TAXATION OF DAMAGES, COSTS AND INTEREST (1)[1]

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VAT position on damages and interest

VAT is a tax on transactions which constitute economic activities (Articles 4 and 6, Sixth Directive[2]). The tax applies to supplies of goods or supplies of services. The liability to pay VAT is imposed on the *supplier*. The amount of the VAT is calculated by reference to the consideration for the supply. The "consideration" is everything obtained by the supplier for the supply (Article 11, Sixth Directive); consideration is obtained for a supply if there is a direct link between the two. In many commercial transactions, the agreed consideration is a certain sum "plus VAT"; or it may be agreed that the specified price is "exclusive of VAT" which amounts to the same thing. That means that, if the supply is a standard-rated supply, the contractual consideration actually agreed to be paid between the parties is 117.5% of the sum stipulated (*Hostgilt v. Megahart* [1999] STC 141). In such a case, the statutory obligation to account to Customs & Excise for the VAT of course remains with the supplier. If the contract is silent as to VAT (and if there is no implied term and no relevant custom and practice in the particular business sector concerned), or if there is no contract, then the price paid is inclusive of VAT; and it will be the obligation of the recipient of the consideration to account to C&E for VAT. It can be seen that if the parties to litigation fail to take VAT into account, the burden of the VAT due on a sum representing damages or other fruits of the litigation is likely to fall on the recipient.

Where litigation relates to a commercial transaction, there are essentially two types of claim for the purposes of analysing the VAT position. The first type is a claim for unpaid contractual sums (or a claim for payment on a *quantum meruit* basis) for a transaction which *has* taken place. (A particular example might be a claim in a professional negligence matter; negligence is often raised as a defence and counter-claim to a claim for unpaid fees.) The second type is a claim for compensation in relation to a transaction which *did not* take place. A similar distinction is made in Customs & Excise' Press Notice 82/87 concerning the settlement of disputes.

In the first type of case, any sums recovered in the litigation are fundamentally "consideration obtained by the supplier" for the supply previously made, and are therefore subject to VAT. There may be difficult issues as to the timing of the VAT charge, in particular in the case of a supply of professional services which is a continuous supply over a long period. Substantial technical difficulties can arise where the supplier has ceased trading before the litigation is resolved, or where more than three years have elapsed (see below). In the specific example of a professional negligence matter raised as a defence to a claim for unpaid fees, the fact that damages for negligence may be set off against the fees due does not affect the position that VAT will be due on the fees, since a service was in fact supplied (this is the case even where the fees are reduced to nil and a payment of damages is made, since even there the fees invoiced have produced some benefit for the negligent party namely to reduce the damages that would otherwise have been due). In some cases, however, it may be in dispute whether any service was in fact supplied, and if there was none then no VAT will be due. In the second type of case, because there was no underlying transaction, the compensation received is not subject to VAT: VAT applies only in relation to a supply of goods or a supply of services. Of course in some cases it may be in dispute whether a service was provided or not, in which case the VAT treatment of any damages will be extremely dependent on the precise outcome of the litigation.

The VAT system as implemented in the United Kingdom is subject to a general three-year time limit that is, claims for repayments of tax cannot be accepted more than three years after the end of the relevant VAT accounting period (see, however, *Marks and Spencer plc v. C&E Comrs* (Case C-62/00) [2002] STC 1036, ECJ in respect of retrospective application of that three year time limit). On the other hand, Customs & Excise do not normally have power to assess a taxpayer to unpaid VAT more than three years after the end of the accounting period. It can be the case that litigation is resolved more than three years after the event, in which case it may not be possible to make any adjustment to the parties' VAT position.

Interest on damages (either assessed interest included in a judgment award, or interest on a judgment debt) normally falls to be disregarded for VAT purposes (except, of course, where the underlying transaction was a loan or other provision of financial services). In *B A Z Bausystem AG v. Finanzamt München für Körperschaften* [1982] 3 CMLR 688, ECJ, Bausystem had sued a customer for payment for a supply of services, and had obtained judgment from the German court for a sum plus interest of 5%. The German revenue authorities sought VAT on the judgment sum and additionally on the interest. The ECJ concluded -

> Interest of the kind with which the present case is concerned has no connection with the supply or the receipt of the supply and does not constitute value in return for a commercial transaction. It is, rather, a mere reimbursement of expenses, in other words, an indemnity due because of lateness in payment.

