which had been acquired.

This is an interesting area of VAT law and one that needs to be monitored because the Supreme Court decisions in WHA emerged in 2013 after a long time considering the appeal and arrangements that an insurance company had made to improve its competitive position for breakdown repairs (MBI).
http://www.bailii.org/cgi-bin/markup.cgi?doc=/uk/cases/UKSC/2013/24.html&query=WHA&method=boolean
In WHA Ltd & Anor v Revenue and Customs [2013] UKSC 24 , a tax avoidance plan turned on WHA receiving a supply of garage repair services which it then charged onto a Gibralter based reinsurance company which was part of the same group. Lord Reed delivered the judgement which had the unanimous agreement of the other four judges in the Supreme Court that WHA did not receive the supplies of garage services for which it paid and consequently WHA was not entitled to recover the VAT which the garages charged.

The WHA case is complex because it was a tax avoidance arrangement which failed to work when the detail of the various contracts was examined. These agreements are accordingly consistent in envisaging the role of WHA as encompassing the negotiation, investigation, adjustment, settlement and payment of claims. There is no indication that WHA's role included undertaking responsibility for the carrying out of repairs. In other title and legal responsibility never belonged to WHA and so the complex scheme did not work. The contracts were ineffective: they conflicted with retention of title clauses used by some of the garages; they did not address the situation where the policy covered only part of the cost of the repair; and they could not in any event prevent title from passing to the owner of the vehicle once a part was fitted. On analysis of the contracts and economic reality, the FTT concluded that concluded that the garages made supplies of repairs and parts to the insured, and not to WHA.

The contracts committed WHA to pay for authorised repairs. The contracts did not, however, make WHA the customer of the garage. Consequently the VAT charged by the garage for the repair was not recoverable.

It is widely accepted that in *Redrow*, the Court posed four questions for a person claiming to deduct input VAT, namely:

> (i) Did that person instruct the supplier to do something?
>
> (ii) Was something done for or obtained by that person?
>
> (iii) Did that person use that something in the course of [sic] furtherance of its business?
>
> (iv) Did that person pay consideration for the something which included VAT?"

In the Chain Telecommunications and in WHA cases, the company might have paid the bill but it failed the other three tests. In Chain Telecommunications it was a predecessor business that it acquired out of administration that instructed and received the legal advice. That legal advice did not relate to the making of taxable supplies in the payer's business.

Thus the answer to the question, under s 24(1)(a) VATA 1994 (whether the services were supplied to Chain) is that they were not. Failure of that precondition means that the VAT paid by Chain as part of its payment of the invoices does not constitute input tax.

Similarly in WHA the goods and services were never acquired by the insurance company even although the insurer paid for the work to be done.

In Chain Telecommunications, three different legal firms had been involved but the VAT of £7,706 could not be recovered. In tax, the letter of the law has to be interpreted and in this case the economic cost of 'doing the right thing' includes the VAT which is irrecoverable.
http://www.bailii.org/uk/cases/UKFTT/TC/2012/TC02016.html

2.2 **Awards of costs if litigation unsuccessful**

If a litigant is unsuccessful, the losing party can find themselves facing a legal bill not only for their own legal costs but also for the other party's costs.

To illustrate the point, let's call the unsuccessful litigant Bill and the successful litigant Ben. The dispute is over a wholly business issue and both Bill and Ben are VAT registered traders. In Scotland, costs will be prescribed by the ACT of Sederunt and may be appealable to the court. In such a case the Court appoints an arbiter to resolve the dispute using the rules set out in the Act of Sederunt.

If Ben's solicitors were to send Bill their invoice for legal fees incurred, Bill could not recover any VAT attaching to Ben's legal costs. In such a case, the VAT on Ben's legal fees have not been incurred for the furtherance of Bill's business.

The proper procedure is for Ben's solicitor to address and send a VAT invoice to his client, Ben. Subject to the usual conditions, this may enable Ben to recover the VAT on that amount. The solicitor should also send a copy of that invoice to Bill. The copy invoice should state that it is not a VAT invoice and it should be stamped to indicate that it is a mere 'copy'. Assuming Ben is fully able to recover the input VAT, Bill will only pay costs of the net of VAT amount. In tax, remember the tenet that it ain't what you do but the way that you do it that is important.

It can get complicated if Ben is partially exempt. Ben will be able to recover part of the VAT and the remaining VAT not recovered is added to the bill and Bill has to pay this but cannot recover the input VAT not recovered by Ben. A covering letter should clarify the amount payable by Bill

If Ben is not VAT-registered or did not use the legal services for a taxable business, Ben cannot recover the VAT. Neither can Bill.

In Turner (t/a Turner Agricultural) v C & E Commrs [1992] BVC 82, the court held that Turner could not reclaim VAT incurred on defendants' costs in a High Court action in which the taxable person (Turner) was an unsuccessful plaintiff. As the unsuccessful plaintiff, Turner had to bear the defendant's costs, but could not recover the VAT element because the legal services were supplied to the defendant and not Turner Agriculture.

