[2016] UKUT 0002 (TCC)

Appeal number: FTC/05/2014

PARTNERSHIP – whether a member of a limited liability partnership was entitled to deduct a payment of €300,000 (£215,455) to settle German litigation in computing his liability to tax on his share of LLP profits – whether the payment was an expense incurred wholly and exclusively for the purposes of the LLP's trade or of the individual member's 'notional' trade – whether the payment was revenue or capital expenditure

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS

Appellants

- and -

MR PETER VAINES

Respondent

TRIBUNAL: JUDGE MALCOLM GAMMIE CBE QC
JUDGE JUDITH POWELL

Sitting in public at Bedford Square, London WC1 on 25 September 2014

Mr Michael Jones (Counsel) instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Appellants

The Respondent in person

DECISION

Introduction

1. The Commissioners for Her Majesty's Revenue and Customs (HMRC) appeal the decision of the First-tier Tribunal (Judge John Brooks and Rebecca Newns) of 15 October 2013 in which they allowed the Respondent's claim to be able to deduct a payment of €300,000 to Bayerische Landesbank on the basis that the payment was incurred wholly and exclusively for the purposes of the profession or trade that the Respondent (Mr Vaines) was carrying on and that the payment was revenue and not capital expenditure.

2. The circumstances in which Mr Vaines came to make the payment were not in dispute and were the subject of a Statement of Agreed Facts. It is relatively brief and we reproduce it below for ease of reference:

> (1) At all material times [Mr Vaines] was a partner in the law firm of Squire Sanders & Dempsey. In the year ended 5 April 2008 [Mr Vaines] was in professional practice as a partner in Squire Sanders & Dempsey and his share of profits from the firm represented his only source of professional income for the year.
>
> (2) Until 31 December 2005 [Mr Vaines] had worked in the London office of law firm Haarmann Hemmelrath which had many offices, in Germany and elsewhere.
>
> (3) On 27 October 2009, [Mr Vaines] made an amendment to his personal income tax return for the year ended 5 April 2008, claiming a deduction of £215,455 against his professional income from Squire Sanders & Dempsey.
>
> (4) The deduction claimed related to a payment to Bayerische Landesbank under an agreement made by a number of individuals who were connected with the law firm Haarmann Hemmelrath. Haarmann Hemmelrath had ceased to trade and owed approximately €17 million to Bayerische Landesbank and other banks.
>
> (5) [Mr Vaines] believed that the risk of challenging the German banks through the German courts was unacceptably high because if they were successful he would be made bankrupt. If he were made bankrupt, [Mr Vaines] would lose his position as a Partner in Squire Sanders & Dempsey.
>
> (6) Following negotiations with Bayerische Landesbank, [Mr Vaines] agreed to pay them €300,000 (£215,455) to release him from all claims to the Bank. The payment was made to the Bank in January 2008, in the tax year 2007-08.

3. The only other finding that the First-tier Tribunal made was that, "Although [Mr Vaines] accepted that the payment to Bayerische Landesbank had enabled him to avoid bankruptcy and protect his reputation, we find, as a matter of fact, that his purpose for making that payment was to preserve and protect his professional career

or trade". We will need to consider the precise scope and import of this finding in due course.

4. Mr Jones for HMRC says that the First-tier Tribunal was wrong on all counts to find as it did. Mr Vaines asks us to uphold the First-tier Tribunal's decision.

The First-tier Tribunal's Decision

5. The building blocks for Mr Vaines' success before the First-tier Tribunal were relatively brief. In a succinct decision, having set out the relevant provisions of the Income Tax (Trading and Other Income) Act 2005 ("ITTOIA") relating to limited liability partnerships specifically and partnerships in general, the Tribunal concluded that their effect, certainly since the introduction of personal self-assessment, was that "*it is the partners who are treated as carrying out the trade and not the firm itself … [so] that each partner is carrying on a trade albeit collectively with others and accordingly his profits are taxed on him individually*" (see FTT §16 & §17).

6. The First-tier Tribunal then noted the restriction imposed by section 34 ITTOIA on the deduction of any expense "not incurred wholly and exclusively for the purposes of the trade". Based on the finding to which we have referred in paragraph 3 above, however, the Tribunal concluded that the prevention of bankruptcy and the preservation of Mr Vaines' reputation did not operate to deny him a deduction for the payment (see FTT §24). Furthermore, the Tribunal noted that a payment to preserve and protect his professional career was a type of expense that could be deducted and, finally, that it was not capital in nature (and its deduction was therefore not denied by section 33 ITTOIA) (FTT §29).

7. For HMRC, Mr Jones said that the First-tier Tribunal was wrong on all three issues:

(1) First, it was wrong as a matter of law that each partner is carrying on a trade as an individual, albeit collectively with others. He said that there was but one trade being the partnership (or LLP) trade.

(2) If HMRC were right on the first point, then by definition the First-tier Tribunal had addressed the wrong question on the second issue. But even if the trade was Mr Vaines' trade rather than the partnership's trade, the First-tier Tribunal had been wrong to conclude that the payment was made wholly and exclusively for the purposes of his trade.

(3) Finally, if HMRC were right on the first point, then the First-tier Tribunal had again addressed the wrong question but even if the trade was Mr Vaines' trade rather than the partnership's trade, the payment was capital in nature.