VAT position on costs

Each party to litigation receives a supply of legal services from its lawyers. (Most minor disbursements would be regarded for VAT purposes as incidental to the principal supply of legal services, and thus disbursements normally receive no special VAT treatment.) Assuming that the lawyers' principal place of business is in the United Kingdom, or at least that the lawyers conduct this aspect of their business from a fixed establishment in the UK, then the VAT treatment of the supply of legal services is as follows. If the client belongs in the United Kingdom VAT is chargeable in the United Kingdom. If, however, the client belongs outside the European Community no VAT is due, since it is not a UK supply. But if the client belongs in another EC member state, VAT is chargeable in the United Kingdom *unless* the client receives the supply for the purposes of a business carried on by him in that other member state. (Note that being a shareholder, or a holding company which merely passively holds shares in its subsidiaries, is not a "business" for VAT purposes[3].) "Belongs" here is to be interpreted according to s.9 Value Added Tax Act 1999. Essentially, in the case of a business, the test has regard to the business establishment or fixed establishment (including a branch or agency) most directly concerned with the supply. In the case of an individual who is not in business (or where the legal services do not relate to his business), he belongs where he has his usual place of residence.

Where Counsel is involved, it is a moot point whether, for VAT purposes, Counsel makes a supply of services to the professional client or to the lay client. The answer usually depends on whether the payment for Counsel's services is made out of the solicitor's office account (in which case it is probably a supply to the solicitor) or out of the client account as a disbursement (in which case it is probably a supply to the client). If the professional client is in the United Kingdom but the lay client is overseas, this will affect whether or not VAT is due on Counsel's fees.

Where VAT is due on legal fees, a party to litigation which is in business and is VAT registered may well be entitled to recover that VAT as "input tax", assuming that the litigation relates to a business matter. (The normal mechanism for recovery is that input tax recoverable is deducted from output tax due, and only the difference is payable to Customs for each VAT accounting period. In some periods a person's input tax may exceed the output tax, in which case a net payment will be due from Customs to the taxpayer.) A notable exception is where the party makes exempt supplies, in which case he is an exempt trader or a partially exempt trader, and input tax will be irrecoverable or partially irrecoverable depending on the extent to which it is attributable to the exempt supplies. Common examples of traders making exempt supplies include: insurance companies, banks, stockbrokers, bookmakers, schools and universities, hospitals, doctors, dentists, nurses, opticians and other providers of health services, some landlords, and persons providing sporting or cultural services of various kinds.

A typical outcome of litigation is that the successful party receives a contribution towards its costs from the other party. For VAT purposes, the payment of costs is a "mere reimbursement of expenses" (*B A Z Bausystem AG v. Finanzamt München für Körperschaften*, supra[4]). Thus the VAT position of the successful party is essentially unaffected by that receipt: the successful party will still have received legal services from its lawyers, and may have a right to recover the VAT input tax shown on its lawyers' invoices, subject to the usual conditions as indicated above, despite that fact that it has received a contribution towards that cost from the other party. Accordingly, if the successful party to litigation is a person who is entitled to recover input tax on his business inputs on the principles set out above, then the award of costs should be calculated on a net of VAT basis. If the successful party is not entitled to recover input tax (in particular, in the case of a private individual), then the award of costs should be calculated to include VAT. If the successful party is entitled to partial recovery of input tax then it seems fair that the award of costs should be calculated to include part of the VAT, although I am not aware of any authority for this view. The unsuccessful party paying the costs will not have a right to recover input tax on those costs, despite making a payment of an amount which includes VAT. This is simply because the supply of legal services in question was not a supply made to the unsuccessful party. A person cannot recover input tax for supplies received by some other person.