2.3 Other legal expenses

Sometimes it is unclear to whom the legal services were provided. For example, an employee driving a company car involved in a motoring accident might incur legal costs in a defence to establish fault. That expense relates to the employee and the employer cannot recover the input VAT. Revenue and Customs Commissioners v Jeancharm Ltd (trading as Beaver International) - [2005] STC 918

A partner may incur an expense in the capacity as an individual (and not as a partner and for the partnership trade). Such VAT would not be recoverable by the partnership. Sherman and another v Customs and Excise ; Commissioners - [2001] STC 733

Care needs to be taken in property transactions . This webinar is not going to cover the complications of the capital goods scheme or partial exemption or the option to tax. But it is quite common for the landlord to pay the tenant's fees or for the tenant to pay the landlord's fees. If a tenant pays the legal fees of a landlord as regards the landlord agreeing that the lease can, say, be assigned to a new tenant, the legal services are supplied to the landlord. In such a case the tenant cannot recover the VAT

Sometimes a bank takes legal advice, but requires the customer to pay the lawyers' fees. If the VAT charged by the lawyers is input tax of the bank, then it usually cannot be reclaimed because it relates to exempt supplies.

In R (on the application of the Medical Protection Society Ltd) v Revenue and Customs Commissioners - [2010] STC 555, one of the issues in a complex case was whether the company was receiving advice from overseas lawyers as a principal or as an agent of its members. The company had obtained a ruling that it did not need to account for VAT by the reverse charge mechanism because the original ruling was based on a misunderstanding, indeed misdirection of the facts.

MPS is a not-for-profit mutual organisation offering a wide range of benefits on a discretionary basis, including indemnity to members in respect of negligence claims. MPS is not an insurer and must not be referred to as an insurer.

MPS has some 225,000 medical and dental members worldwide in over 40 countries. As such, it is the largest mutual medical protection organisation in the world.

The basic picture presented (wrongly) in the disclosure letter was one in which MPS's members appeared to be in the driving seat so far as concerned instructing lawyers to deal with claims against them and the handling of any proceedings, with an additional obligation upon them (and their lawyers) to report to MPS and keep it informed and to allow MPS to review and (if it so chose) control steps which might be taken by them. By contrast, the picture which emerges from the Guidelines is one in which it is MPS which is firmly in the driving seat so far as instructing lawyers and the handling of proceedings is concerned, with a limited obligation upon it and the lawyers to keep the affected member informed about what is going on and giving him very limited power to control what happens (his consent is required to settle a claim, but for little else). In other words MPS acted as principal and the overseas lawyers services were supplied to it. It needed to account by the reverse charge mechanism for the services it received.

Sole proprietors and partnerships who are full-time farmers may normally claim 70 per cent of the VAT incurred on repairs and maintenance of the farmhouse, but it may be a lesser amount for alterations (Walthall [1999] BVC 4,073).

This treatment was agreed with the National Farmers Union (NFU).

Sometimes it is necessary to return to the fundamental principles. C & E Commrs v Redrow Group plc [1999] BVC 96 is an interesting decision. Redrow operated a sales incentive scheme, paying the fees of estate agents instructed in the sale of existing houses owned by purchasers of Redrow homes. At first blush, the sale of an existing house is going to be an exempt transaction. If the supply is exempt, the related input tax is not recoverable

Redrow instructed an estate agent of its choice and agreed a price for the existing house. On exchange of contracts for the prospective purchaser's house, the estate agent invoiced Redrow. Redrow was liable to pay the agent in the event of a sale, but under the agreement between Redrow and the agent Redrow's liability was extinguished if the prospective purchaser did not proceed with the purchase of a Redrow house. Now this is the key to the decision because the expense was actually being incurred for the purposes of Redrow's business which was to make a taxable (but zero rated) supply of a new house.

The House of Lords held that Redrow obtained something of value in return for the payment of the estate agents' fees. What was obtained was for the purpose of Redrow's business and therefore the input tax could be deducted subject to the normal rules. In this instance, the estate

agents fees were incurred with respect to a zero-rated supply – the sale of a new house by Redrow.

The final point in this section is where the purpose of the expense is not for the business. The commonest example is where the expense is private purpose and the VAT cannot be recovered. Legal fees paid by and invoiced to a company in respect of a legal action against a director can have a business benefit if they enable the director to continue to work full time for the company. However, they are for the purpose of the director's personal affairs (P & O European Ferries (Dover) Ltd [1992] BVC 955. A similar principle was held in Customs and Excise Commissioners v Rosner - [1994] STC 228

2.4 VAT treatment of disbursements

Solicitors' disbursements is a difficult area for VAT. Not all items shown as disbursements on a solicitor's bill to a client are disbursements for VAT purposes. It is not the description of a supply, but the contractual relationship between the parties that determines the VAT treatment.

