Neutral Citation: **[2023] UKUT 00218 (TCC)**

Case Number: UT/2022/000045
UT/2022/000051

UPPER TRIBUNAL
(Tax and Chancery Chamber)

Rolls Building, London

CORPORATION TAX – whether FTT erred in finding payments pursuant to settlement agreements with regulators were non-deductible – no – taxpayers' appeals dismissed. Whether FTT erred in treating an element of payment which it consider deductible when that payment was part of a package of payments having a penal character – yes – HMRC's appeal allowed

Heard on: 16 and 17 May 2023
Judgment date: 05 September 2023

Before

MR JUSTICE MILES
JUDGE SWAMI RAGHAVAN

Between

(1) SCOTTISHPOWER (SCPL) LIMITED
(2) SCOTTISHPOWER RENEWABLES (UK) LIMITED
(3) SCOTTISHPOWER (DCL) LIMITED
(4) SCOTTISHPOWER ENERGY RETAIL LIMITED

Appellants

and

THE COMMISSIONERS FOR HIS MAJESTY'S REVENUE AND CUSTOMS
Respondents

Representation:

For the Appellants: David Goldberg KC, Laura Inglis, Counsel, instructed by Linklaters LLP

For the Respondents: David Ewart KC, Thomas Chacko, Counsel, instructed by the General Counsel and Solicitor to His Majesty's Revenue and Customs

DECISION

INTRODUCTION

1. This is an appeal by the taxpayers, and a cross-appeal by HMRC in relation to a decision of the First-tier Tribunal (Tax Chamber) ("**FTT**") reported as *Scottish Power (SPCL) Ltd and others v HMRC* [2022] UKFTT 41 (TC) ("**the FTT Decision**").

2. The taxpayers are energy providers regulated by the energy regulator, Ofgem. The taxpayers entered into various agreements with Ofgem in settlement of a number of regulatory investigations into matters such as mis-selling, complaints handling and costs transparency. Under the various settlement agreements, made between October 2013 to April 2016, the taxpayers paid sums called "penalties" in nominal amounts (£1), together with payments to consumers, consumer groups and charities totalling approximately £28m.

3. HMRC concluded that the taxpayers were wrong to deduct the £28m payments from their profits for the purposes of corporation tax and amended the taxpayers' corporation tax returns accordingly. On appeal by the taxpayers, the FTT agreed with HMRC that the vast majority of the payments were not deductible. The taxpayers appeal against that decision, with the permission of the FTT. HMRC appeal against the FTT's conclusion that one of the payments was deductible. That was a payment of £554,013 to consumers directly affected by the mis-selling. The FTT considered it was made as compensation, paid wholly and exclusively for the purposes of the taxpayer's trade.

4. A central issue in the appeal is the scope of the principles to be derived from the House of Lords reasoning in *McKnight (HM Inspector of Taxes) v Sheppard* [1999] 1 WLR 1333, [1999] STC 669 ("***McKnight***"). In that case, the taxpayer sought to deduct fines imposed by the Stock Exchange on the taxpayer stockbroker for breaches of the Stock Exchange Council's rules and his legal costs of challenging those fines.

5. HMRC argue (putting it broadly) that *McKnight* establishes that payments which are in the nature of penalties, or in lieu of such penalties, are non-deductible.

6. The taxpayers dispute both the scope of the principles to be derived from *McKnight* and (in any event) their applicability to the settlement payments to consumers and others in issue here. They also argue that the discussion of deductibility in *McKnight* was *obiter* (the question before the House of Lords only concerned the disputed deduction for legal costs) and that any principle supposedly illustrated by it is inconsistent with the subsequent enactment of s46 Corporation Tax Act 2009 ("**CTA 2009**"). Under that provision, profits (and therefore the deductibility of expenses) for corporation tax purposes must follow generally accepted accounting practice and can only be adjusted from that treatment where "required or authorised by law". Here, as the FTT found, the payments were deductible according to generally accepted accounting practice, and (so the taxpayers argue) no legal adjustment applies so as to allow departure from that treatment.

7. Before addressing the relevant statutory law and case-law, it is helpful to outline the regulatory framework which provided the context for the settlements under which the payments were made, and the factual background relevant to the payments.

REGULATORY AND FACTUAL BACKGROUND

8. The taxpayers, as suppliers and generators of electricity and gas, were regulated by the Gas and Electricity Markets Authority ("**GEMA**"). The detail of the relevant regulatory framework, which derives from the statute, policy statements and guidelines was

comprehensively set out by the FTT at [3] to [21] of the FTT Decision. The following summary is sufficient for the purposes of this appeal.

9. GEMA's day to day work, including investigations and enforcement, is carried out by Ofgem (the Office of Gas and Electricity Markets). Under the relevant statutory provisions (the Electricity Act 1989 ("**the Electricity Act**"), and the Gas Act 1986 ("**the Gas Act**")), energy suppliers must comply with certain licence conditions (standard licence conditions "**SLCs**") or statutorily specified conditions ("relevant requirements"). GEMA's statutory objective is to protect the interests of existing and future electricity and gas consumers (taking their interests "as a whole"). Its enforcement powers include (under s27A of the Electricity Act, similar provisions applying under the Gas Act) the ability to impose a penalty "of such amount as is reasonable in the circumstances" where it is satisfied the supplier has contravened any licence condition or relevant requirement. Any penalties so levied are paid to the Treasury via the Consolidated Fund.

10. With effect from 18 February 2014, GEMA could also, where satisfied such contraventions resulted in consumer loss or inconvenience, make a Consumer Redress Order requiring action to remedy the consequences of contravention (under s27G of the Electricity Act). Its enforcement objectives and process, including the process for determining the amount payable by way of penalty or consumer redress were set out in a Policy Statement of 6 November 2014 (published pursuant to statutory obligations).

11. The Policy Statement included reference to a strategic enforcement objective of delivering "credible deterrence", and that "non-compliance should normally cost significantly more than compliance" such that GEMA would seek to ensure that "any financial penalty, compensation or other payment under a consumer redress order….significantly exceed[ed] the gain to the regulated person…and the detriment caused to customers affected by the contravention or failure". A five step process was set out for calculating the total amount payable under a penalty or consumer redress order which would usually cover (i) the removal of consumer detriment and any gain made by the regulated person, and (ii) a penal element, being an amount reflecting the seriousness of the contravention or failure and the need for deterrence.

12. Ofgem's Enforcement Guidelines of 12 September 2014 described the investigation process and covered the settlement of cases. The FTT accepted that the guidelines also accurately described Ofgem's practice in the relevant preceding years.

The FTT Decision

13. The FTT Decision was comprehensive, making detailed findings of fact from the oral and documentary evidence before it, which it received over the course of a five day hearing, covering matters such as the background to the settlement agreements and the respective stances of the parties to that. The underlying primary facts are not subject to challenge. We focus here on the facts necessary to understand and deal with the grounds of appeal, and incorporate more factual detail where necessary in the discussion sections which follow.