Interest

A receipt of interest will be subject to income tax or corporation tax under Schedule D Case III. (That relates to income with a source in the United Kingdom; different provisions may apply for foreign source income. For the source of the income in the case of a payment of interest, see *National Bank of Greece SA v. Westminster Bank* [1971] AC 945.) If the payer of 'yearly interest' is a company (except in the case of payments to a UK resident company) or local authority, or if the payee is resident outside the United Kingdom, then the interest must be paid net of tax: tax must be deducted in accordance with s.349 ICTA 1988. (There are certain exceptions, in particular in the case of interest paid by banks in various circumstances: see s.349(3) ICTA 1988.)

The interest assessed and included in a judgment award (i.e., pursuant to the Court's jurisdiction under s.35A Supreme Court Act 1981) may or may not be regarded as a payment of interest for tax purposes. Normally, and in particular in a case where a sum was due to be paid by the defendant to the claimant at some earlier date (whether contractually or otherwise), the interest element of the judgment will represent "interest" for tax purposes with consequences for the recipient under Schedule D Case III and also consequences for the payer if s.349 ICTA 1988 applies (*Westminster Bank Ltd v. Riches* (1947) 28 TC 159, HL). Occasionally the 'interest' included in an award of damages is simply a means of calculating the present day value of some earlier loss or damage, for example in the case of damage to a capital asset (*Glenboig Union Fireclay Co Ltd v. CIR* 12 TC 427). The distinctions can be subtle, while the consequences of overlooking the application of s.349 ICTA 1988 can be severe, since the payer of interest may find itself liable to account to the Inland Revenue for tax on the interest, while unable to recover an equivalent sum from the amount already paid to the payee.

Interest on a judgment debt (Judgments Act 1838, s.17) is interest for tax purposes (and thus subject to tax under Schedule D Case III). It is not, however, considered to be "yearly interest" for the purposes of s.349 ICTA 1988: *Re: Cooper* [1911] 2 KB 550. Interest on an arbitration award, which is equivalent to interest on a judgment debt and payable under section 20 Arbitration Act 1950, is similarly treated as not subject to s.349 ICTA 1988 (although the Revenue have not published their views on this, they have been prepared to confirm this view in writing in some cases).

Capital gains tax position when the ownership of an asset is in question

The beneficial ownership of an asset may be in dispute in many types of action. Obvious examples include trust matters (in particular where there is a constructive trust claim or a tracing claim), fraud cases (*A-G for Hong Kong v. Reid* [1994] AC 327), claims to have an equitable interest in property, disputes over title to property, many types of company law claims (for example, securities might not have been validly issued), and voidable transactions (including insolvency cases). Actions of this kind often result in a declaration that an asset or a certain share of an asset belongs to one party or the other, or that a prior transfer of assets was void. By their very nature, proceedings of this kind often concern capital assets[5]. Such cases can produce very difficult CGT[6] questions, such as:-

(a) Has the successful party to the litigation had the same beneficial interest in the asset all along, or has the beneficial interest been acquired at some point?

(b) What is the acquisition cost of the asset, for the purposes of applying CGT to an eventual disposal by the successful party?

(c) Does the order of the Court (or the agreement whereby the proceedings are settled) result in a disposal of the asset (or a share in it) by the unsuccessful party and an acquisition of it by the successful party?

(d) Where there is a disposal, what is the consideration for that disposal, and does the market value rule apply? (s.17 of the Taxation of Chargeable Gains Act 1992 ("TCGA 1992"))

The answers to these questions will, of course, depend on the precise circumstances.

Void and voidable transactions

At one extreme, a transaction which the Court finds to have been void will clearly have had no CGT effects. In that case, the unsuccessful party will not be making a CGT disposal of an asset as a result of the order of the Court since (as the Court will have found) he never owned that asset anyway. It is less clear what the CGT treatment of a voidable transaction should be. Such a transaction does have legal effect unless and until avoided by the order of the Court on the application of an interested party. But the effect of the order of the Court avoiding the transaction is to deem the transaction to have been void *ab initio*, and in that case the same tax consequences would follow as if the transaction had been void. Where the parties settle the litigation without an order of the Court avoiding the transaction, the position may be different: in that case, the original transaction would not seem to have been avoided and thus it may have tax effects, even though the parties to the litigation (presumably the Inland Revenue is not a party) may have reached a position between themselves which is as if the transaction had been avoided. Some voidable transactions may be subsequently ratified, in which case all parties will certainly be treated for CGT purposes as if the transactions had been valid from the start.