General disbursements included in a solicitor's bill should have VAT at the standard rate added on the item. Examples of general disbursements are postage (generally exempt if by Royal mail), travel expenses (zero rated if by public transport), telephone charges and telegraphic transfer fees. Many of these expenses bear no VAT when paid for by the solicitor, but when charged to the client become VATable. This is because HMRC consider such costs to be overheads of a solicitor's business. They are expenses that a solicitor incurs in making the supply of legal services to the client.

The contrast to this is where the solicitor incurs the expense when acting as the agent of the client. Agency disbursements are goods or services that are expenses of the client, although initially paid for by the solicitor. Examples might include the stamp duty paid by the solicitor when conveyancing a newly acquired property.

It can be difficult to distinguish between general and agency expenses and individual cases require detailed consideration of the facts.

In Barratt, Goff and Tomlinson and The Law Society as Intervenor v Revenue & Customs [2011] UKFTT 71 the issue was whether fees paid for medical records and medico-legal reports by solicitors acting for clients in personal injury and medical negligence claims were disbursements and thus outside scope of VAT if incurred before 2007 or are not disbursements and liable to VAT. The underlying point is of wide application and often crops up in the taxation treatment of legal advice but the actual expense of medical reports has, since 2007, been standard rated for VAT.

The firm of solicitors received assessments totalling £76,894 for the VAT on fees charged by medical professionals for providing medical records and medico-legal reports for litigation purposes. HMRC viewed these fees as part of a VAT-inclusive supply of legal services. The fees were not disbursements for VAT purposes, argued HMRC.

The question of whether the expenditure incurred is liable to VAT has diminished in importance since 2007 as a result of an amendment to Item 1(a) of Group 7 of Schedule 9 to the Value Added Tax Act 1994 ("the Act"). That amendment provided that only those services "consisting in the provision of medical care" were to be exempt from VAT. Consequently, the majority of the experts providing reports are now VAT-registered, so that the cost of their reports will be subject to VAT.

The conditions for treatment as disbursements is included in paragraph 25.1.1. of the Commissioners' Notice 700. The question is whether the firm of solicitors were acting as agent or as principal. HMRC argued that the firm acted as principal whereas the firm appealed the assessment on the grounds that:

> "Medical reports and medical records are obtained on behalf of the injured party in the course of personal injury litigation. The expenses of these are borne by the injured party and they can therefore be treated as disbursements for VAT purposes. Barratts does not supply the records and reports to the injured party and reimbursement of Barratts by the injured party forms no part of the consideration given by the injured party for the supply of services by Barratts to the injured party and no consideration is given by Barratts for the reports and records."

Somewhat unusually in proceedings before the tax tribunal, the solicitors' professional body, The Law Society, sought to intervene in the appeal in order to support Barratts' case. By Direction of 2 February 2010, the tribunal granted The Law Society permission to file written submissions pursuant to rule 5(3)(d) of the Tribunal Procedure (First-Tier Tribunal) (Tax Chamber) Rules 2009.

There is a standard "Letter of instruction to medical expert" under the Pre-Action Protocol for Personal Injury Claims for this purpose. The letter identifies the client, and commences "We are acting for the above named in connection with injuries received in an accident which occurred on the above date". It reminds the expert that the report must comply with the CPR, that he must be independent, and that he must address his report to the court.

It is standard practice for Barratts to give instructions to a medical expert, rather than for the client to instruct him or her. One reason for this is to ensure that the report covers all matters relevant to the quantification of the client's claim. The invoice for the expert's report is addressed to Barratts, but records the client's name. Although addressed to the court, the medical report is the property of the client. Should he decide to change solicitors or conduct the litigation himself, he is free to utilise the report as he wishes.

Looking at the authorities, the tribunal ruled that this was a disbursement by the firm of solicitors. Accordingly, they did not need to charge VAT an that element of the analysed bill sent. Of course, since 2007 the law has changed and now the supply of the report would be standard rated but the test is important to establish the nature of the supply and the recipient of the supply.

For an agency disbursement to be treated as a disbursement for VAT purposes all the following conditions must be satisfied:

(1) the solicitor must have acted as the agent when paying the third party;

(2) the client must actually receive and use the goods or services provided by the third party;

(3) the client was responsible for paying the third party;

(4) the client authorised the solicitor to make the payment on the client's behalf;

(5) the client knew that the goods or services the solicitor paid for would be provided by a third party;

(6) the solicitor's outlay will be separately itemised when invoiced to the client;

(7) the solicitor recovers only the exact amount paid to the third party;

(8) the goods or services concerned are clearly additional to the solicitor's own services supplied to the client

3. Direct Tax treatment of legal expenses

There are numerous reasons why a deduction may be denied for legal, and other professional expenses: an expense may be regarded as attributable to capital; it may be regarded as not wholly and exclusively laid out for business purposes (in other words duality); or it may be seen as an application of profits already earned rather than as an expense in calculating those profits (for example in taking a tax appeal against an estimated assessment). In addition, policy reasons may disallow the deduction of a fine or penalty imposed on a business.