8. We shall deal with the parties' submissions in the context of our discussion of the issues.

Issue 1: The partnership's trade or Mr Vaines' trade?

9. Section 5 ITTOIA charges to income tax the profits of a trade, profession or vocation. The profits so charged which arise to a UK resident individual are

chargeable to tax wherever the trade is carried on (s.6(1) ITTOIA) and the person liable for any tax charged is the person receiving or entitled to the profits (s.8 ITTOIA). Section 7(1) ITTOIA indicates that tax is charged on the full amount of the profits of the tax year and under section 7(2) these are the profits of the basis period for the tax year. The basis period rules are found in Chapter 15 of Part 2 of ITTOIA. The normal basis period rules operate by reference to the date in the tax year by reference to which 12 month accounts are drawn up (s.198(1) ITTOIA) with specific rules to cover the situation in which a person has started or ceased (or is treated as starting or ceasing) to carry on a trade.

10. The basic rules for computing trade profits are found in Chapter 3 of Part 2 of ITTOIA. They specify as a starting point that the profits of a trade must be calculated in accordance with generally accepted accounting practice (s.25(1) ITTOIA). The rules restricting deductions, with which we will be concerned in relation to Issues 2 and 3, are found in Chapter 4 of Part 2. We will refer to them further below.

11. There are particular rules for applying this framework of computation and assessment to partnerships but, as a general observation, it is the full amount of the profits of the trade for the basis period that are charged to tax each year.

12. The special rules for partnerships are found in Part 9 ITTOIA. The main provisions are as follows:

> **847 General provisions**
> (1) In this Act persons carrying on a trade in partnership are referred to collectively as a "firm".
>
> **848 Assessment of partnerships**
> Unless otherwise indicated (whether expressly or by implication), a firm is not to be regarded for income tax purposes as an entity separate and distinct from the partners.
>
> *Calculation of partners' shares*
> **849 Calculation of firm's profits or losses**
> (1) If—
>
> (a) a firm carries on a trade, and
>
> (b) any partner in the firm is chargeable to income tax,
>
> the profits or losses of the trade are calculated on the basis set out in subsection (2) or (3), as the case may require.
>
> (2) For any period of account in which the partner is a UK resident individual, the profits or losses of the trade are calculated as if the firm were a UK resident individual.

(3) For any period of account in which the partner is non-UK resident, the profits or losses of the trade are calculated as if the firm were a non-UK resident individual.

850 Allocation of firm's profits or losses between partners

(1) For any period of account a partner's share of a profit or loss of a trade carried on by a firm is determined for income tax purposes in accordance with the firm's profit-sharing arrangements during that period.

…

Firms with trading income

852 Carrying on by partner of notional trade

(1) For each tax year in which a firm carries on a trade (the "actual trade"), each partner's share of the firm's trading profits or losses is treated, for the purposes of Chapter 15 of Part 2 (basis periods), as profits or losses of a trade carried on by the partner alone (the "notional trade").

(2) A partner starts to carry on a notional trade at the later of—

(a) when becoming a partner in the firm, and

(b) when the firm starts to carry on the actual trade.

This is subject to subsection (3).

(3) If the partner carries on the actual trade alone before the firm starts to carry it on, the partner starts to carry on the notional trade when the partner starts to carry on the actual trade.

(4) A partner permanently ceases to carry on a notional trade at the earlier of—

(a) when the partner ceases to be a partner in the firm, and

(b) when the firm permanently ceases to carry on the actual trade.

This is subject to subsections (5) and (6).

(5) If the partner carries on the actual trade alone after the firm permanently ceases to carry it on, the partner permanently ceases to carry on the notional trade when the partner permanently ceases to carry on the actual trade.

(6) If—

(a) the firm carries on the actual trade wholly or partly outside the United Kingdom, and

(b) the partner becomes or ceases to be UK resident,

the partner is treated as permanently ceasing to carry on one notional trade when the change of residence occurs and starting to carry on another immediately afterwards.

853 Basis periods for partners' notional trades

(1) The basis period of a partner's notional trade is determined by applying the rules in Chapter 15 of Part 2 as if—

(a) the trade were carried on by an individual, and

(b) its accounts were drawn up to the same dates as the accounts of the actual trade.

…

863 Limited liability partnerships

(1) For income tax purposes, if a limited liability partnership carries on a trade, profession or business with a view to profit—

(a) all the activities of the limited liability partnership are treated as carried on in partnership by its members (and not by the limited liability partnership as such),

(b) anything done by, to or in relation to the limited liability partnership for the purposes of, or in connection with, any of its activities is treated as done by, to or in relation to the members as partners, and

(c) the property of the limited liability partnership is treated as held by the members as partnership property.

References in this subsection to the activities of the limited liability partnership are to anything that it does, whether or not in the course of carrying on a trade, profession or business with a view to profit.

(2) For all purposes, except as otherwise provided, in the Income Tax Acts—

(a) references to a firm or partnership include a limited liability partnership in relation to which subsection (1) applies,

(b) references to members or partners of a firm or partnership include members of such a limited liability partnership,

(c) references to a company do not include such a limited liability partnership, and

(d) references to members of a company do not include members of such a limited liability partnership.