Mortgaged property and sale by mortgagee

Mortgaged property is considered to belong to the mortgagor for CGT purposes, irrespective of the form of the mortgage or charge (s.26 TCGA 1992). If the mortgagee enforces the security and sells the asset, that is considered to be a sale by the mortgagor for CGT purposes and so it may give rise to CGT for the mortgagor even though it is an involuntary transaction.

Bare trusts, constructive trusts, co-ownership, disputed ownership

Capital gains tax disregards bare trusts and other trusts where the beneficial owner is absolutely beneficially entitled: in such cases, the beneficial owner is considered to be the owner of the asset for CGT purposes (s.60(1) TCGA 1992). In the case of an asset held for persons as beneficial tenants in common, CGT applies as if each beneficial owner were the absolute owner of an asset consisting of a corresponding share in the actual asset. This treatment will apply in any situation where one or more beneficial owners have the absolute right to direct the trustees how to deal with the asset (*Saunders v. Vautier*; s.60(2) TCGA 1992). Section 60(2) TCGA 1992 provides:

> It is hereby declared that references in this Act to any asset held by a person as trustee for another person absolutely entitled as against the trustee are references to a case where that other person has the exclusive right, subject only to satisfying any outstanding charge, lien or other right of the trustees to resort to the asset for payment of duty, taxes, costs or other outgoings, to direct how that asset shall be dealt with.

It seems likely that the word "trustee", in section 60, includes any kind of trustee and thus that it includes a constructive trustee. In the case of a declaration by the Court that a person has been trustee or constructive trustee of an asset at all times since its acquisition by that person, then there is no CGT disposal of that asset as a side-effect of the litigation: the true owner of the asset is considered to have acquired the asset at the time, and for the same consideration, as the trustee originally acquired it.

In some cases the claimant's interest in an asset may have been acquired at a later time than the asset was originally acquired, or gradually over a long period. This would include the gradual acquisition of a beneficial interest in a house by a co-habitee (*Lloyds Bank v*

Rossett [1991] 1 AC 107): that must be considered to be, for CGT purposes, a series of transfers of small shares in the asset from one co-habitee to the other. In some cases the consideration given would be consideration in kind, as opposed to financial, which can sometimes give rise to the difficult problem of how to value that consideration. But in many cases the market value rule will apply (s.17 TCGA 1992): a transfer between connected persons or otherwise not at arm's length is treated as taking place at market value. Transfers of an asset or a share of an asset between husband and wife are deemed always to take place on a no-gain, no-loss basis (s.58 TCGA 1992), that is to say the transferee's acquisition cost will be equal to a corresponding share of the transferor's acquisition cost.

The important point is that where the order of the Court is declaratory, that is to say it establishes what the true position has always been, then the CGT position of the parties will reflect the past history of ownership of the asset as it has been found to be by the Court. In other cases, the order of the Court may be more than declaratory: the Court may order a transfer of assets from one party to another which results in a position different from the *status quo ante*. That will amount to a CGT disposal by the transferring party. For example, where the ownership of two assets is in dispute, one asset may be transferred to one party and one asset to the other party. For CGT purposes, that would amount to a disposal by each party of a one-half share in the asset not retained, if the *status quo ante* was that each held a one-half share in each asset. The position would be similar where a partnership is dissolved and the partnership assets are partitioned between the partners (s.59 TCGA 1992 and Revenue Statement of Practice D12 provide for each partner to be treated, for CGT purposes, as if he owned a share in each partnership asset corresponding to his share of capital surplus on a dissolution of the partnership).