The investigations and settlement agreements:

14. The investigations leading to the four settlement agreements in issue involved the following regulatory breaches:

(1) *Mis-selling* - Ofgem considered that SLC 25, which imposed obligations in relation to marketing activities, had been breached. Insufficiently robust training and monitoring of doorstep and telesales marketing had resulted in misleading information being provided to customers.

(2) *Cost-reflectivity* - SLC 27.2A required that differences in terms and conditions between payment methods (e.g. between prepayment and direct debit) should reflect the relative costs of the different methods. Ofgem considered that the taxpayer did not have robust procedures to justify its price differentials.

(3) *Energy Saving (also referred to as CO_2 and CESP)* - the taxpayers failed to meet prescribed carbon emission reduction targets by promoting energy saving actions to consumers as set out in relevant legislation (the Electricity and Gas (Community Energy Saving Programme) Order 2009) ("**CESP**").

(4) *Complaints Handling*- Ofgem considered that the taxpayers breached SLC 25 (requiring suppliers to take reasonable steps to achieve matters such as fair, accurate and prompt behaviour), SLC 27 (timely billing and correction of billing errors), and the complaints handling standards and procedures in the Gas and Electricity (Consumer Complaints Handling Standards) Regulations 2008.

15. The taxpayers entered into separate settlement agreements in respect of each investigation. In each case the relevant taxpayer paid a nominal penalty of £1; and significant sums to charities or campaigns focussed on energy consumers (mis-selling: £445,987; costs-reflectivity: £750,000; energy saving: £299,998; and complaints handling: £3,290,791 (to two charities).

16. In addition:

(1) For mis-selling, £7,316,585 was paid to vulnerable customers who were identified as such by being in the taxpayers' "Warm Homes Scheme", and £554,013 to affected customers (this is the sum which the FTT allowed, and to which HMRC's appeal relates). The £554,013 was part of a £1m payment, the balance of which (£445,987) was paid to an energy consumer charity as set out above.

(2) For complaints handling, £14,709,208 was paid to affected customers. These were calculated as round sum payments of £73 to each such customer.

17. In each case, following Ofgem's opening of the investigation, Ofgem proposed penalties. Negotiations ensued and a settlement agreement was ultimately reached. These agreements contained an acceptance by the taxpayer of the relevant breach, an agreement not to appeal, and obligations to make the payments described above. Each of the payments which are the subject of the appeal were made under and in accordance with the settlement agreements. The agreements took effect as contracts.

18. The settlement agreements, as well as outlining the procedure by which settlement decisions were to be subject to agreement by GEMA's settlement committee, and the relevant payments to be made, included a number of appendices, including draft penalty notices to be published by GEMA regarding its intention to impose the penalty, agreed press notices, and in some cases agreed forms of letter to be sent to customers, together with methodologies for contacting customers and tracking down affected customers.

19. Although the draft penalty notices each referred to a penalty of £1, they were lengthy and detailed documents, setting out the breaches, the criteria relevant to the level of financial penalty, mitigating and aggravating factors, and the proposed penalty decision.

20. The FTT summarised the eventual published draft notices for mis-selling at [43]. Each notice began with a summary. By way of example the mis-selling settlement agreement of 10 October 2013 explained, after mentioning the regulatory breach of SLC 25:

> "1.2 The Authority [*GEMA*] considers it appropriate to impose a penalty on SP [*Scottish Power Energy Retail Limited*]. However, SP has agreed to make

> contributions amounting to £8.5m in the form of compensation and payments to vulnerable customers. The Authority considers that the payments offered by SP to aid consumers will be of greater benefit to energy customers than if a substantial penalty was imposed. Accordingly, the Authority considers that a nominal penalty of £1 should be imposed. Furthermore, the level of the penalty contributions has been reduced to reflect the steps taken by SP to take corrective measures and the agreed settlement of this investigation."

21. In each of the penalty decisions all of the various agreed payments were mentioned in the section setting out the reasoning for the penalty decision.

22. In the energy saving decision and the complaints handling decision the payments were referred to as "consumer redress".

23. In the case of the complaints handling penalty the section of the notice explaining the decision started:

> "Taking account of all these factors and also mindful of its principal objective to protect the interests of existing and future consumers, ScottishPower has agreed to pay £18 million (less £1) in lieu of a higher penalty"

24. The FTT made some general findings about the circumstances in which the agreements were concluded:

(1) The taxpayers were not compelled to make settlements ([35]): "The agreements were not "imposed" on [them]: they agreed to terms in the expectation that if they did not a penalty greater than £1 would be imposed" ([110])).

(2) The taxpayers entered into the agreement for various reasons: to avoid adverse reputational impact, management time being diverted, promotion of goodwill with customers, and because they preferred to make payments for the benefit of consumers rather than paying monies to the Exchequer ([35]).

25. The FTT derived from the authorities the principle that payments in respect of a penalty, or in lieu of a penalty, were non-deductible; while compensation payments were deductible. It found that each of the settlement payments were in lieu of the penalty except to the extent the payments were compensatory. It therefore proceeded to analyse each of the payments to determine whether they were penal or compensatory. It concluded that only the £554k amount (paid under the mis-selling settlement agreement to affected consumers) was compensatory.

26. It went on to consider, in respect of that amount (and in respect of the other payments, if it was wrong in its conclusion they were in lieu of penalties) whether the payments were wholly and exclusively for the purposes of the taxpayers' trade, and concluded that they were.

27. Mr Goldberg KC, who also appeared for the taxpayers below, relied on various specific findings of the FTT:

(1) The payments were deducted in computing the profits of the relevant trade in accordance with the ordinary principles of commercial accounting ([111]).

(2) The actions or inactions which gave rise to payments were part of the taxpayers' trading activities of selling gas and electricity energy. They were made as a consequence of not meeting required standards. The breaches of CESP and complaints handling "were practically almost unavoidable" ([112]).

(3) The purposes for which the actions were taken which gave rise to the payments were wholly and exclusively for the trade (this was on the assumption the payments had not been found to be penalties) ([113]).

(4) The payments were incurred in the course of activities carried on for the purposes of trade, and were also made for the purposes of closing down the investigation and avoiding adverse publicity ([119]).

28. The FTT rejected the taxpayers' arguments that the payments to charities were deductible under s189 CTA 2010, finding the payments did not satisfy the necessary conditions so as to make them "qualifying charitable donations". No appeal is pursued in relation to that conclusion.

STATUTORY FRAMEWORK

29. Section 35 CTA 2009 states that:

> "The charge to corporation tax on income applies to the profits of the trade".

30. Section 46(1) provides that:

> "The profits of a trade must be calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits for corporation tax purposes."

31. One such adjustment is found in the provisions of Chapter 4, which restrict the availability of deductions. The relevant provision for present purposes is s54. That provides:

> **"54 Expenses not wholly and exclusively for trade and unconnected losses**
>
> (1) In calculating the profits of a trade, no deduction is allowed for—
>
> (a) expenses not incurred wholly and exclusively for the purposes of the trade, or
>
> (b) losses not connected with or arising out of the trade.
>
> (2) If an expense is incurred for more than one purpose, this section does not prohibit a deduction for any identifiable part or identifiable proportion of the expense which is incurred wholly and exclusively for the purposes of the trade."