…

13. Squire Sanders & Dempsey ("SS&D") is a limited liability partnership, which is (as a matter of general law) a body corporate but by virtue of section 863 ITTOIA is dealt with for income tax purposes as a partnership. As section 863(1) makes clear, what is attributed to the members of the LLP is attributed to them collectively as partners and subsection (2)(a) indicates that references to a firm or partnership include an LLP that is carrying on a trade with a view to profit, that is to say, one to which subsection (1) applies. Thus, looking at section 849, where an LLP is carrying on a trade and a member of the LLP is a UK resident individual (such as Mr Vaines), the profits of the LLP are to be calculated as if the LLP were a UK resident individual.

14. The legislation specifically envisages that it is the LLP that is carrying on the trade and although its activities are to be treated as carried on in partnership by its members rather than by the LLP itself (see s.863(1)(a)), there is nothing in that to indicate that Mr Vaines is carrying on a trade alone: quite the opposite.

15. The concept that there is one trade carried on by the partners in common (or by the members as partners) is consistent with the idea that it is the profits of the trade that are charged to tax, albeit that the scope of that charge may depend upon the residence of the persons who from time to time are carrying it on. The profits of that one trade are computed and charged and section 850 then provides the natural link to the partners who are chargeable in respect of them according to the LLP's profit-sharing arrangements for the period.

16. HMRC relied upon Mr Justice Vinelott's description in *MacKinlay v Arthur Young McClelland Moores & Co* (1986) 62 TC 704, of the "three stages" in the assessment to tax of a partnership's profits, which was subsequently endorsed by the House of Lords. Vinelott J said this at page 724:

> "Before turning to those cases I should, I think, say something about the way in which partnership profits are assessed to tax. There are, in effect, three stages. First the profits of the firm for an appropriate basis period must be ascertained. What has to be ascertained is the profits of the firm and not of the individual partners. That is not, I think, stated anywhere in the Income Tax Acts, but it follows necessarily from the fact that there is only one business and not a number of different businesses carried on by each of the partners. The income of the firm for the year is then treated as divided between the partners who were partners during the year to which the claim relates—the year of assessment—in one of the many senses of that word … That is the second stage. The tax payable is then calculated according to the circumstances of each partner … When the tax exigible in respect of each share of the partnership income has been ascertained the total tax payable is calculated. Section 152 (formerly Rule

10 of the Rules applicable to Cases I and II of Sch D) provides that the total sum so calculated is to be treated as "one sum … separate and distinct from any other tax chargeable on those persons … and a joint assessment shall be made in the partnership name." That is the third stage."

17. The issue in the *Arthur Young* case was the entitlement of the firm to deduct in computing the firm's profits certain personal removal expenses incurred by two partners and reimbursed by the firm when they were required by the firm to move to different branches in other parts of the United Kingdom. The Special Commissioners decided that the firm could deduct the expenses but Vinelott J disagreed. The Court of Appeal restored the Special Commissioners' decision on the basis that, for the purposes of computing the profits of a firm liable to income tax "a partnership is regarded as an entity distinct from its members" (per Slade LJ 62 TC at 740, citing *Heastie v Veitch & Co* [1934] I KB 535). But the House of Lords agreed with Mr Justice Vinelott.

18. As Lord Oliver noted (having referred to what Slade LJ had said) (62 TC at 754I-755B):

> "Now there is, if I may say so respectfully, a confusion here. It is perfectly true that in *Heastie v Veitch & Co.*, [1934] 1 KB 535, 547 Romer L.J. remarked that by rule 10 applicable to Cases I and II (now contained in s. 152 of the Act) a partnership is treated for the purposes of Sch D taxation as a separate entity from the individual partners composing the firm—that is at stage three of Vinelott J's analysis—but there is nothing in that decision nor in the other cases cited by Slade L.J. to justify a conclusion that it can permissibly be so treated at stage one of the analysis in relation to sums which have been received by a partner from the partnership funds in his capacity as a partner."

19. The First-tier Tribunal concluded, however, that there had been a material change in the relevant legislation since that in place in 1980 when Vinelott J and Lord Oliver analysed the position. The Tribunal expressed the point in the following terms:

> "15. However, as Mr Vaines correctly pointed out, Vinelott J, and indeed the House of Lords in that case, was concerned with the position as it existed before the introduction of self-assessment when a partnership was treated for income tax purposes, under section 111 of the Income and Corporation Taxes Act 1988, as "*an entity which is separate and distinct from those persons*" who carried out the trade or profession in partnership and it would appear that this was why Vinelott J referred to there being "only one business". This can, and should, be contrasted with the present position under s 848 ITTOIA that a partnership is not to be regarded for income tax purposes as separate and distinct from the partners."

20. As can be seen from Vinelott J's summary, the relevant statutory provision at the time of the *Arthur Young* case was in fact section 152 of the Income and Corporation Taxes Act 1970. This became section 111 of the Income and Corporation Taxes Act 1988 ("ICTA") and was in its original form in the following terms:

> "111. Where a trade or profession is carried on by two or more persons jointly, income tax in respect thereof shall be computed and stated jointly, and in one sum, and shall be separate and distinct from any other tax chargeable on those persons or any of them, and a joint assessment shall be made in the partnership name."

21. It can be seen that the expression "*an entity which is separate and distinct from those persons*" did not appear as such in the original section 111, which is concerned with the joint assessment of the partnership profits in the firm's name. As appears from Vinelott J's summary, confirmed in terms by Lord Oliver, this relates to stage 3 of the partnership computation and assessment process. Associated with section 111 was originally section 8 and (from 1990) section 9 of the Taxes Management Act 1970 ("TMA"), which made provision for an inspector to require delivery of a partnership return to facilitate the making of an assessment to income tax in the partnership name.

