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The spygate scandal

Features

Business Tax

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Jesse Crozier and Ryan Hawthorne put the McLaren case and the deductibility of corporate fines under the magnifying glass.

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Key Points

- Is a £32m fine for industrial espionage tax deductible?
- The split decision of the First-tier Tribunal.
- The principles of previous decided cases.
- Is the purpose of the fine to punish or simply deter?

- Is the tax treatment of penalties now uncertain?

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It may be of little surprise that the Tax Justice Network found the First-tier Tribunal's decision in *McLaren Racing Limited v HMRC* [2012] UKFTT 601 (TC) to be "extraordinary". However, the wider surprise at the decision among accountants, tax advisers and lawyers points to both the controversy surrounding the principle of deducting punitive fines and to the departure from previous decisions of the courts. Indeed, the judgment itself compounds the ongoing legal confusion surrounding the tax position of corporate fines to the extent that the decision came down to the casting vote of the presiding judge.

The first-tier Tribunal decision

The McLaren Formula One team was fined by the World Motor Sports Council (WMSC) for breaching the rules of the organisation's governing body, after McLaren's chief engineer was caught in possession of confidential technical information belonging to a competitor, Ferrari. The episode, in 2007, became known as spygate and the WMSC concluded that this confidential information had been used to give McLaren a sporting advantage. The fine imposed amounted to £32m, which McLaren sought to deduct from its taxable profits as a business expense.

The two members of the First-tier Tribunal diverged quite dramatically in their assessment of McLaren's appeal. Judge Charles Hellier, presiding, held that the penalty was deductible for tax purposes. He was of the view that, in the non-statutory context, where the actions which gave rise to a penalty could otherwise be said to have been for the purpose of the trade, it is only if the nature of the penalty is to punish a person and if there is a serious public policy which would be diluted by the tax deductibility that the penalty should not be regarded as a deductible expense of the trade. This led Judge Hellier to conclude that it was an expense, entitling McLaren to deduct the sum under TA 1988, s 74(1)(a) or (e) (now CTA 2009, s 54). By analogy, a non-compensatory penalty for late completion imposed in a building contract could be a deductible expense.

In reaching this conclusion, Judge Hellier considered the following:

- the penalty's nature as an alternative to exclusion from Formula One;
- the commercial motivation for the penalty;
- the consideration given to the resources of the McLaren team; and
- the requirement that part of the penalty was a deduction of points.

To deter, but not to punish

As a result of the above, Judge Hellier concluded that the policy behind the penalty was intended to affect McLaren in its trade rather than as a corporate personality itself. The penalty was set so as to deter others from the same course of conduct in the pursuit of their trades, but the deterrence effect did not of itself point to a policy of personal punishment for McLaren.

In his view, the £32m was a commercial penalty intended to affect McLaren in its commercial activity. It was not analogous to a statutory penalty principally designed to punish McLaren as a corporate person. Such a fine, even arising from industrial espionage, amounted, in effect, to the cost of being in the sport. Even if the penalty was personal punishment of McLaren, there was not sufficient public interest in the nature of the conduct of motor racing as to be able to say that it would be preposterous to allow this penalty to be shared with the general body of taxpayers. The penalty was levied mainly to regulate commercial activity, not to protect the public.

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The admirably brief dissent of the tribunal's second judge, Mr Nicholas Dee took a different approach. Mr Dee started by asking what the penalty was for, and readily concluded that it was intended to punish McLaren. He concluded that it was "hard to believe that the huge sum intended to punish such serious misconduct constitutes an expense laid out wholly and exclusively for the purposes of the trade ... No part of their trade could encompass what their employees or agents had done." Something in the character of the fine took it outside the ambit of an expense within the meaning of s 74(1)(a) and (e). But Judge Hellier's view prevailed by virtue of the presiding member's casting vote and McLaren's appeal was successful.

The principle

There is authority for this view that damages imposed by the courts are tax deductible in certain instances. As an example, the Australian courts have previously held that damages for defamation awarded against a newspaper were tax deductible on the basis that this was a "regular and unavoidable incident" of the publishing business. However, where the damages were payable for malicious libel, Macnaghten J held in *Fairrie v Hall* (1947) 28 TC 200 that the damages fell upon the taxpayer "in the character of a calumniator ... It was only remotely connected with his trade ... it would be preposterous if the [taxpayer] were allowed to deduct these sums."

This distinction has long featured in the consideration of deductibility of fines or penalties as well as damages. There are clear cases where, although an expense was incurred, on the face of it, in the course of a trade, such fines would nonetheless not be deductible due to the punitive nature of the expense. The reason behind the fine either rendered it outside the scope of the trade or unconscionable to allow as a deductible expense.

In *EC Warnes* [1919] 2 KB 444 and *Glehn* [1920] 2 KB 553, the High Court and Court of Appeal respectively held that penalties imposed under the Customs (War Powers) Act 1915 were not tax deductible. All three members of the Court of Appeal in *Glehn* held that the penalty was not deductible, although with some difficult in putting "the distinction into very exact language".

The House of Lords in *McKnight (Inspector of Taxes) v Sheppard* [1999] 1 WLR 1333 extended this analysis to non-statutory fines and penalties "by parity of reasoning". In *Sheppard*, the non-statutory Stock Exchange Council imposed the fines on Mr Sheppard for misconduct and gross misconduct. Despite the non-statutory nature of the sanction, Lord Hoffmann considered the Court of Appeal's reasoning in *Glehn* to apply. Lord Hoffmann summarised the Court of Appeal's decision in *Glehn* as relating to the underlying "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."