Section 46 was considered by the Supreme Court in *NCL Investments Ltd v HMRC* [2022] UKSC 9. The Supreme Court started by noting that it was long established that the profit of a taxpayer's trade was to be determined in accordance with "ordinary principles of commercial accountancy" as explained in *Odeon Associated Theatres Ltd v Jones* [1971] 1WLR 442, at 453 to 454, and that, as described by Lord Hoffmann in *HMRC v William Grant & Sons Distillers* Ltd [2007] 1WLR 1448 at para 1, that proposition had been codified in s42(1) of Finance Act 1998 (the predecessor provision to s46) ([20], [21]).

32. As to what was meant by an "adjustment required or authorised by law" the Supreme Court said at [29]:

> "Tax is the creature of statute and, as the citations above from *Odeon* and *William Grant* make clear, adjustments required or authorised to be made to profits calculated in accordance with generally accepted accounting principles are likely to be adjustments specified by statute. While it is possible for a judge-made rule to require or authorise such an adjustment to be made, it would have to be a rule which it is clear applies notwithstanding that the company's profits have been calculated in accordance with generally accepted accounting principles."

33. The Supreme Court considered that the particular case-law the Revenue relied on in *NCL* as a basis for adjustment provided "no support for there being such a rule," having earlier noted that there was no finding in that case of what the ordinary principles of commercial

accounting then required (nor any equivalent to s46 CTA 2009 giving "statutory primacy to generally accepted accounting practice").

34. The Supreme Court also endorsed the FTT's rejection of the Revenue's argument that s54 imported a further requirement of having to show that an expense had been "incurred". The FTT had explained:

> "…The whole flavour of section 46 and section 48 is that, if a sum is properly reflected as a debit in a calculation of accounting profit, the starting point is that the sum is deductible unless there is a specific statutory rule to the contrary…"

.

GROUNDS OF APPEAL AND THE PARTIES' CASES IN SUMMARY:

35. In their notice of appeal the taxpayers raise the following grounds:

(1) **Ground 1**: The FTT has allowed HMRC to tax Scottish Power beyond its trading profits contrary to s35 CTA 2009.

(2) **Ground 2**: The FTT incorrectly held that most of the Redress Payments were penalties or in the nature of penalties.

(3) **Ground 3**: the FTT erred in holding that only the £554,013 paid to affected consumers under the mis-selling settlement was compensatory and therefore deductible.

36. The taxpayers' primary arguments may be summarised as follows. Applying s46 CTA correctly, the accounting principles provide the answer (there being no challenge to the FTT's finding at [111] that, for accounting purposes, the payments were deductible). While there could, in principle be adjustments under judge-made rules, those could not allow a profit to be created that was inconsistent with the principles in the Corporation Tax Acts, particularly that requiring the application of generally accepted accounting practice. The suggested exclusionary rule derived from *McKnight* (which was in any case *obiter*) did not meet that requirement and was no longer applicable following the enactment of s46. In any event, any such suggested exclusionary rule does not extend to payments "in lieu of penalties" and (as stated) it was circumscribed by other distinct and independent requirements regarding payments, including regularity, unavoidability, and not being by way of compensation. The case-law save for *McKnight* was concerned with whether the sum in question was "wholly and exclusively" for the purposes of the trade. Even if *McKnight* established a rule that penalties, or payments in lieu of penalties were non-deductible, that did not apply to the facts of the consumer redress payments here. The only penalties imposed were the £1 penalties. The other payments were voluntary and negotiated; they were not imposed or compelled and they ought properly to have been characterised as compensation, rooted in the trade, and therefore deductible (the FTT having found the activities which gave rise to the penalties were all wholly and exclusively for the purposes of the trade).

37. HMRC's case, in summary, was that *McKnight* was not *obiter*, and that it establishes that payments in the nature of penalties (whether formal or in lieu of penalties) were not deductible. That principle is unaltered by s46 CTA. The rule in *McKnight* did not contain further limitations or exclude compensation and there was sufficient evidence before the FTT to hold that the payments were made in lieu of penalties. The FTT cannot be said to have gone wrong in reaching that conclusion, which is one of fact and not law.

DISCUSSION

38. Before addressing *McKnight*, it is helpful to mention two cases which featured in it.

39. In *IRC v von Glehn* [1920] 2 KB 553, an exporter sought to deduct payments in respect of penalties and associated legal costs for infringements of war-time customs legislation, which required the trader to produce evidence that the goods had not reached enemy territory. The trader could not do this. The relevant statutory provisions prohibited deductions "not connected with or arising out of" the trade or of any expenses "not being money wholly and exclusively laid out or expended for the purposes of" the trade. The Court of Appeal unanimously held that the expenses were not deductible. Lord Sterndale MR acknowledged that it could be said the payment was connected with the trade in the sense that "if the trade had not been carried on the penalty would not have been incurred; there would have been no opportunity for the breach of the law which took place" but considered that was not the sense of connection the legislation contemplated. Nor, he explained, were the payments "wholly and exclusively laid out or expended for the purposes of" the trade (p.566):

> "During the course of the trading this company committed a breach of the law. As I say, it has been agreed that they did not intend to do anything wrong in the sense that they were willingly and knowingly sending these goods to an enemy destination; but they committed a breach of the law, and for that breach of the law they were fined. That, as it seems to me, was not a loss connected with the business, but was a fine imposed upon the company personally, so far as a company can be considered to be a person, for a breach of the law which it had committed. It is perhaps a little difficult to put the distinction into a very exact language, but there seems to me to be a difference between a commercial loss in trading and a penalty imposed upon a person or a company for a breach of the law which they committed in that trading."

40. Warrington LJ accepted the expenditure arose out of the trade "because if it had not been that the company were carrying on the trade they would not have had to incur [the] expenditure" but concluded at p.569 that it was:

> "…not a loss connected with or arising out of the trade. It is a sum which the persons conducting the trade have had to pay because in conducting it they have so acted as to render themselves liable to this penalty. It is not a commercial loss, and I think when the Act speaks of a loss connected with or arising out of such trade it means a commercial loss connected with or arising out the trade."

41. Scrutton LJ considered the penalties were not necessary to earn the profits or for the purpose of earning profits "…they were unfortunate incidents which followed after the profits had been earned".

42. In *The Herald Weekly Times Limited v The Federal Commission of Taxation* (1932) 48 CLR 113, the High Court of Australia held that libel damages awarded against the taxpayer newspaper business were deductible. The joint judgment of Gavan Duffy CJ and Dixon J (which formed part of the majority reasoning) rejected the lower court's disallowance of the deduction: that had wrongly disregarded "the purpose of producing income that inspired the publication which had made unavoidable the expenditure". Gavan Duffy CJ and Dixon J explained at p.119:

> "When it appears that the inclusion in the newspaper of matter alleged by claimants to be defamatory is a regular and almost unavoidable incident of publishing it, so that the claims directly flow from acts done for no other

> purpose than earning revenue, acts forming the essence of the business, no valid reason remains for denying that the money was wholly and exclusively expended for the production of assessable income."