22. The manner of assessment for partners changed with the introduction of self-assessment (together with a switch from the preceding to the current year basis as part of the process). Section 111 ICTA was replaced by a new section 111 with 13 subsections that are now found spread across a number of sections in Part 9 of ITTOIA but notably sections 848, 849, 850 and 852. The last of these gives effect to the concept of a "notional trade" in contrast to the "actual trade". Section 111(1) to (4) provided as follows—

> "(1) Where a trade or profession is carried on by persons in partnership, the partnership shall not, unless the contrary intention appears, be treated for the purposes of the Tax Acts as an entity which is separate and distinct from those persons.
>
> (2) So long as a trade or profession is carried on by persons in partnership, and any of those persons is chargeable to income tax, the profits or losses arising from the trade or profession ("the actual trade or profession") shall be computed for the purposes of income tax in like manner as if—
>
> (a) the partnership were an individual; and
>
> (b) that individual were an individual resident in the United Kingdom.
>
> (3) A person's share in the profits or losses arising from the actual trade or profession which for any period are computed in accordance with subsection (2) above shall be determined according to the interests of the partners during that period.
>
> (4) Where a person's share in any profits or losses is determined in accordance with subsection (3) above, sections 60 to 63A [the basis period rules] shall apply as if—
>
> (a) that share of the profits or losses derived from a trade or profession carried on by him alone;

(b) that trade or profession ("the deemed trade or profession") had been set up and commenced by him at the time when he became a partner or, where the actual trade or profession previously carried on by him alone, the time when the actual trade or profession was set up and commenced;

(c) as regards each year of assessment, any accounting date or accounting change of the actual trade or profession were also an accounting date or accounting change of the deemed trade or profession;

(d) subsection (2) of section 62 applied in relation to any accounting change of the deemed trade or profession if, and only if, on the assumption that the partnership were an individual, that subsection would apply in relation to the corresponding accounting change of the actual trade or profession; and

(e) the deemed trade or profession were permanently discontinued by him at the time when he ceases to be a partner or, where the actual trade or profession is subsequently carried on by him alone, the time when the actual trade or profession is permanently discontinued."

23. At the same time new sections 8 and 9 TMA provided for returns to include a self-assessment and a new section 12AA TMA made provision for a partnership return to facilitate the establishment of the amounts that individual partners should include in their self-assessment.

24. Although section 111 ICTA has been rewritten to a number of sections in Part 9 of ITTOIA, the basic approach adopted by section 111 is still evident from those provisions of Part 9: in particular, the actual trade is the trade carried on by the partners collectively (s.111(2)), the profits of the actual trade are then shared among the partners according to their interest for the period (s.111(3)) and the concept of a "deemed trade or profession" (now the "notional trade or profession") is then introduced for the purposes of assessing each partner to tax in respect of his share by reference to the correct basis period (s.111(4)).

25. Prior to self-assessment, the basis periods for the assessment of partnership profits depended upon whether the entry or departure of any partner was treated as a cessation of the partnership trade or its discontinuance. The determination of the basis period for the assessment of the partnership's profits on partners generally depended upon that determination. Following the introduction of self-assessment, however, each partner is assessed to tax on their share of the profits by reference to the basis period determined according to their notional trade. It is, however, as the language of the Act recognises, a notional trade only for the purposes of assessment. The actual trade remains that of the partners collectively and it is the profits of that collective trade that must be computed before being allocated or shared among partners to provide each partner's share of the profit that is the profit of their notional trades for the purposes of their self-assessment.

26. In relation to the concept of actual and notional trades, the First-tier Tribunal said this—

> "19. In addition we do not accept that s 852 ITTOIA with its reference to the "actual trade" of the firm and "notional trade" of each partner's share of profits as (*sic*) losses provides any assistance to HMRC. As is made abundantly clear in the legislation where it states "for the purposes of Chapter 15 of Part 2 (basis periods)" that that (*sic*) the carrying on by a partner of a "notional trade" is in relation to those purposes only and does not have the general application suggested by Mr Hillier."

27. We do find this entirely clear but equally we not think that it is correct. As the *Arthur Young* case indicates and as one would expect, the switch from assessment to self-assessment and the change in approach to apply the basis period rules to a notional trade are concerned with stage 3 of the partnership computation and assessment process. Parliament could have decided to change stages 1 and 2 but we can see nothing in the legislation to indicate that it did. If each partner was to be treated as carrying on his or her 'notional trade' as a general matter, it might raise the question whether a partner could adjust the deemed profits of the notional trade (being the allocated share of the partnership's profits). However, it is plain from section 852 ITTOIA (and section 111(4) ICTA before it) that the 'notional trade' is a construct designed for the purposes of the basis period rules only.

28. Thus, the concept of a 'notional trade' is, as we have explained, to enable Mr Vaines to self-assess tax on his share of the profits of the partnership trade by reference to the correct basis period. It is also true that, as a member of SS&D, Mr Vaines was to be treated (for income tax purposes) as carrying on SS&D's trade. Nevertheless, the trade that he was carrying on and in respect of which the profits had to be computed for the purposes of the charge to income tax was SS&D's trade as carried on in common by all the members and not by Mr Vaines alone. As such, his payment of €300,000 fell to be deducted, if at all, in the context of SS&D's trade as so carried on and not as the First-tier Tribunal supposed by reference to his circumstances alone.