There may also be issues on the timing of when a deduction for the expense can be allowed. Arguments on timing points should be less now that FRS 12 deals with provisions. In James Spencer & Co v IR Commrs (1950) 32 TC 111, which concerned a firm of stevedores, it was considered prudent to include a provision even though liability had not been admitted. Nowadays, FRS 12 would prevent such a provision. The case established the tax law that a deduction could not be allowed until liability had been admitted.

In a ‘toolkit’ issued in June 2014, entitled ‘Capital v Revenue Expenditure Toolkit: 2013–14 Self Assessment and Company Tax Returns’, HMRC have warned that:

‘Incidental expenditure incurred when acquiring or disposing of an asset should be treated as capital expenditure. The most common example of such expenditure is legal and professional fees incurred in acquiring or disposing of an asset. Incidental expenditure may also include the cost of such items as the transportation and installation of the asset.

...

When a business incurs expenditure on an unsuccessful attempt to obtain an asset or other advantage that will be of enduring benefit to the business the expenditure is classified as capital for tax purposes, just as it would have been if the attempt were successful.’

The following have been held to be deductible—

(a) the costs of defending the title to trade assets[1];There are numerous examples which support this view. In Southern v Borax Consolidated Ltd,1940, 23 TC 597 the company was allowed to deduct costs incurred in defending a title to a capital asset, against a claimant with no title to the asset

(b) Damages for defamation payable by a newspaper company (Herald and Weekly Times Ltd v Federal Commr of Taxation (1932) 48 CLR 113, High Court of Australia, approved by the House of Lords in McKnight (HMIT) v Sheppard [1999] BTC 236). The important point here was that the Court recognized that this was almost a common occurrence for a newspaper to face in its everyday business activity

- (b) costs incurred in the UK in settling an action under the anti-trust law of the USA;
- (c) costs of settling an action arising from the promotion of companies where such activity was part of the taxpayer's trade;
- (d) costs of settling a slander action as one of the terms of recovery of a trading debt;G Scammell & Nephew Ltd v Rowles 1939,22 TC 479
- (e) costs of promoting a private bill enabling compensation to be paid to redundant employees;
- (f) costs of—

(1) a supplemental charter; The supplementary charter was necessary for the company's business so the legal costs were allowed in the Carron case (see below for reference)

  - (2) an action therewith brought by a shareholder; IR Commrs v Carron Co 1968, 45 TC 18,and
  - (3) payments made to that shareholder;
- (g) legal fees for advice on a claim by the other party to proceedings to take evidence from employees of the taxpayer;
- h) legal costs to defend charges brought by a professional regulatory body (the Stock Exchange Council), where there was a threat of expulsion or suspension from that body (which would have destroyed the taxpayer's business) if the charges had been upheld. (McKnight (HMIT) v Sheppard [1999] BTC 236). The taxpayer’s purpose had been to protect his business, despite the effect of the expenditure also having been to preserve his personal reputation. (see below for the important principle distinguishing purpose and effect)

The following have been held not to be deductible—

- (i) the costs of a tax appeal;

- (ii) penalties in proceedings for illegal trading; Fines or other penalties imposed in relation to illegal, etc. transactions are not deductible for tax purposes(IR Commrs v Alexander von Glehn & Co Ltd (1920) 12 TC 232;
- (iii) damages and costs for libel in a business communication
- (iv) costs of reduction of capital
- (v) costs of incorporating a new company
- (vi) costs of replacing bonds by others at a lower rate;
- (vii) costs of an application for the extension of a public carriers' licence to more vehicles;
- (viii) expenses of an issue of debentures;
- (ix) the expenses of promoting a bill in Parliament for the construction of a railway
- (x) the cost of unsuccessful applications for licences for houses owned or leased by brewers;
- (xi) the expenses of a transfer of a mortgage;
- (xii) the costs of successfully defending the ownership of a business
- (xiii) the damages and costs incurred by brewers in an action brought by a hotel guest for injury sustained at the hotel[21]; The damages paid in an action for negligence (Strong & Co v Woodifield (1906) 5 TC 215: were not incurred by the taxpayer in his capacity of a trader but as a householder)). This is known as the doctrine of remoteness
- (xiv) the costs of applications for the removal of licences to—

    (1) move from premises with a poor trade to upgraded premises;

    - (2) preserve existing trade threatened by planning changes; and
    - (3) develop trade through new public houses
- (xv) costs incurred by a former assistant solicitor in refuting a charge that he had solicited a client of his former principal
- (xvi) legal fees incurred to defend an action brought by a shareholder against the directors and employees of the taxpayer company;
- xvii) litigation costs of protecting an individual partner's interests in a dispute with the other partner on the dissolution of a partnership In C Connelly & Co v Wilbey (HMIT) [1992] BTC 538) (expenses incurred by the taxpayer to protect his interests in the partnership could not be regarded as an expense of the practice).;
- xviii) costs incurred in connection with the successful defence of a partner (to preserve his professional qualifications and status) in a firm of chartered accountants in criminal proceedings, and related costs in respect of advice to the other partner in the partnership. The duality of purpose and the personal benefit to the partner denied the deduction for tax purposes in Spofforth & Prince v Golder (1945) 26 TC 310 (

In *Market South West (Holdings) Ltd v Revenue and Customs Comrs [2010] UKFTT 121, (TC) TC 432*, the First-Tier Tribunal found that expenditure on legal and professional fees was disallowable.