43. They distinguished *von Glehn* at p.120 on the basis that:

> "…The penalty is imposed as a punishment of the offender considered as a responsible person owing obedience to the law. Its nature severs it from the expenses of trading. It is inflicted on the offender as a personal deterrent, and it is not incurred by him in his character of trader."

44. *McKnight* concerned a stockbroker, subject to Stock Exchange Council fines, who sought to deduct those fines and the legal expenses incurred in defending the disciplinary proceedings in relation to those fines. The issue was whether the sums were "money, wholly and exclusively laid out or expended for the purposes of the trade" under the predecessor provisions to s54 (then contained in s130(a) of the Income and Corporation Taxes Act 1970 ("**s130(a)**"). At first instance, the Special Commissioner allowed deduction of legal expenses but not the fines. The High Court disallowed both the penalty and legal expenses. The taxpayer did not pursue the non-deduction of the penalty but successfully appealed the issue of the legal expenses to the Court of Appeal. The House of Lords dismissed the appeal. The decision was given in the speech of Lord Hoffmann with which the others agreed.

45. The Revenue advanced two arguments. The first was that taxpayer had an impermissible dual purpose, including protecting his reputation. Lord Hoffmann rejected the argument.

46. The Revenue's second argument was that the words "for the purposes of the trade" in s130(a) meant that there had to be a sufficient connection between the expense and the earning of profits in the trade. The Revenue referred to Lord Sterndale's reasoning in *von Glehn* that the payment of the penalty there was not for the purposes of the trade but was made because of a wrongful act on the part of the company. Lord Hoffmann cast no doubt on the conclusion in *von Glehn* but considered the Court was "curiously inarticulate about why the fine was not money expended for the purposes of the trade". Scrutton LJ's reasoning (that the payments followed after the profits had been earned" was unsatisfactory as it was "only another way of saying [the payments] could not be deducted in the calculation of profits". Noting that the Court of Appeal had accepted that the relevant expense was incurred in the course of the company's trade, Lord Hoffmann explained at p.1337:

> "There must therefore have been something in the nature of the expense which prevented it from being deductible. I think with great respect that the Court of Appeal had difficulty in identifying exactly what this was because they were looking in the wrong place. They hoped to find the answer in the broad general principles of what counts as an allowable deduction. But the reason in my opinion is much more specific and relates to the particular character of a fine or penalty. Its purpose is to punish the taxpayer and a court may easily conclude that the legislative policy would be diluted if the taxpayer were allowed to share the burden with the rest of the community by a deduction for the purposes of tax. This, I think, is what Lord Sterndale M.R. meant when he said that the fine was imposed 'upon the company personally'."

47. Lord Hoffmann continued at p.1338:

> "By parity of reasoning, I think that the Special Commissioner and the Judge were quite right in not allowing the fines to be deducted. It does not follow, however, that the costs were not deductible. Once it is appreciated that, in a case like this, non-deductibility depends upon the nature of the expenditure and the specific policy of the rule under which it became payable, it can be seen that the relevant considerations maybe quite different. This explains the

> divergent answers given by the Courts in the various cases on fines, penalties, damages and costs to which your Lordships were referred. So, for example, in *The Herald and Weekly Times Ltd. v. Federal Commissioner of Taxation* (1932) 48 C.L.R. 113 the High Court of Australia decided that damages for defamation payable by a newspaper company were a deductible expense. This seems to me correct: as Gavan Duffy C.J. and Dixon J. said in their joint judgment, at page 119, such claims against a newspaper are a regular and almost unavoidable incident of publishing it and the damages are compensatory rather than punitive. There would seem no reason of policy why a rule which allows recovery of damages by plaintiffs defamed in the course of carrying on the business should prohibit deduction of those damages as an expense. In *von Glehn*, Scrutton L.J. expressed some anxiety lest the broad principles he thought he was applying should exclude the deductibility of civil damages for negligence. But the relevant principles are in fact a great deal more specific and can accommodate both *von Glehn* and *The Herald and Weekly Times Ltd. v. Federal Commissioner of Taxation* (1932) 48 C.L.R. 113 without inconsistency."

48. Lord Hoffmann went on to note that the assumption in *von Glehn* that legal expenses should be treated in the same way as the penalty was wrong. The issues were different. It would appear unfair not to allow a deduction for legal costs if the taxpayer's defence had succeeded, and it was fundamental that everyone should be entitled to defend themselves. He continued (1338):

> "I do not see that any clear policy would be infringed by allowing the deduction of the legal expenses incurred in resisting the disciplinary proceedings. On the contrary, I think that non-deductibility would be in effect an additional fine or penalty for which the regulatory scheme does not provide."

49. Hence the issue in *McKnight* turned on the interpretation of the words "the purposes of the trade" within s.130(a). *McKnight* shows that payments with the character of fines or penalties are not deductible under that section (or its successors). Lord Hoffmann explained that where a payment has the nature of a fine or penalty 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. It will also be seen that the fact that expenses are incurred in the course of a trade does not preclude a conclusion that they are non-deductible. It does not follow from the fact that they are incurred in the course of the trade that they are "for the purposes of" the trade for the purposes of s.130(a) or its successors. This is shown by Lord Hoffman's endorsement of the result in *von Glehn* where it was acknowledged that the expenses there were incurred in the course of the trade and would not have arisen but for the trade being carried on, but were still non-deductible.

50. As already explained, the taxpayers argued that, whatever was established by *McKnight* could not be an "adjustment required or authorised by law" in calculating profits for corporation tax purposes within the meaning of s46 CTA.

51. We do not accept this description of *McKnight*. We do not think that the House of Lords was seeking to make any adjustment to the principle that profits for corporation tax purposes are calculated under generally accepted accounting practices. The issue in *McKnight* was whether the payment was "for the purposes of the trade" under s130(a), properly construed. Lord Hoffmann, who had great expertise in tax law, would of course have been aware of the long-established principle that the profits of a trade were calculated under ordinary accounting principles. This rule had indeed been referred to by Nourse LJ in the Court of Appeal in *McKnight*, citing *Odeon Associated Theatres Ltd. v. Jones* [1971] 1 WLR 442. Lord

Hoffmann did not take himself to be creating some kind of extra-statutory, judge-made rule of law. He was simply engaged in the orthodox, conventional, task of construing the material part of the statute (s.130(a)) and applying it to the relevant facts. Nor did Lord Hoffmann suggest that this interpretation of s.130(a) involved an exception to the established rule about profits being calculated by reference to accounting principles. The treatment to be given to penalties (as falling outside s.130(a)) is not a matter of calculation; the principle is that payments of penalties are not within s.130(a) at all.

52. We are therefore unable to accept the taxpayers' submission that *McKnight* created a judge-made rule incapable of surviving the CTA (as understood and interpreted in *NCL* at [29]).