29. In this respect section 111(1) ICTA (following self-assessment) and section 848 ITTOIA do no more than state the general proposition of English law (that is applicable in taxing United Kingdom partnerships generally, notwithstanding the different position under Scots law for Scottish partnerships) that a partnership is not a separate entity and that the partners are each carrying on the partnership's trade in common. That is the statutory expression of the situation that exists at the first of Vinelott J's stages (which, as Vinelott J noted, was at that time nowhere stated in the Act) and reflects the point that was made by Lord Oliver in rejecting the Court of Appeal's approach in *Arthur Young*.

30. As Lord Oliver indicated, a partnership was treated *for assessment purposes* as if it were separate from the partners and was assessed in its own name notwithstanding its 'transparent' nature as a matter of the general law. But as he also noted, there was nothing to justify a conclusion that it could be treated as a separate entity at stage one of the analysis for the purpose of deciding whether certain personal expenses of two partners were deductible in computing the partnership's profits (see paragraph 18

above); in other words, stage one at the time in effect reflected an unwritten rule that now appears in section 848 ITTOIA.

31. It is the profits of the trade carried on collectively that has always been recognised as the subject matter of computation and charge. That has not changed with the introduction of self-assessment. It is in the context of the partnership trade conducted collectively that Mr Vaines must justify the deduction of his payment.

32. Against that conclusion Mr Vaines says that sections 849 and 850 ITTOIA are merely matters of calculation and do not determine who is actually carrying on the trade. He then says that section 863(1)(b) ITTOIA makes it explicit that the members of an LLP are the persons carrying on the trade. Section 863(1)(b) does not, however, state that anything done by the LLP for the purposes of or in connection with any of its activities is treated as done by each member as such; rather it is "by the members *as partners*".

33. Given that section 863 is designed to treat LLPs (as bodies corporate) for tax purposes as if they were partnerships, it would be strange to conclude that section 863(1)(b) left members of an LLP in a different position (in this respect at least) from the position of partners generally. The language of section 863(1)(b) in this respect seems designed to ensure that they are in the same position. It would follow that the construction for which Mr Vaines contends must be one that produces the same result for LLP members as for ordinary partners.

34. As regards partnerships generally, Mr Vaines relies on section 848 on the basis that the firm is not an entity separate and distinct from the partners. As he put the point, the 'firm' is merely a reference and is not the taxable entity and it is the partners who are carrying on the trade. The 'firm', however, is a collective reference to the persons carrying on a trade in partnership (i.e. as partners) and the firm is not an entity separate and distinct from the partners. That leaves open, however, the manner and approach to the computation of the profits to be derived from the partnership's trade.

35. Finally, on this issue, Mr Vaines referred us to a large number of provisions of the Taxes Acts which refer to a taxpayer carrying on a trade "alone or in partnership". In this respect, there is no doubt that Mr Vaines in common with the other members of SS&D is carrying on trade in partnership (or, strictly, "as partners"). For the reasons that we have given, however, and in disagreement with the First-tier Tribunal, it is in the context of the partnership trade of SS&D conducted collectively that Mr Vaines must justify the deduction of his payment.

Issue 2: Was the payment wholly and exclusively incurred for the purposes of the trade?

36. Our conclusion on the first issue inevitably leads to a conclusion adverse to Mr Vaines on the second issue. Section 34(1) ITTOIA provides that:

> "In calculating the profits of a trade, no deduction is allowed for—

(a) expenses not incurred wholly and exclusively for the purposes of the trade,"

37. "The trade" in this context is the trade of SS&D conducted collectively by its members as partners. The payment in question was not borne by SS&D and there is no suggestion that Mr Vaines' decision to pay €300,000 to Bayerische Landesbank was a matter for discussion and agreement between him and the firm's management committee or the members of SS&D as a body (other than those who found themselves in a similar position to Mr Vaines). The First-tier Tribunal's conclusion that, as a matter of fact, his purpose in making the payment was "to preserve and protect his professional career or trade" is of no assistance to Mr Vaines. It indicates that this was a personal expense, directed at resolving Mr Vaines' situation, and not one that was related to the professional activities of SS&D that he was carrying on in common with the other members of the firm.

38. It was a liability that had arisen from his previous engagement with the law firm Haarmann Hemmelrath and in that respect had nothing whatsoever to do with the business of SS&D. We are not considering a case in which, when he joined SS&D as a member, Mr Vaines negotiated an arrangement under which SS&D would contribute to or discharge any liability that he might have incurred in respect of his previous association with Haarmann Hemmelrath. In fact (as appears from Mr Vaines' witness statement to the First-tier Tribunal), the payment of €300,000 was initially funded by SS&D which agreed to lend Mr Vaines the money and which he then repaid over an agreed period. This indicates that SS&D specifically declined to take any responsibility for the payment. As it is, the decision in *Arthur Young* would suggest that if SS&D had agreed to assume responsibility for any part of the payment it might not have been deductible by SS&D in any event (as to which see further below). That scenario, however, would involve different facts and a different analysis to determine whether and on what basis the firm might have claimed to deduct any expense that it had borne as a result of any agreement with Mr Vaines.