In the case, the taxpayer company operated an indoor market at a site in Cornwall. The relevant planning permission only allowed it to trade at weekends. The company applied for planning permission to allow it to trade on weekdays. The Council granted planning permission to trade on ten weekdays. The company subsequently breached the terms of this permission by trading from the site each Wednesday. The Council issued an enforcement notice, against which the company appealed. The High Court dismissed this appeal. In its tax return, the company claimed a deduction for the legal and professional fees incurred in applying for planning permission and in appealing against the enforcement notice issued by the Council. HMRC issued an amendment disallowing the deduction on the basis that this was capital expenditure. The company appealed.

The First-Tier Tribunal dismissed the appeal, holding that the fees were expenditure of a capital nature. The expenditure went beyond the mere maintenance of an existing asset.

In Mr Paul Duckmanton v Revenue & Customs [2011] UKFTT 664 , the taxpayer claimed a deduction for considerable legal fees incurred in defending (successfully) a criminal charge of gross negligence manslaughter.

The amounts of legal expenses in dispute are as follows –

Tax year	Accounts y.e.	Expenses in dispute
2003-04	31. 8.03	£48,752
2004-05	31. 8.04	£55,929
2005-06	31. 8.05	£163,991

The expenses claimed by Mr Duckmanton relate to legal and professional fees incurred by him in defending a charge of Gross Negligence Manslaughter, in respect of a fatality arising out of a road traffic accident in 2002 involving one of his goods vehicles driven by a Mr Roberts who was guilty of causing death of a pedestrian as a result of driver negligence. Mr Duckmanton was also charged with two counts of attempting to Pervert the Course of Justice, in respect of which he pleaded guilty.

Mr Duckmanton's contentions are that his sole purpose in defending the charge of Gross Negligence Manslaughter was to enable him to retain his "operators licence". Without this licence he says that he would have been unable to trade as a car transporter operator and would thus have had to cease trading.

HMRC contend that the legal fees were incurred in defending criminal charges and that accordingly they cannot be said to have been incurred during the pursuit of a trade. Any duality of purpose to the expenses such as keeping Mr Duckmanton out of jail would be fatal to a tax deduction.

Mr Duckmanton said that at the time of the trial, irrespective of the eventual outcome, preserving his business reputation and status as a person of good repute, in his capacity as a transport manager, and thereby hopefully preserving his operator's licence, was or paramount importance. It was, he said, more important to him to establish that the accident had been caused by driver error and not because of a breach of safety standards, and thereby preserve his reputation, than it was to avoid the prospect of being sent to prison for a term of five years.

The following case authorities were referred to in argument :

Spofforth and Prince v Golder [1945] 26 TC 310

Bowden v Russell & Russell [1965] 42 TC 301

Knight v Parry [1972] 48 TC 419

Vodafone Cellular Ltd & Others v Shaw [1995] 69 TC 376

McKnight v Sheppard [1999] 71 TC 419

The question whether expenses were incurred wholly and exclusively for the purposes of a trade is a question of fact. Section 74 ICTA and 34 ITTOIA say in clear terms that the purpose must be the sole purpose. Case law authority shows that if the sole purpose of the taxpayer in incurring expenditure is business preservation, the expenditure should not be disallowed simply because the purpose of the expenditure necessarily involved some other result. If however, as in this case, legal fees are incurred with the object of firstly defending criminal charges, secondly preserving a business reputation and

thirdly avoiding the possibility of a substantial damages claim, then the requirements of the legislation are clearly not satisfied.

Although Mr Duckmanton, in giving evidence, may now some nine years after the event honestly believe that he was indifferent to the prospect of imprisonment, we cannot accept that this was a secondary motivation when the expenditure was actually incurred at the time of the trial. The FTT decided that the duality of purpose to the expenditure was such as to disallow it for tax purposes.

In Purolite International Ltd v Revenue & Customs [2012] UKFTT 475, the issue was whether a UK company could deduct a proportion of legal expenses incurred in America defending a director and another group company member for an alleged violation of Cuban trading embargo.
PIL's trade consisted of the manufacture and sale of ion exchange resins. These are used for such purposes as water purification, pharmaceutical applications and in medical procedures, for example in dialysis units. Between 1994 and 1999, PIL supplied resins to Cuba. Until the end of 1996 this was partly via Bro-Tech Corporation (BTC's) representative office in Canada, but subsequently the supplies were made direct, but with BTC's assistance. An analysis of shipments to Cuba provided by PIL to HMRC shows that from 17 October 1994 until 18 December 1996, total sales to Cuba were US$804,704. Of these, US$389,259 (48 per cent) went directly from the UK. From 11 March 1997 until 31 July 1999, total sales to Cuba were US$899,304; all of these went directly from the UK.