53. Mr Goldberg placed weight on the fact that *McKnight* was decided before the enactment of the predecessor to s46. However we agree with Mr Ewart KC for HMRC that the order of events is irrelevant. Lord Hoffmann was not seeking to establish an adjustment to the principles by which profits are calculated (viz., in accordance with generally accepted accounting practices); he was simply construing words in s.130(a) (words which also appear in the relevant successor statutes).

54. More generally we reject Mr Goldberg's arguments that what he called the judge-made rule in *McKnight* was inconsistent with the principles in the Corporation Tax Acts. *McKnight* is a decision about the proper construction of one of the material statutory provisions; and there is no inconsistency between it and what is now s.46 or the other statutory provisions.

55. Mr Goldberg argued that the non-deductibility of the penalties in *McKnight* was *obiter* as the House of Lords' decision only concerned legal expenses and not the penalty. We reject that argument. Lord Hoffmann's earlier discussions of penalties and the relevant policy under which it was imposed were an essential part of the reasoning process by which he reached his ultimate decision. The earlier discussion is therefore part of the *ratio decidendi* of the decision and binding. In any event the House of Lords in *McKnight* held that *von Glehn* was correct, and that decision is also binding on this tribunal.

56. Mr Goldberg further submitted that, even if part of the *ratio*, any principle to be drawn from *McKnight* should be subject to three distinct further limitations, any of which, if applicable, would mean the payments here were fully deductible. He argued that there should be no prohibition on deduction where (i) the expense becomes payable as a regular incident of the trade, (ii) where the payments (however irregular) arise almost unavoidably, or (iii) where the payment is in fact compensatory. In addition, Mr Goldberg argued for a number of further restrictions based on the final three paragraphs of Lord Hoffman's speech. In essence these are that non-deductibility must be fair, and that the rule must be capable of being straightforwardly and consistently applied.

57. We agree with HMRC's submissions that this approach to *McKnight* involves a misunderstanding of what *McKnight* decided. Lord Hoffmann explained that where a payment was in the nature of a penalty it does not fall within s.130(a). When he distinguished expenses such as the payment of defamation claims in *Herald Weekly* as being a "regular and avoidable incident of publishing" and the damages being compensatory rather than punitive, he was drawing a broad distinction between payments which, considered in the round and after a global assessment, were to be characterised as the payment of a penalty and those which were not. Lord Hoffmann emphasised that the relevant principles could accommodate *von Glehn* and *Herald Weekly* (the cases which referred to expenses being the regular incident of trade, payments arising almost unavoidably, and payments being by way of compensation) without inconsistency. As we see it the question is ultimately one of characterisation: is the expense in the nature of a fine or penalty or something else? We do not read Lord Hoffmann

as intending to set up a series of tests of the kind Mr Goldberg argues for. That is to read his general explanation of how the principle can accommodate the different decided cases as if it was a series of statutory requirements or conditions.

58. Lord Hoffmann's discussion in the last part of his speech of fairness, and the straightforward and consistent application of the principles fed into his conclusion that, the same concerns about the dilution of the penal effect, did not apply to the deduction of the legal expenses. In other words they were part of his overall characterisation of the legal expenses as non-penal in nature and were not intended as a list of independent conditions or requirements.

59. Returning to Lord Hoffmann's explanation for the non-deductibility of penalties, we agree with HMRC's submission that the FTT was correct to view the same approach as applying equally to payments in lieu of (i.e. in place of) penalties. We are unable to accept Mr Goldberg's argument in reply that, applying the reasoning in *McKnight* to payments in lieu of penalties represented an extension to the principle. The FTT did not simply say that because the payments were made in lieu of penalties they were themselves penalties, though this was an important step in their analysis. The FTT considered the entire sequence of events, being the opening of the investigations, the negotiations, the settlement agreements and the notices attached to them. They also concluded that, had the taxpayers not agreed to make the payments it is likely that penalties of at least the same amount would have been imposed. We consider that the FTT were entitled on the evidence to conclude that the payments "in the nature of penalties" (this being the way they posed the test in [107]). This was an evaluation reached on the whole of the evidence.

60. The FTT concluded at [139] that the same public policy which denies a deduction for a penalty also denies a deduction for payments which arise from a breach of statutory conditions and which are made in avoiding a larger penalty under the aegis of the body which would have imposed such a penalty. The non-deduction policy inherent in the statutory provision which permits the Authority to punish must also be inherent in the ability of the Authority to extract other payments instead of, or under the threat of imposing, a penalty. We agree with that reasoning.

61. In our view Mr Goldberg's submission, which stressed certain formal features of the payments and the way they were described by the parties, would favour form over substance. The reasoning in *McKnight*, based as it was on the objective of not diluting the relevant rules which led to the payment, applies to all payments with a punitive nature or character. In our view Lord Hoffmann's the reference to the "character" of the payment shows the principle is to be applied by reference to substance rather than form..

62. For similar reasons we reject Mr Goldberg's further submission that a payment can only be said properly to be in lieu of a penalty where a penalty had been formally imposed and then replaced with something else. The FTT Decision found as a fact that if the settlement agreements had not been made, a penalty of at least the same amount would have been imposed. The FTT was entitled in our view to reach this conclusion. In the light of this finding the FTT could accurately describe the payments as being in lieu of penalties.

63. The taxpayers also submitted that, in his discussion of penalties, Lord Hoffmann was seeking to draw a distinction between payments arising from the trader/regulator relationship on the one hand and payments arising from the trader/customer or supplier relationship which were "rooted in the trade," on the other, even if in some cases the latter involved a degree of intervention from the regulator. The taxpayers sought to draw a contrast between, on the one hand, a parking fine, payable for parking in the wrong place (so that the obligation exists independently), and, on the other hand, damages paid to third parties in the course of the trade,

or payments made because customers who have been let down, even if that involved some form of regulatory intervention.

64. We do not accept that this kind of analysis is supported by the reasoning in *McKnight.* That asks the simpler question whether the payment is punitive in nature or character (so that, taking account of the source for the punitive payment, the punitive effect would be diluted by allowing a deduction). The case of *von Glehn* also confirms, as we have noted above, that the fact a payment is incurred in the course of a trade or would not have arisen were it not for the trade does not mean the payment must be deductible. *McKnight* did not cast any doubt on that reasoning.

Did the FTT identify and apply the correct approach?

65. The FTT prefaced the Discussion section of the FTT Decision (at [107]) by:

> "…considering whether any of the Redress Payments were in the nature of penalties intended to punish and non-deductible on the basis of the policy grounds described by Lord Hoffman."

66. The FTT also considered (at [136] to [139]) that payments made in lieu of a penalty were subject to the same public policy concerns regarding deterrence.

67. It follows from our earlier discussion that we are unable to see any error by the FTT in taking this approach. The taxpayer's arguments under Ground 1, that the FTT erred in its approach must accordingly be rejected.