39. As it was, Mr Vaines' decision to pay €300,000 to Bayerische Landesbank was a personal decision that he needed to make unless he was to risk bankruptcy and as a result risk his continuing membership of SS&D. On that basis the payment was not made wholly and exclusively for the purposes of the trade (or, more accurately, the professional activities) of SS&D but to enable Mr Vaines to be secure in the knowledge that he could continue as a member of SS&D. The conclusion that no deduction can be claimed on that basis scarcely requires the citation of authority; it perhaps suffices to mention one of the earliest authorities on a payment for a liability not arising from the trade, *Strong & Co v Woodifield* [1906] AC 448.

40. Mr Vaines drew our attention to the 'practice' that he said operated in the case of a partnership of general medical practitioners, where he said (by reference to HMRC's Helpsheet 231) that it was possible for medical practitioners to adjust their share of the partnership's profits to take account of expenses borne personally. The Helpsheet in fact starts by setting out the conventional position regarding the computation of partnership profits, including the statement (printed in bold) that "It is not possible for individual partners to make supplementary claims, whether for expenses or capital allowances, in their own tax return". It goes on to note, however, that HMRC will accept entries in the relevant sections of the Partnership Tax Return

(our emphasis) that include adjustments for expenditure incurred by a partner which, following adjustment, is then treated for practical purposes as if it had been included in the partnership's accounts even though it was not in fact so included.

41. Whatever the position in relation to medical practices, where there may well have to be some agreement between the medical practitioners concerned as to how certain expenses are borne (for example, those relating to a doctor's particular specialism), the Helpsheet does not appear to offer Mr Vaines any assistance. In particular, the Helpsheet does not suggest that a partner may adjust his share of partnership income in *his own tax return* for an expense that he has incurred as a matter of his unilateral decision and without any basis in an agreement with his fellow partners.

42. Even if we are wrong on issue 1, we would still conclude that the payment of €300,000 to Bayerische Landesbank is not deductible as an expense wholly and exclusively incurred for the purposes of Mr Vaines' trade. Mr Jones for HMRC relied on the basic proposition that issue 2 (ignoring the conclusion on issue 1) had to be resolved by reference to the circumstances of the underlying liability and not the payment as such. The payment operated to dispose of an onerous liability which Mr Vaines had incurred through his association with Haarmann Hemmelrath. He said that whether such a payment was wholly and exclusively incurred had to be addressed by reference to the underlying liability that was extinguished and not by reference to the payment which achieved that. He relied in particular on *Alexander Howard & Co Ltd v Bentley* 30 TC 334, *Anglo-Persian Oil Co Ltd v Dale* 16 TC 253 and *Bean v Doncaster Amalgamated Collieries Ltd* 27 TC 296.

43. As is apparent, the payment in question had no connection with Mr Vaines' trade (or professional activity) as a member of SS&D. It discharged a personal liability (even if not admitted) of Mr Vaines to Bayerische Landesbank arising out of the conduct of Haarmann Hemmelrath's business. As Mr Jones pointed out, Mr Vaines might have been at risk of bankruptcy for failure to discharge a debt arising from any number of transactions—he mentioned the acquisition of a sports car as an example. He said that the logic of Mr Vaines' argument might then suggest that compromising or settling *any* dispute as to payment to avoid the risk of bankruptcy might then be claimed to be deductible in computing professional profits.

44. The only basis for deduction is the First-tier Tribunal's finding of fact that although the payment to Bayerische Landesbank had enabled him to avoid bankruptcy and protect his reputation, as a matter of fact, his purpose for making the payment was to preserve and protect his professional career or trade. Leaving aside the fact that the First-tier Tribunal had Mr Vaines' trade in mind rather than that of SS&D, Mr Vaines must be able to establish that preserving and protecting his professional career was not just a purpose but his only purpose. There is no basis for 'apportioning' the payment to attribute part of it to a sole trade purpose.

45. As existing authorities indicate, while there is a distinction between the purpose and effect of particular expenditure, the effect achieved by particular expenditure may be so inevitable that it necessarily represents an unspoken or 'subconscious' purpose. As Lord Oliver put it in *Arthur Young* (62 TC at 757), "*Some results are so inevitably and inextricably involved in particular activities they cannot but be said to be a purpose of the activity*".

46. This aspect of particular expenditure was carefully considered by the Special Commissioner in *McKnight v Sheppard* (1999) 71 TC 419, a case upon which Mr Vaines' relied in support of the First-tier Tribunal's finding in his favour on issue 2. The taxpayer in *McKnight v Sheppard* was a sole trader and the expenses in question (disciplinary fines and legal costs incurred in defending disciplinary proceedings) were essentially related to his conduct while carrying on that trade. By comparison in the present case the payment of €300,000 to Bayerische Landesbank arises from Mr Vaines' previous engagement with Haarmann Hemmelrath and the 'trade' in respect of which he now seeks to deduct that payment is his 'trade' as conducted through SS&D. Mr Vaines did not go so far as to suggest that he was at all times conducting a single trade or professional activity, irrespective of the firm for which he was working from time to time. Thus, he needed to establish that a payment arising from his involvement with a former firm, designed to avoid the risk of bankruptcy, and all the consequences that flow from bankruptcy, was made wholly and exclusively for the purposes of the 'trade' he was conducting with his current firm.