On 6 October 1999, BTC, Steve Brodie, Don Brodie , the owners of the companies and another who was BTC's sales manager were notified that they were the subject of a US federal grand jury investigation. They then consulted US lawyers. Following a trial in March 2002 lasting approximately a month, the defendants were found guilty on the conspiracy count of trading with the enemy. Don Brodie, Steve Brodie and JS who was the sales manager were fined $10,000 each and sentenced to one year's probation; BTC was fined $250,000. All the legal costs were billed to Steve Brodie but as controlling shareholders the Brodie brothers decided that BTC, the corporate defendant, should pay all of the costs.

Subsequently, it was decided that the legal costs should be shared. The percentage was that £3,445,253 was borne by PIL for the year ended 31 December 2002, £149,101 for the year ended 31 December 2003 and £212,940 for the year ended 31 December 2004. The total amount charged to PIL was therefore £3,807,294. The company claimed a tax deduction for this contribution towards costs of defending a prosecution brought in respect of supplies of resins made by PIL in the course of its trade.

Crucially, there is no evidence in the form of formal minutes or informal notes recording the dates of decisions made by the brothers and their details, or indicating the policy thought process and the conclusions of that process arrived at for individual companies. PIL was not one of the persons subject to the investigation. It is not surprising that HMRC said that the 77% of the legal costs charged to PIL were not incurred wholly and exclusively for PIL's trade.

The tribunal regarded the decision that there would have to be some form of allocation as logically dependent on, and subject to, the earlier decisions to incur the expenditure. This required the FTT to consider on whose behalf the earlier decisions were taken. The object of those decisions was to protect the parties charged, and not PIL. That finding of fact by the tribunal was fatal to any claim to deduct the expense by PIL.

For all these reasons the FTT found that PIL's expenditure in making a contribution to the legal costs was not wholly and exclusively for the purposes of its trade.

The FTT ruled that the decision to arrive at an allocation as between the companies involved in the alleged breaches of the embargo is entirely understandable as a commercial matter. However, that is not sufficient to establish, for UK corporation tax purposes, that PIL's attributed share of the costs is deductible in computing the profits of its trade.

PIL's lost its appeal and was denied a tax deduction. It failed for the duality of purpose and because the company had no evidence of why the allocation of costs had been made other than the recollection of one of the directors whose credibility was undermined because the event had occurred 13 years ago and his memory was shown to be defective in other aspects.

It illustrates that if the amounts are material, it is essential that decisions are recorded and the reasoning at that time recorded.

The full judgment can be read at http://www.bailii.org/uk/cases/UKFTT/TC/2012/TC02152.html

In Linslade Post Office & General Store (a firm) v Revenue & Customs [2012] UKFTT 457, the issue was whether the legal costs (£36,174) of preserving the firm and its assets against a family member's claims was allowable for tax purposes.

Facts: The sister of the senior partner alleged that she was a partner. The sister had conducted the proceedings as a legally aided claimant and no award of costs were made against her in favour of the successful partnership dependents. She was not a partner. The partnership then claimed to deduct the legal costs as wholly and exclusively for the purposes of the trade.

Arguments: For the partnership, they argued that they were merely defending the existing assets of the partnership against an outside party. There were no assets added or deducted from the partnership. In contrast, HMRC argued that the partnership had incurred legal expenses and relied on the authority of *C Connelly & Co v Wilbey [1992] STC 783* where a partner in a firm of Chartered Accountants tried to dissolve the partnership. In that case the fees were to protect the interests of an individual in the partnership and were not incurred as a trading expense of the practice.

Decision: As the relative was never a partner, the case could be distinguished from the *Connelly* case which was clearly a dispute between two partners. The legal expenses were protecting the assets and profits of the partnership. Expenses incurred in the ordinary course of maintaining the assets of the business are revenue expenses and properly deductible in the computation of taxable profit. The decision can be read in full at:
http://www.bailii.org/uk/cases/UKFTT/TC/2012/TC02136.html

APPENDIX A

Question and Answer on Legal Expenses

Q1: My client incurred legal expenses in pursuing a debt which a customer had not paid. Is the expense allowable and can the input VAT be recovered?

A: Yes to both. Debt collection is a normal incidence of trading activity and the expense has been incurred for the purpose of the trade and wholly and exclusively for that purpose.

Q2: My client, a builder, faced an action from a customer to make good defects in a property which he had constructed. This was disputed going to court with substantial legal fees being incurred. He lost. He has had to pay:

(a) The fees of another builder to remedy the defective work
(b) Legal fees not only of himself but also costs awarded against him in the action

Are the legal fees and other incidental costs allowable?