68. The FTT then however drew a distinction between punitive payments and compensatory ones, and proceeded to examine whether each of the payments (considered separately) was compensatory. We consider that that approach was wrong. The focus should have remained on whether overall the payments bore the necessary punitive character. Where (as here) each payment was part of an overall package, it appears to us that the proper approach was to ask whether, on a global assessment of the evidence, the relevant payment has a punitive character. It will of course be relevant in undertaking that assessment to take into account all the circumstances, including the reasons why the payment came to be made (eg whether it was pursuant to a regulatory requirement or investigation or under a judgment in a libel case), the party to whom the payment falls to be made, and the extent to which the payment (in whole or part) in fact operates to compensate victims of the wrong. Those are all elements of the assessment. But once the assessor has reached an overall characterisation of the payments, one should not then go back and consider whether parts of the package can be regarded as being more "compensatory" than "punitive". We revisit this point when considering the taxpayer's third ground (that the FTT erred in only holding the £554k amount paid to affected consumers in relation the mis-selling settlement was compensatory) and HMRC's appeal, which argues that it was not open to the FTT (on its own findings of fact) to find that £554k was anything other than penal.

Ground 2: Challenge to the FTT's application of the reasoning in *McKnight* to the facts

69. Under Ground 2, the taxpayers argued in the alternative that even if *McKnight* was binding so as to require the non-deductibility of penalties or in the nature of penalties, the FTT was wrong to find that test was satisfied on the facts here. We remind ourselves that this tribunal is concerned with appeals of law and not with challenges to the factual conclusions of the FTT.

70. The first reason relied on stems from the fact the only items that were actually charged as penalties were the £1 amounts. The taxpayers argue that where a regulatory regime specifically provides for the imposition of penalties (here the provision under s27A(1) – see

[7] above), but the payments made are not imposed thereunder, and do not satisfy the statutory requirements for penalties, it must follow that such payments cannot be regarded as penalties.

71. This amounts to saying the reasoning in *McKnight* only applies to payments formally designated under the relevant regime as penalties. We have already explained why we reject that argument. We accept that the way in which the action which gave rise to the payment is designated in a regulatory regime will be relevant, but it will not be determinative. We have covered this in [59] to [61] above.

72. The taxpayers' remaining arguments rested on a number of factual findings the FTT made which (so they argue) are inconsistent with the payments having the necessary punitive character, but instead indicate the payments were compensatory and arose out of activities rooted in the taxpayers' trade. In summary these are:

(1) The voluntary nature of the settlement which was negotiated and not imposed. The FTT found the taxpayer "was not compelled to make a settlement agreement" and that it could "in every case have refused to settle and either accepted a penalty or appealed against a penalty imposed by GEMA([35]). The FTT acknowledged (at [131]) that it did not consider the non-compensatory penalties to have been "imposed" and also accepted the agreements were negotiated and agreed ([142]).

(2) The taxpayers took a commercial decision to make redress and obtained value for doing so (avoiding litigation risks, diversion of management time, and adverse publicity yet maintaining goodwill with Ofgem and promoting it with customers ([35]). The redress payments were a commercial quid pro quo (and thus rooted in the trade).

(3) The payments also flowed directly from acts forming the essence of the trade in issue done for the purpose of earning profits. Reliance is placed on ([112], [113] and [119] (see [27] above). We note that the relevant part of the finding at [119] was in response to Mr Goldberg's invitation to find that the disputed redress payments bore the same character as other compensation payments (made in accordance with the taxpayer's complaints procedure, by agreement, and presumably where no challenge had been made to their deductibility). The FTT agreed that such compensation was deductible and that the disputed redress payments were similarly "incurred in the course of activities carried on for the purpose of the trade" (and also for other purposes of the trade: closing down the investigation and avoiding adverse publicity).

(4) Mr Goldberg also relied in his oral submissions on a section of the FTT Decision at [161] to [164]. There the FTT explained how the taxpayers' trade included marketing, billing, and activities to comply with licensing conditions such as CO_2 reduction activities, and went on to conclude that the actions or inactions of the taxpayer which gave rise to the redress payments were "part of the activities undertaken by [the taxpayer] as part of, and for the purposes of, that trade".

(5) The taxpayers highlighted that the payments were similar if not the same as payments of compensation for breach of contract (relying on the FTT findings with which we deal below).

73. Mr Ewart prefaced his response to this ground of appeal by pointing out that the FTT's conclusion that the payments were punitive in character was an evaluative finding of fact. It was enough in defending the ground if HMRC could satisfy us that there was sufficient evidence to enable the FTT (not perversely) to reach the conclusion the payments were in lieu of a penalty.

74. We are not persuaded by the taxpayers' submissions that it was not open to the FTT to find the redress payments were non-deductible as being payments in lieu of a penalty (and therefore having the character of a penalty).

75. As we explain below, the findings relied on do not have the significance the taxpayers suggest. Moreover as HMRC argue, there was sufficient evidence before the FTT to justify the findings the taxpayers now challenge on appeal.

76. It is correct that the settlement agreements were entered into voluntarily, were subject to negotiation and were not imposed or compelled in any formal sense. But taking account of the full negotiations, we consider that the FTT were entitled to conclude that the agreements were entered into under the threat of penalties far greater than £1 and were properly to be characterised as being made in place of or in lieu of penalties.

77. When the FTT acknowledged the penalties were not "imposed" (at [110]) it went on in the same sentence to say:

> "[the appellants] agreed to [Ofgem's] terms in the expectation that if they did not a penalty greater than £1 would be imposed."

78. The FTT also found that:

> "137… in each case had a payment not been agreed it is likely that even after any appeal, a penalty of the same order of magnitude as the settlement amount would have been borne because it seems unlikely, in view of Ofgem's attitude and the way the witnesses described SPERL's aims in settlement, that SPERL would have settled if it had been given robust advice that only a very much smaller sum would have been successfully imposed.
>
> 138. In this sense we regard the settlements to have been made in place of what might have been imposed and so to have avoided a penalty larger than £1."

79. The FTT thus concluded on the balance of probabilities that by reaching the settlement the taxpayer had avoided an equal or larger penalty. In his oral submissions Mr Goldberg suggested the taxpayers would not have agreed to pay an £18m penalty, that they would have fought the case and probably won. That uncertainty, he submitted, meant one could not say the payments were in lieu of the penalty. However the FTT addressed this issue: it specifically noted earlier in [137] the possibility that a penalty "would be subject to appeal and could end up being lower". The FTT in essence considered that, given the evidence it received from the respective parties, the taxpayers would not have entered into the settlement agreement for the amounts if the taxpayers had thought the amount Ofgem could achieve in a successful penalty was smaller. In our view that was a conclusion it was entitled to reach.

80. In relation to the findings that the taxpayers had commercial reasons to settle, none of these points detract from the conclusion of the FTT that the payments were made in order to avoid the threatened penalty.