47. In concluding that the statutory test was met, the First-tier Tribunal cited Henderson J's exposition in *Duckmanton v HMRC* [2013] UKUT 305 (TCC) of the applicable principles, in which he repeated Millett LJ's summary in *Vodafone Cellular Limited v Shaw* (1997) 69 TC 376 at 436-437 of the modern law on the interpretation and application of the test. We shall not repeat the entire citation here. The two key points for present purposes from Millett LJ's summary are:

> (1) A taxpayer's subjective intentions are not limited to the conscious motives which were in his mind at the time he incurred the expense. "*Some consequences are so inevitably and inextricably involved in the payment that unless merely incidental they must be taken to be a purpose for which the payment is made*".
>
> (2) The question does not involve an enquiry of the taxpayer whether he consciously intended to obtain a trade or personal advantage by the payment. The primary enquiry is to ascertain what was the particular object of the taxpayer in making the payment. Once that is ascertained, its characterisation as a trade or private purpose is a matter for the Tribunal and not for the taxpayer.

48. Having cited Henderson J's exposition, the First-tier Tribunal concluded on the matter as follows:

> "24. However, given our finding of fact (in paragraph 3, above) that the purpose of Mr Vaines in making that payment was to preserve and his (*sic*) protect his professional career or trade and that in *McKnight (HM Inspector of Taxes) v Sheppard* [1997] STC 669 Lord Hoffman (*sic*) giving the decision of the House of Lords said, at 673:
>
> > "The well known case of *Morgan (Inspector of Taxes) v Tate & Lyle Ltd* [1955] AC 21, 35 TC 367 is authority for the proposition that money spent for the purpose of preserving the trade from destruction can properly be treated as wholly and exclusively expended for the purposes of the trade."

> We find that the payment of €300,000 made by Mr Vaines to Bayerische Landesbank was wholly and exclusively for the purposes of his trade."

49. With respect to the First-tier Tribunal, we do not think that its conclusion followed from what it stated. First, the question whether Mr Vaines' purpose in making that payment was *wholly and exclusively* to preserve and protect his professional career or trade, is not answered by the Tribunal's earlier finding as to what his stated purpose was. The statutory test involves, *inter alia*, consideration of the points to which we have referred in paragraph 47 above. There is no indication that the First-tier Tribunal's finding of fact in paragraph 3 was arrived at after considering those matters when they only appear at a later stage in its decision and then only by way of citation of authority rather than following any substantive consideration of the issues, such as can be seen in the Special Commissioners' decision in *McKnight v Sheppard*.

50. Secondly, the particular citation from Lord Hoffmann's speech in *McKnight v Sheppard* does not appear to be to the point. A payment to preserve the trade from destruction can properly be treated as wholly and exclusively expended for the purposes of the trade (and, indeed, may be revenue rather than capital expenditure). However, the fact that a payment is made to preserve the trade from destruction does not tell you that it *is* wholly and exclusively incurred for the purposes of the trade. The First-tier Tribunal appears to have concluded that because Mr Vaines was able to describe his payment as having the effect of preserving and protecting his professional career or trade it was necessarily incurred wholly and exclusively for the purposes of his trade without further consideration or enquiry.

51. Accordingly, we think that the First-tier Tribunal's conclusion on issue 2 (leaving aside its conclusion on issue 1) reveals an error of law and cannot stand.

52. The usual illustration of the distinction between object and effect is that provided by Lord Brightman in *Mallalieu v Drummond* [1983] 2 AC 861 at 870F-871A, involving the cost incurred by a medical consultant in travelling to attend a friend in the south of France. It is relatively straightforward to see that such expenditure may be incurred with one of two purposes in mind even though in either case the expenditure will enable the consultant to enjoy the benefits of visiting the French Riviera. Similarly, in *McKnight v Sheppard*, it is possible to see that the decision whether or not to incur substantial legal costs in defending disciplinary charges may be driven by different objectives even though an inevitable effect of the expenditure (whatever its purpose) may (if successful) be to protect the taxpayer's personal reputation.

53. As *Mallalieu v Drummond* and *Arthur Young* illustrate, however, there is some expenditure for which it is impossible, or virtually impossible, to draw this distinction. In particular, if the expenditure itself necessarily achieves a particular objective (such as discharging a particular liability) it may be impossible, or virtually impossible, to describe that objective as no more than an effect or an incidental effect of the expenditure. Thus, the expense of a partner moving house inevitably and unavoidably has a personal element to it even though the move is at the request of the 'management' of the partnership or is designed to achieve a partnership objective. As Lord Oliver put it (62 TC 704 at 757)—

> "It is inescapable as it seems to me, that the expenditure, motivated no doubt by the fact of moving house, which in turn was motivated by the desire to put the partner concerned in a better position to further the interests of the firm, was an expenditure serving and necessarily and inherently intended to serve the personal interests of the partner in establishing his private residence for himself and his family and it cannot be said to be exclusively for the purposes of the partnership practice."

54. Similarly, a lady barrister might prefer to wear brighter colours, but the inevitable and unavoidable object of acquiring restrained and sober garb for court remains that of preserving warmth and decency.