McLaren revisited

Judge Hellier took Lord Hoffmann's analysis of *Glehn* to suggest that for a penalty to fall outside the ambit of a tax-deductible expense it must be both punitive in character *and* for it to dilute or weaken the purpose of the statute that imposed the penalty. But in applying this "by parity of reasoning" to non-statutory penalties, Lord Hoffmann's analysis cannot have been to look to the dilution of statute. Judge Hellier concluded that there must be some "more general policy consideration" which should not be diluted. In so doing, Judge Hellier had to determine the nature of the policy implications and, in this case, found that "considerable caution is required in extending to a nonstatutory field, policy considerations originally emanating from the consideration of statutes so as to apply the second 'dilution limb' of the policy argument". In reaching this conclusion, Judge Hellier revisited the Special Commissioner's decision in *Sheppard* in which the commissioner referred to the need to "protect the investing public". He saw no comparable interest at stake in McLaren's case.

Judge Hellier also gave much weight to the remarks of Lord Sterndale MR in *Glehn* that the penalty in that case had been "imposed upon the company personally" rather than being a loss connected with the business. The penalty in McLaren's case was visited upon it due to its commercial relationship with Formula One and the WMSC, and was consequently a commercial transaction as the cost of continuing to participate in Formula One. But this only poses the question, what is it for a fine to be imposed on the company personally? In the cases of statutory and non-statutory fines imposed for improper conduct, it is difficult to see a meaningful distinction on which Judge Hellier's judgment rested.

The nature of the conduct

Judge Hellier appears to compare the sums to the amounts that a "builder eventually pays for the sand he has incorporated into a building, or an insurer pays out to meet a claim he is

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contractually obliged to meet ... there would generally be no question as to the trading nature of the expenditure." The difference, of course, is in the nature of the conduct. It would be beyond question that fines imposed on McLaren for Lewis Hamilton failing to pit stop correctly would be tax deductible, but, as Mr Dee concluded in his dissenting judgment, there was something inherently different in a fine imposed for industrial espionage.

Yet, Judge Hellier's preferred formulation of McLaren's trade was broad enough to encompass such activities as part of McLaren's business: it was "trying to make money from the design and racing of Formula One cars" which included as "an ordinary part of McLaren's activities [that it] seek information on its competitors' designs and strategy". It seems that, in this sport, anything goes: "the profit-making activity carried out by McLaren was not limited to acting within the confines of the [Formula One] agreement and could include 'cheating'."

It is submitted that Judge Hellier's expansive approach to the ambit of McLaren's trade is inconsistent with judicial indications -- in *Evans, Glehn*, *Fairrie* and *Sheppard* -- that there are limits on what can properly be considered to constitute part of a trade. Judge Hellier seems to have disregarded these indications in favour of an expansive reading of the scope of a trade. There also remains an important question of whether his dismissive approach to the "aids and glosses on the statutory words" found in past case law is appropriate.

The dissenting judgment

Mr Dee's approach is more typical of the approach taken by Scrutt on LJ in *Glehn*, where it was considered that the intuitive response to whether the taxpayer could deduct a fine for breach of a wartime statute was obvious: "Of course he cannot." This instinctive reaction may not have much analytical force, but obviously had a significant bearing upon Mr Dee. From his "starting point" in considering the reason for the fine, it was clear this was not a deductible expense. Alas, it is the difficulty in transferring this intuitive reaction into reasoned guidance that has plagued the issue of deductibility of corporate fines since the *Glehn* decision.

Even setting aside the instinctive reaction, there is also a ready comparison with *Sheppard*, in that both were found guilty of some gross misconduct and both were fined by the industry regulator. Judge Hellier, at least implicitly, found that there was something peculiar about the role of the Stock Exchange that did not apply to Formula One and the WMSC. But it is not clear what that distinction is. It may be that the distinction turns on the level of probity or trust required in the industry, but this was not a view expressed by Judge Hellier. All that can be said about the distinction drawn in the *McLaren* appeal is that it is subtle and remains elusive.

Impact

This decision is likely to lead to public outcry because taxpayers are seen to foot part of the bill for McLaren's "cheating". However, while it might seem somewhat "unfair" for McLaren to be able to deduct from its taxable profits a fine imposed as a consequence of its wrongdoing, the same could also be said for the reduction in McLaren's income that was imposed by the WMSC in addition to the fine, and the subsequent reduction in taxable profit, which HMRC did not take issue with.

What the *McLaren* decision does is to rebalance the question of when a penalty is tax deductible. Before this decision, the leading authorities made it clear that the courts would take a dim view of attempts to deduct such penalties. It is likely that those acting for taxpayers will now be buoyed by this decision and further litigation will follow. What, for example, is the position on the fine imposed on John Terry for racial abuse? Could it be that a court could find that his fracas with Anton Ferdinand was not wholly outside the scope of his trade? For the courts to conclude that it was may be unconscionable, but it is no longer beyond question.

Unfortunately, it would appear that the *McLaren* decision has posed more questions than it has answered. This case highlights the difficulty faced by taxpayers and HMRC in determining when expenditure is incurred wholly and exclusively for the purpose of a trade, or is sufficiently connected with that trade to be tax deductible. The fact that the First-tier Tribunal was split in its decision, and that the decisions in *Glehn* and *Sheppard* do not offer any ready and uncontroversial guidance, demonstrates that the correct treatment of expenditure of this nature is far from clear and an appeal to the Upper Tribunal seems almost inevitable.