81. Mr Goldberg submitted that the payment of the sums flowed from activities "rooted in the trade". In our view this submission also does not advance the analysis. As already mentioned, the authorities (*von Glehn* and its endorsement in *McKnight*) show that the fact that payments arise from the trade, in the sense that they would not have arisen otherwise than by reason of the trading activities of the taxpayer, does not preclude a finding that a payment has a punitive character. So none of the findings relied on which accept the taxpayer's acts or omissions which gave rise to the redress payments were part of the trade's activity and were done for the purposes of earning income in the trade compel a conclusion that the payments were not penalties.

82. Although we note that the FTT was invited to make a finding that "the Redress Payments were made wholly and exclusively for the purpose of [Scottish Power's] trade" it should be noted that the finding the FTT actually made at [113], was expressed in terms of "the actions which gave rise to the payments were wholly and exclusively for the trade" (emphasis added). The finding was also specifically qualified as applying only if the redress payments were not penalties. This finding, along with the others, (and of course the FTT's conclusion at [172] that the deduction of the payments would not be precluded by s54 (because of the "wholly and exclusively requirement")) were made on the hypothetical basis the payments were not penalties. They are not findings which apply outside that hypothetical context to assist in determining whether the payment was in the nature of a penalty - the very issue on which the hypothesis is based. (To the extent the findings were made in respect of the £554k payment which the FTT considered was not in the nature of penalty, the findings were not hypothetical but we will address that when we deal with HMRC's appeal).

83. As regards the similarity of the payments to damages for breach of contract, the FTT's findings present a mixed picture. The FTT accepted at [116] that some conditions in the SLCs and complaints handling rules could have been part of the terms of the contracts with consumers (and in his oral submissions Mr Goldberg gave examples of timely billing as an implied term). However the FTT was clear that not all (such as the CO_2 requirement and record-keeping to show costs reflectivity) would "be suitable for inclusion". Ultimately the question of whether the requirements which Ofgem considered were breaches were or could have been incorporated into the contracts and thereby have given rise to contractual damages if breached could not determine or govern the question of whether the redress payments were in the nature of a penalty. That required an overall assessment. It is plain that Ofgem, unsurprisingly as a regulator operating with a statutory remit, was concerned with regulatory breaches. Even if there was an overlap between the regulatory obligation and the terms of the contract, (or even tortious claims, for instance in respect of misleading behaviour) there was nothing in any of the settlement agreements and surrounding terms to suggest concerns regarding breach of contractual obligations or duties arising in tort, featured in the make-up of the redress payments sought. In the communications between the parties the entire discussion was about regulatory breaches. Again there is nothing in the FTT findings relied on by the taxpayer which would compel a finding that the relevant payments were not penalties.

84. We agree with the submissions of HMRC that, on the contrary, there was sufficient support in the evidence before the FTT to enable it to find that the payments had the character of penalties. In addition to the findings already mentioned above, the documentary evidence included the following:

(1) When Ofgem wrote to the taxpayer to inform it of the settlement committee's authorisation of one of the settlements (complaint-handling) it set out that the committee had agreed "that a penalty figure of £23 million before any penalty discount is appropriate". The letter went on to outline the early settlement windows and discounts, with the greatest discounts for the earliest window being a penalty of £18m and continues:

> "At this stage of the settlement process, we would be prepared to consider ScottishPower making redress payments to the value of £18 million (minus a £1 financial penalty … in lieu of a full £18 million financial penalty."

(2) The final notice in relation to that complaints-handing settlement also explicitly referred to the payments being in lieu of a penalty (see [20] above)

(3) The press release referred to the £18m sending out a "strong message to all energy companies about the importance of treating customers well at all times…" which spoke to deterrence.

(4) An internal memo in relation to the taxpayer board's approval of the settlement referred to a resolution being passed approving "a fine of £2.4 million or that sum made up of a nominal fine plus consumer redress in lieu of a penalty".

85. In our view it was open to the FTT to consider that this evidence, in relation to two of the investigations, illustrated a more general point regarding the relationship between the payments and the avoidance of an equal or larger penalty that would apply as much to the other settlements.

86. We are also not persuaded that any of the additional points Mr Goldberg raised show the FTT was wrong to hold that the majority of the payments were in the nature of penalties:

(1) He submitted that the public policy concern about the dilution of the deterrent effect of the regulatory rules and regime did not arise where the payments were directed to consumers: if there was no deduction then the cost of that would ultimately fall on the consumer. Mr Goldberg accepted however that there was no suggestion in the evidence here that the amounts involved and the state of the taxpayers' finances were such that the taxpayers would need to pass on the cost in that way.

(2) He also submitted there was no difference between the sort of consumer redress agreed as part of the settlement and the new scheme of consumer redress under s27G (see [9] above). (None of the payments used that power although it had come into force after the first of the four sets of payments). This submission was in response to Mr Ewart's explanation of HMRC's position that although Ofgem used the term consumer redress in relation to the payments, that usage did not refer to the consumer redress orders envisaged under s27G; and that HMRC did not say that all payments pursuant to consumer redress orders under s27G would always be non-deductible. The deductibility of payments under s27G is not before us. But the fact that such a regime has existed for some time does not appear to us to have any bearing on the approach taken by the FTT in this case. It rightly considered what actually happened and not what the position might have been had a different approach been followed.

(3) Consumer redress, this time in the field of banking regulation, was also the subject of another submission. Mr Goldberg referred us to s133A CTA which introduced a specific prohibition on the deduction of banking consumer redress payments, the implication of this being that they would otherwise be considered deductible. We are unable to draw any interpretative assistance from this provision. The deductibility of redress payments does not inevitably follow from their regulatory categorisation as such. The enactment of s133A does not preclude the possibility that such payments, depending on the circumstances in which they were paid, might have been non-deductible under the approach of *McKnight* anyway.

Ground 3: FTT erred in holding that only the £554k paid to affected consumers was compensatory and therefore deductible

87. Under this ground the taxpayers point out the £554k payment was held to be deductible as the payment was akin to damages for breach of a tortious obligation not to mislead and was calculated to make good the loss the customer suffered. The taxpayers argued that on the FTT's own reasoning the £14,709,208 paid pursuant to the complaints handing settlement, ought also to have been found by the FTT to be deductible compensation. It too was paid to customers directly affected by the breaches. A sum could still be compensation even if round

figures were used (here that was £73 for each of the 201,496 affected customers). That made sense where, as here, there was a large pool of affected customers and the harm suffered was small. The parties had also specifically referred to the "compensation of up to £15m" going to affected customers in the settlement agreement. As regards the other redress payments, the taxpayers argued that the FTT adopted too narrow a view of compensation. These payments were also compensatory in that they "made good" harm. The harm was done in the course of the trade, rooting the payment in the trade and making it deductible. Where it was impossible to identify and locate all affected customers it was reasonable to agree an overall compensation figure and then pay some of that either to vulnerable customers or to charities benefitting energy consumers generally. HMRC maintain the FTT was correct to conclude that only the £554k was compensatory (subject to the cross-appeal: see below).