55. An appropriate way to consider this issue is to think of Mr Vaines as a sole trader. In *McKnight v Sheppard*, Mr Sheppard did not have to incur the legal costs that he did. No doubt he had to defend himself in the disciplinary proceedings in any event but when he was asked why he had incurred the costs that he did, his answer (accepted by the Commissioner) was that his purpose was to save his business from destruction rather than to protect his reputation. The Commissioner did not accept the latter assertion, on the basis that Mr Sheppard would have had to have had a particularly thick skin to have had no concern for his reputation. The Commissioner did accept, however, that preservation of his personal reputation was an incidental effect of his decision to incur the particular legal costs that he was seeking to deduct. Thus, the expenditure enabled him to save his business and to preserve his reputation and it was important to ask whether the expenditure served two purposes or only one with the other being an incidental effect. Similarly, the cost of travelling to the French Riviera may serve two purposes—attending your patient and having a holiday—and it is important to know (not just as a matter of subjective statement but also as a matter of objective assessment) whether both or only one of those purposes is being served (and in the latter case, which one).

56. In the case of partners' moving expenses and lady barristers' clothing, it is almost impossible to answer the question as to which purpose is being served without recognising that the expenditure necessarily serves both personal and business needs. The one cannot be said to be incidental to the other because the expenditure necessarily serves both. (We say 'almost' or 'virtually' impossible because the enquiry must always be framed in the context of the particular facts of the case and, for example, expenditure on a 'uniform' rather than just on the restrained and sober garb expected of barristers in court may nevertheless satisfy the test notwithstanding any incidental effects of warmth and decency).

57. The same conclusion will usually flow from Mr Jones' example of discharging the disputed cost of a sports car if acquired for personal use. An individual, dissatisfied with his purchase, may decide not to dispute payment because of the inevitable distraction that a dispute may cause to the conduct of his business, including perhaps the risk of bankruptcy. However, the payment necessarily discharges a personal liability and it is then virtually impossible to say that that was a merely incidental effect of the payment rather than its purpose.

58. Is Mr Vaines in the same position as a dissatisfied purchaser of a sports car? The disputed liability to Bayerische Landesbank was connected with the exercise by Mr

Vaines of his profession but with the firm of Haarmann Hemmelrath, which must be regarded as a separate trade or profession, even on the hypothesis that Mr Vaines is a sole trader (the sole trade in respect of which he seeks to deduct the payment being his professional activities with SS&D rather than with Haarmann Hemmelrath). Faced with the claim by Bayerische Landesbank, Mr Vaines essentially had only three unenviable choices: to concede the claim and be made bankrupt, to fight the claim and risk being made bankrupt or to compromise the claim, as he did. None of those choices arose out of or were related to his professional activities with SS&D, and the fact that he decided to compromise the claim rather than concede or fight it because he recognised that bankruptcy was too large a risk to his membership of SS&D does not in our view turn what is essentially a decision on a personal matter into one that is taken wholly and exclusively for the purposes of his trade with SS&D. Mr Sheppard had a choice to make as to whether and what scale of legal costs to incur. In Mr Vaines' case the payment inevitably resolved what was (in relation to his membership of SS&D) a personal matter; it was not just an incidental but pleasant effect of his decision to protect his professional career.

59. It therefore seems to us that paying €300,000 to Bayerische Landesbank had the inevitable objective of avoiding protracted litigation in Germany and the risk of bankruptcy. As Mr Vaines accepted before the First-tier Tribunal, "the payment to Bayerische Landesbank *had enabled him to avoid bankruptcy and* protect his reputation" (our emphasis). It seems to us, however, that that was a necessary purpose of his payment, just as the expenditure in *Arthur Young* had enabled the partners concerned to move house and Miss Mallalieu's expenditure on sober garb had enabled her to keep warm and preserve her decency.

60. Mr Vaines' decision to pay €300,000 may have been driven by considerations of his professional career and his position as a member of SS&D. Indeed, they may have been uppermost in his mind at the time. In this respect, there may appear to be a fine distinction between a decision (similar to that in *McKnight v Sheppard*) to engage and incur the costs of an expensive German law firm to contest the asserted liability and a decision to settle the matter altogether by paying the bank to go away. Any case must ultimately depend on an evaluation of its particular circumstances. In Mr Vaines' case, it seems to us that professional considerations cannot have been the sole consideration. The settlement payment inevitably disposed of a potential liability that did not arise from his 'trade' with SS&D and necessarily brought with it the wider and personal benefits of avoiding extensive litigation and the risk of possible bankruptcy. As such it is not possible to conclude in his case that he paid €300,000 wholly and exclusively for the purposes of his trade with SS&D (even if we leave aside our conclusion on issue 1).

Issue 3: Was the payment capital or revenue?

61. Given our conclusions on issues 1 and 2 it is unnecessary for us to deal with the question of whether Mr Vaines' payment to Bayerische Landesbank was capital or a revenue expense. A variety of authorities (such as *Morgan v Tate & Lyle Ltd* [1955] AC 21, 35 TC 367) establish that payments designed to protect or preserve a person's trade or profession may be deductible as revenue expenditure and are not necessarily to be disallowed as capital. If we had been able to conclude in Mr Vaines' favour on

issues 1 and 2 we might well also have concluded that he was entitled to succeed on issue 3.

62. As it is, we think it unnecessary to speculate further on this because HMRC's appeal must in our view succeed in any event on issues 1 and 2. We therefore allow HMRC's appeal on that basis.

Malcolm Gammie
TRIBUNAL JUDGE

Judith Powell
TRIBUNAL JUDGE

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