In some situations it can be extremely difficult to determine the consideration for the CGT disposal and acquisition of the asset (or share in the asset). If the transferee is ordered to give up an interest in other property in exchange for the property acquired, then the value of that other property will dictate the consideration. If there is no clear exchange of property then it may be necessary to value the rights that the transferee had against the transferor prior to the litigation. It may be suggested that the market value rule (s.17 TCGA 1992) should apply, on the basis that it is not a transaction at arm’s length: on the other hand, it could be argued that any transaction resulting from the order of the Court in hostile litigation is by its very nature an arm’s length transaction.

Specific performance

One feature of the CGT system that can occasionally cause problems in practice is that the date of a disposal, for CGT purposes, is the date of exchange of contracts. (This assumes that the contract is unconditional. In the case of a conditional contract, the disposal date is the date when the condition is satisfied and the contract becomes unconditional (s.28(2) TCGA

1992) and similarly in the case of an option to dispose of and acquire an asset, the disposal date is the date when the option is exercised (s.144 TCGA 1992).) Thus, between contract and completion the purchaser of the asset is considered to be the owner of that asset for CGT purposes. If the purchaser needs to go to the Court to obtain specific performance, that will not affect the CGT treatment: even though completion may be considerably delayed after the time specified in the contract, the purchaser is considered to have acquired the asset at the time of the contract. If an action for specific performance is unsuccessful, however (for example because in the interim the vendor has sold the asset to a bona fide purchaser without notice) then clearly the CGT treatment will not be as if the asset has been acquired, since the asset in question has in fact not been acquired: s.28 TCGA 1992 applies only to determine the time of acquisition where an asset is indeed acquired. Instead, the purchaser is considered to have acquired an asset consisting of the right to obtain the property (see also *Marren v Ingles*), and to have disposed of that asset for consideration equal to any deposit forfeited and any damages awarded by the Court (s.144(7) TCGA 1992). Thus, a forfeited deposit is always[7] subject to CGT; the costs of entering into the contract and the irrecoverable costs of any legal proceedings may be brought into account as part of the acquisition cost.

Income tax treatment of transactions set aside and constructive trusts

Income tax (and the equivalent for companies, corporation tax) will in general apply by reference to the state of affairs following the Court's decision in civil litigation. At its most basic level, this is because the tax applies by reference to a person's income or profits, and those may be adjusted as a result of the Court's decision. In *Spence v. IRC* (1941) 24 TC 311, the House of Lords had set aside a sale of shares induced by fraudulent misrepresentation, and ordered the defendant to account to the plaintiff for the dividends he had received between the sale and the decision of the House of Lords. The Revenue repaid to the defendant the tax on those dividends. The Revenue sought to recover tax on the dividends from the plaintiff. The Court of Session (Inner House) dismissed the plaintiff's appeal against the tax assessment, saying: "From the date the contract was reduced [i.e., set aside], Mr Spence fell to be treated as having been throughout the proprietor of the shares and equally the person properly entitled to receive the dividends." *Spence* is to be distinguished from *Morley-Clarke v. Jones* [1986] Ch 311, where the Court varied an earlier order for maintenance payable to a wife so that the maintenance was payable directly to the child, with retrospective effect. In the latter case, Oliver LJ said -

> A retrospective order cannot, any more than a retrospective agreement, undo the past and convert something that has already happened, and to which legal consequences have already attached, into something else which never in fact did happen. … In Spence the restitutio in integrum represented by the court order obtained some years later did not so much reconstruct history as recognise and declare that which had all along been the legal position, although

> until the order the parties were in a state of some uncertainty as to what their rights were.