A: These costs of another builder to remedy the defective work, no matter how unwelcome, are costs incurred in the furtherance of the builder's trade. Accordingly, the input VAT may be recovered and the net cost is a deductible expense in the computation of profit.
His legal costs will be allowable and in relation to his legal costs the input VAT will be recoverable . However the VAT on the other parties legal costs will not be recoverable but the gross costs of the other party should be deductible from profit.

Q3: My client has incurred considerable legal expense in trying to obtain the lease of business premises. Unfortunately he was not successful. The expenditure is therefore abortive. Can it be deducted for tax purposes?

A: Even though no asset was created for the enduring benefit of the trade, the expenditure related to the intention to acquire a capital asset in the form of a lease. Accordingly the expenditure is capital expenditure even though no asset was obtained. As capital expenditure, it cannot be deducted in the profit and loss account for tax purposes. For VAT, this expense has been incurred in the furtherance of the business even though it proved abortive. There is no distinction between capital and revenue for the purpose of VAT expenditure so the input VAT may be recovered if your client makes taxable supplies that are fully taxable

Q4: My clients have traded successfully in partnership for many years. Recently there was a dispute with the result that one of the partners departed and a legal partnership agreement was created for the remaining partners. The legal expenses proved to be considerable. Are these allowable for tax purposes in this ongoing business?

A: No they are not. There is a difference between an expense which is incurred for the business and an expense which is incurred for the partners who make up that business even though under Scots law the partnership is a legal entity separate and distinct from the individuals who make up that partnership (section 4(2)) Partnership Act 1890. The expense of creating a legal partnership agreement is not allowable for tax purposes.

Q5: My client has had to relocate a number of employees. He arranged a package deal with a legal firm. The employees conveyancing costs involved in selling and buying houses in the new area were all met by the firm. Are these expenses allowable for tax purposes and can the input VAT charged by the solicitor be recovered by the business?

A: Oh wow! At the level of basic principle, this is probably quite an arguable item. My initial reaction is that the input VAT charged by the firm of solicitors to sell and acquire properties used as domestic residences for employees is not allowable. But in practice, HMRC allow the recovery of the legal costs borne by an employer when an employee relocates This is not incurred in the furtherance of a business and is not incurred with a view to making a taxable supply. Such VAT is really a service being provided to the individuals who are not taxable

entities and the VAT would not normally be recoverable. Despite this analysis, in practice, HMRC allow an employer to reclaim VAT charged on the removal costs where an employee has to move house following a job change and the employer agrees to pay such costs even though strictly the supply was to the employee (SSL Ltd (1987) 3 BVC 632 This is confirmed in the HMRC manual:

5.24.2 Relocation expenses
Many employers will provide assistance to employees or future employees in relocating nearer their new job. Assistance may take many forms, including the payment of estate agent fees, payment for a removal firm when moving house, the provision of maintenance/gardening for an employees former property awaiting sale, short term accommodation in a hotel.

Providing such expenditure is linked to the actual relocation it can be treated as being the employers input tax. The supply of services order should not be applied.

If however the expenditure is not linked specifically to the relocation but forms part of the ongoing living expenses at the new property then it is not input tax. Thus the provision of new bespoke curtains or carpets for a new house is acceptable as it is a normal expense of moving house. Yet the provision of a new stereo system would not be acceptable as it is an expenditure unrelated to the relocation.

It is clearly similar to wages and as such the expense may be deducted in the computation of profits. There is a statutory exemption which will help avoid or minimise any benefit in kind as the legal costs of conveyancing, met by the employer, need not be taxed on the employee provided they meet the qualifying conditions of sections 271 to 287 ITEPA 2003. Although the legal costs relate to capital expenditure of the employee, the expense incurred by the employer is a revenue cost of obtaining the employee services and as such can be allowed in the computation of the employer's tax liability.

Q6: My client has a rapidly expanding business. During the year, he relocated purchasing new premises and selling the old premises. Are the legal fees incurred allowable?

A: The input VAT on this expenditure may be recovered if the business is making taxable supplies. As amounts have not been disclosed, I will only mention that the option to tax may need to be considered and partial exemption may be a problem if there is an exempt disposal of business premises.

For direct tax purposes, both disposal and acquisition of premises relates to capital expenditure and as such the legal costs cannot be deducted for income tax purposes.
The legal costs may be qualifying capital expenditure for CGT calculations

Q7: After HMRC had opened an enquiry, they raised additional assessments which were appealed. Counsel's opinion was obtained, thereby incurring considerable legal costs. After several meetings and extensive correspondence, HMRC accepted my arguments and vacated the assessments. Although I complained, HMRC have said that the case highlighted a complex issue which needed to be clarified and the inspector acted properly in seeking the additional information and inviting legal arguments. He made his decision without excessive delay and so HMRC has said there are no grounds for complaint and no compensation will be offered. Are the legal expenses including Counsel's fees recoverable?