88. We have explained above that when reaching a view about the deductibility of expenses a global assessment must be undertaken. Part of the characterisation process requires the tribunal to assess whether payments are properly to be regarded as being in the nature of penalties. No doubt one feature of the evaluation will be whether the payment can be regarded as compensatory rather than penal. However a payment may have some features of compensation (for instance, it is to be paid to identified consumers for identifiable shortcomings, which would amount to torts or breaches of contract) but may still, overall, be properly characterised as punitive because it has been imposed for regulatory breaches (which happen also to be tortious or contractual ones) and has been imposed by action of the regulator – or indeed by a court. An example might be a criminal compensation order, which is both compensatory and punitive.

89. It follows that, in our view, the FTT erred in seeing the compensatory features of certain selected payments as determinative. We also consider the FTT was wrong to regard these payments as akin to damages for tortious misrepresentation and therefore deductible. On its own findings, it appears to us that they were in fact required to be paid (as part of overall packages) for breaches of regulatory obligations. As we have said, the overall question is not whether there are some features which are consistent with the payments having a compensatory function; it is whether the payments (even assuming some compensatory element) fall under the punitive characterisation found in *von Glehn* and *McKnight*. For reasons we have given we consider that the FTT was entitled to reach its overall conclusion that the payments (which were part of wider package deals) had the character of penalties so that their deductibility would dilute the statutory purposes of the regulatory regime.

90. Even if we are wrong about this approach, we would not have been persuaded in any case, that there was any error in the FTT finding the other payments were not compensatory.

91. There was nothing in the findings to suggest these had been calculated by reference to customer loss even in the case of the £14,709,208 payment. That payment was part of the £18m (less £1) which the penalty notice described the taxpayer as having agreed to pay in lieu of a higher penalty. The sum allocated to affected customers could not exceed £15m (it was stipulated that not less than £3m had to be paid to an agreed charity or cause) and had to result in a payment of between no more than £150 and no less than £50. The regulatory contraventions included late and inaccurate billing, inadequate complaints handling and poor implementation of Energy Ombudsman remedies. However the payments went to "Qualifying Customers" a designated subset of those affected ("Priority Services Register" and "Warm Homes Discount" customers who were due a bill more than 6 weeks overdue in a specified period or who made a complaint about the taxpayer's migration to a new IT system in a specified period). The agreement explained that as at the date of the agreement there were expected to be 100,000 Qualifying Customers giving an average payment of £150 each. The higher eventual number (201,496) meant the payment ended up at £73 per customer.

92. The £73 payments totalling £14,709,208 were therefore part of a £15m sum, itself part of a global £18m sum that was expressed to be in lieu of a penalty payment. The sums did not go to all the customers affected by the breaches. The Qualifying Customers who received the payment did so without having to show any loss (e.g. in the case of late billing that they could have requested a credit balance sooner, or switched to a cheaper provider, or regarding inadequate complaint handling how that then manifested in a loss).

93. Although the relevant settlement agreement described the payments as "compensation totalling up to £15 million to Qualifying Customers" it was open to the FTT, taking account of the circumstances in which the payments were calculated and made, to not regard the payments as compensatory. The payments were paid to some affected customers in recognition of the regulatory breaches but they did not purport to calculate the loss or harm suffered as a result of the breaches.

94. In relation to other payments (£7.3m to vulnerable customers identified under the Warm Homes Scheme, and the various sums paid to charities and a public awareness campaign), in our view it was again open to the FTT to find that they were not compensatory. It was accepted that those payments went to customers, or through charities, resulted in benefits to customers or other consumers more generally, who did not suffer losses as a result of the breaches. Nor were there any findings to suggest that those payment amounts, despite not being directed to those who had suffered particular loss , had been calculated by reference to particular harm suffered arising out of the regulatory breaches.

HMRC'S APPEAL

95. HMRC's cross-appeal does not dispute the FTT's finding the £554k was in a sense compensatory. HMRC argues however that the FTT erred in law in respect of its holding that £554,013 was deductible. The only proper conclusion, HMRC submit, was that the payment was part of a package that was penal in nature and therefore deductible under the principles in *McKnight*. The documents leading to the settlement show Ofgem worked out a total sum of penalty; the manner that was to be met (after application of the early settlement discount) was through a series of negotiated payments.

96. HMRC's grounds of appeal included the further argument that even if the payment was not penal, that it was not paid wholly and exclusively for the purposes of the taxpayer's trade. In their skeleton HMRC confirmed they no longer ran that argument but reserved the right to take the point if an appeal went further to the Supreme Court.

97. In his oral submissions Mr Ewart argued that the correct approach, which the FTT should have adopted, was to look at the nature of the package of payments as a whole. In particular the £554k payment was not in any real sense additional to the other payments but was part of a global payment of £8.5m that was in lieu of a penalty.

98. The £554k payment arose as follows. It was part of a £1m component within Scottish Power's agreement to pay £8.5m to consumers. The other component was £7.5m which was meant to go to vulnerable customers (identified through the Warm Homes Scheme) who received a round sum amount (that had to be at least £50 and turned out to be £52) . The amount actually paid was £7,316,365; not all recipients cashed their cheques and that balance £183,615 was paid to a consumer energy charity (SPET). The £1m of which the £554k was part was set aside to fund compensation to consumers affected by the mis-selling but in the event it appears not all of those customers could be identified (or had cashed their cheques). Thus the balance of £445,987 was paid to the charity SPET.

99. We agree with the submissions of Mr Ewart. The facts indicate the £554k payment was clearly part of a package of payments. It was negotiated as part of an overall deal. An overall sum of £8.5m was carved into smaller amounts and they were the subject of negotiation. But the overall deal was that the taxpayer would have to pay £8.5m. The full package had, in line with the FTT's findings in relation to the other payments, been put together under the threat of penalty and was (just as much as the other parts of the package) paid in lieu of a penalty - in the sense that it was arrived at under the regulatory auspices and would have been imposed if the deal was not done.

100. In reply Mr Goldberg said that raised the question which was the tail and which the dog. By that we understood him to mean the balance of the payments should bear the character of the £554k. But, in light of the other findings of the FTT, that would indeed in our view be a clear case of the tail wagging the dog. He also submitted it was odd to have a rule that required one to apply the same purpose to everything. However that does not reflect the proposition here. The caselaw shows that one has to characterise the payments in the light of all the evidence. If the facts are such that the payments were comprised within a wider package, as they were here, then that is just as much part of the payment's character and falls to be evaluated as such. Having reached the views that it did about the package, in our view it was wrong for the FTT then to distinguish parts of the package on the basis that they had some of the characteristics of compensation.

101. We therefore agree that the FTT's conclusion that the £554k payment was deductible was an error of law. We set aside the FTT's decision and remake it so as to conclude that the £554k, as with all the other payments was a payment that had the character of a penalty and was non-deductible.

CONCLUSION

102. The taxpayers' appeals are dismissed. HMRC's appeal in relation to the £554k payment is allowed and the FTT Decision is remade as set out above so as to render that payment non-deductible.

MR JUSTICE MILES
JUDGE SWAMI RAGHAVAN

Release date: 05 September 2023