In a case where the Court finds that certain assets were received subject to a constructive trust in favour of some other party, the assets would not normally be regarded as "received" for tax purposes — and in the case of a payment of money, that would not normally be regarded for tax purposes as a payment to the constructive trustee. See, for example, *Hillsdown Holdings plc v. IRC* [1999] STC 561 where a pension fund, believing it was in surplus, paid the surplus to the employer. It later turned out that there was no surplus and therefore that the payment to the employer was in breach of the terms of the pension fund trust deed; accordingly, the employer held the payment on constructive trust for the fund. Arden J held that in those circumstances there was no payment out of the fund to the employer, for the purposes of s.601 Income and Corporation Taxes Act 1988 ("ICTA 1988") which imposes a charge to tax on such payments. Contrast *Venables v. Hornby* [2002] STC 1248, CA; [2002] EWCA Civ 1277[8], where a payment made to a member of the pension scheme in breach of trust was regarded as a payment for the purposes of s.600 ICTA 1988 which imposes a charge to tax on unauthorised payments to scheme members — even though there the scheme member to whom the payment was made was in fact an express trustee of the scheme.

Does it make a difference to the tax or VAT treatment if a claim is settled?

As has been seen above, the capital gains tax, income tax and VAT treatment, in general, reflects the transactions which have occurred, the income which has been received, and the supplies which have been made, in the case of all three taxes having regard to the proper legal analysis of what has taken place. In a normal case, although the existence of the claim may make it uncertain for a while what has in fact taken place, that uncertainty will be resolved by the decision of the Court, and the tax consequences will follow. Where a claim is settled, the uncertainty as to the correct legal analysis of the transactions which have taken place may remain unresolved. This will be the case in particular where a settlement is reached without any admission of liability. In that case, although the parties might not be agreed about the correct analysis of what has happened, each party must still assess its own tax treatment by reference to what is believed to have happened. A party's tax advisers may be called upon effectively to decide the issues raised in the litigation, merely so that the party's self-assessment tax return may be completed correctly. Counsel's Opinion as to the correct analysis of the situation in dispute may be very important here. In most cases (if the tax return is examined at all) it is likely that the Revenue will accept the evaluation of specialist Counsel involved in the litigation, rather than seeking, for example, to have the issues decided by the Special Commissioners or the VAT Tribunal. If each party submits a different tax treatment, however, then it is possible that the Revenue will protect its position by assessing both parties to tax and leaving each party to resolve the position on appeal against that assessment: in that situation the appeals would normally be heard consecutively by the same Special Commissioners.

As for VAT, in *Reich v C&E Comrs* (1992) VAT Tribunal Decision no 9548, unreported, the taxpayer (who provided business introductions) had previously had a dispute with a customer as to whether any service had been supplied. The dispute had been settled on the basis that part of the fee claimed would be paid (presumably without any admission of liability). Customs assessed the taxpayer to VAT on the settlement sum, and the taxpayer appealed. The Tribunal held that VAT was not chargeable unless it was clearly established that the underlying supply had been made. The litigation had in fact been settled on the basis that a substantial sum, but not the whole sum claimed, was paid. As the Tribunal chairman said,

> This can only be because the parties placed on the claim an agreed estimate of its true worth as a claim, not because they recognised that consideration was being paid for a supply that had been made.

Sometimes when a claim is settled, specific provision may be made for one party's costs. That should be taken into account as a receipt in relation to the income tax or CGT treatment of the receiving party. But for VAT purposes it cannot be regarded as the consideration for any supply. As the Tribunal said in *Reich* -

> To take an obvious point, the sum paid in settlement was paid 'inclusive of costs'. The element attributable in the negotiation to costs, whatever it might be, has to be disregarded in arriving at the net sum receivable by the claimant.

The parties would be well advised to anticipate some of the tax difficulties through including appropriate provisions in the settlement agreement or draft order. If possible, any facts which have become uncontentious should be recited, in particular it will assist to determine the tax treatment if the parties state whether or not they consider that the original transaction properly took place, and whether or not goods or a service were supplied. In areas of doubt, it would be wise to include in the settlement agreement or draft order a provision as to which party is to bear the cost of the tax if tax in fact proves to be due: this might take the form of an indemnity. This is likely to be uncontentious where the position is such that if one party is liable to tax on a receipt of compensation then the other will be entitled to a tax deduction (see below).