A: In strict law, Smith's Potato Estates Ltd v Bolland, 30 TC 267 established that there is a distinction between drawing up a set of accounts for business purposes and settling tax liabilities. The latter is an expense which is incurred after the profit has been earned but the courts recognised that it is difficult to separate the expenditure although in this case it is fairly clear that the expense of the appeal has been incurred after the profit for the year was measured and earned.

HMRC have a practice which can be read at SP 16/91 which relates to accountancy expenses and in practice the cost of ascertaining each year's profit is normally allowed for tax purposes as indeed is the cost of dealing with an HMRC enquiry provided there is no question of

fraudulent evasion of tax and penalties. HMRC have a position that the cost of dealing with an enquiry which does not result in penalties or re-opening earlier years should be allowed in full.

In your case, HMRC erroneously issued discovery assessments which formed part of the appeal. My recommendation would be to make a disclosure note accompanying the return and to claim a tax deduction in full for all of the legal expenses incurred in this dispute. Any input VAT would also be recoverable.

Q8: My clients have traded from their business premises for many years. Recently, they faced a challenge about access and egress rights to the property. Without such rights their property became unusable and considerably devalued. They successfully defended their rights of access and egress but HMRC are arguing that the legal expense has produced clarification and the certainty that they do have a right of access and egress where before this was doubtful. Is the legal expense allowable and what arguments might be persuasive?

A: The capital assets of your clients is the entity of their business premises which have been used for many years. They faced a challenge but were successful in defending their right to access and egress the property. As such it would appear that the principle in Southern v Borax Consolidated, 23 TC 597 applies. These costs have been incurred in defending the title to an existing capital asset. The inspector's argument that, as a result of the legal expenditure, a new asset in the form of certainty about the right of access and egress has been created is ingenious. I think however the test is that over the years of occupancy it was always believed that the right of access and egress existed and this was merely defended. A tax deduction is available.

Q9: Are legal costs incurred by a taxi driver to preserve his driving licence after being charged with a speeding motoring offence allowable?

A: There have been cases about this issue and the author knows of an Edinburgh taxi driver who successfully took this issue to the General Commissioners and won his appeal. Subsequently, McKnight v Sheppard (1999) BTC 236 emerged. This was a case in which a stockbroker was penalised for alleged breaches of the rules and regulations of the Stock Exchange. The stockbroker incurred substantial legal expense which he said was necessary to prevent the disruption of his business and to preserve his reputation.

HMRC argued that the preservation of his reputation was a personal benefit and therefore the duality of purposes meant the whole expenditure was disallowed. HMRC's argument relied on **Mallalieu** v Drummond, a case concerning a barrister who was denied a deduction for the court clothing she wore on the basis that there was a duality of purpose to the expenditure. However Mr Sheppard was successful in his argument that the primary purpose was to prevent the disruption of his business and allow him to continue trading and any other incidental benefit was not relevant for tax purposes.

It is therefore possible, with good advice and a willingness to argue, to obtain a tax deduction for the legal costs.

Q10: My client incurred significant legal costs as a result of altering a building to install a piece of plant and machinery. As these costs are incidental to the installation of a piece of plant and machinery, is it possible to claim capital allowances?

A: Broadly yes.

Q11: Are the legal fees incurred by an employer allowable when the action is being taken by a former employee suing the employer for unfair dismissal? Does it matter that the case has been settled out of court by a compromise agreement which resulted in the employer paying a modest amount of compensation to the former employee?

A: In tax law the obtaining or getting rid of rights is normally capital expenditure. Conversely, the hiring and firing of employees will be on revenue account. There are a few expenses such as

payments to cease trading not being for the purposes of the trade but generally expenditure on salaries and obtaining and getting rid of employees would be allowable for tax purposes.

The out of court settlement might be argued by HMRC as indicating some form of illegal activity. HMRC's attitude is that no expense incurred for breaking the law should be allowed for tax purposes but I think that legal expense relating to an employment dispute is different. My recommendation would be to disclose the matter on the face of the tax computation and mention it in the white space of the return but to claim the tax deduction for the expense which has been incurred. Any input VAT would also be recoverable if the trader is fully taxable.

Q12 You have just said that where the employer pays the legal fees to retain the services of a director (at item 2.3 of the notes) the expense is personal to the director and the input VAT is not recoverable. I thought that where an employer pays the legal fees to help an employee , including a director, relocate for the purposes of the company's business, the input VAT was recoverable.

A; You are right. Employers may assist employees or future employees in relocating nearer to the job. Input tax may be reclaimed on costs paid by the employer that are directly associated with the house move, such as estate agent and legal fees, removal costs and short-term accommodation in a hotel.

In practice, HMRC allow an employer to reclaim VAT charged on the removal costs where an employee has to move house following a job change and the employer agrees to pay such costs even though strictly the supply was to the employee (SSL Ltd (1987) 3 BVC 632;
I was equally correct in what I said that input VAT defending a director against a prosecution was not recoverable.