Where litigation is settled by agreement, any payment of interest between the parties, whether provided for under the terms of the settlement agreement or otherwise, will not be interest on a judgment debt, and therefore it may well be 'yearly interest' subject to s.349 ICTA 1988. If the payer of the interest forgets this point, it may find itself liable to account for tax on the interest paid while unable to recover that tax from the payee. The position will be different in the case of litigation settled by way of a *Tomlin* order or other agreed order of the

Court, where any sum payable by one party to another will be a judgment debt and thus not subject to s.349 ICTA 1988.

The position of the payer of damages or compensation

A company or other business ordered to pay damages, or which settles litigation on the basis that compensation will be paid, will be concerned to know whether that sum will be tax deductible (in the case of a private individual, of course, it cannot be). That is, will the damages be deductible in computing the profits of the trade or profession under Schedule D Case I or Schedule D Case II (or in the case of a property business, the Schedule A profits)? The legal tests are first, whether the expense of a capital nature or an income nature, and second, whether it is

> "money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation" (s.74 Income and Corporation Taxes Act 1988, "ICTA 1988").

In applying these tests, regard must be had to the subject matter of the litigation, from the point of view of the payer of damages. That may not be obvious.

There is perhaps even a test before these two, that is, are the damages properly an expense of the business at all? For example, a partnership may be sued by an expelled partner, and ordered to pay damages: are those damages against the partners for breach of the partnership agreement, or are the damages an expense of the partnership business? It depends on the nature of the claim. Damages and penalties which properly arise out of the conduct of the *proprietor* of the business or which relate to the proprietor's title to the business as a whole would not be a deductible expense of the business. This would encompass many partnership actions, and most actions between shareholders. In *IRC v. Alexander von Glehn & Co Ltd* [1920] 2 B 553, CA, a penalty was imposed on a company for exporting goods under the Customs (War Powers) Act 1915; the penalty was not for the purposes of the trade but because of a wrongful act on the part of the company. The same would apply to other similar types of penalty, for example fines under the Companies Acts, or fines imposed by professional bodies such as the Institute of Chartered Accountants. In contrast, if the action relates to the business' title to its assets, then damages incurred would be business expenses and deductible. In *Morgan v. Tate & Lyle Ltd* (1954) 35 TC 367, HL the company feared nationalisation of the sugar industry, that is to say compulsory acquisition of all or most of the assets of the business. The expenses incurred by the company in conducting a publicity campaign to prevent nationalisation were incurred to defend the company's title to its assets, and were held to be deductible. The distinctions in this area can be very fine. See, for example, *Hammond v. IRC* [1975] STC 334. A company indemnified its directors and certain shareholders against the costs of an action brought by a substantial shareholder claiming that certain shares of the company were not validly issued. Templeman J held that it was open to the Special Commissioners (who heard the tax appeal at first instance) to decide, as a question of fact, either that the indemnities were granted and paid exclusively for the purposes of the trade, or that they were for other purposes such as securing the positions of the shareholders and directors personally. (It is possible that this case would have been decided differently today, in the light of the special position in relation to costs established in *Sheppard v. McKnight*, discussed below, but the general principle as to what constitutes an expense of the trade and what constitutes an expense of the proprietors remains valid.)

Of course, there are some types of civil claim where the damages (and costs) will almost always be deductible. That will be the case for most types of tortious claim, where the tort was committed in the conduct of the business. So, for example, in *Herald and Weekly Times Ltd v. Federal Commissioner* (1932) 48 CLR 113, the High Court of Australia decided that damages for defamation were deductible expenses of a newspaper business. An employer's liability for injury to employees would be deductible (and any corresponding insurance payment would be brought into account as a receipt, of course). Damages for professional negligence would be deductible. I would suggest a general principle that all these types of claims could be regarded as *normal risks* of the relevant trades or professions; the position might be different in the case of exceptional types of torts which are outside the normal scope of the business (similar to the approach in *Midland Bank v. Hett, Stubbs & Kemp* [1979] Ch 384 in the case of partners' liability for tort committed by another partner).

In intellectual property matters (breach of copyright, trademark or passing-off claims), damages payable by a defendant would normally be tax deductible, on the basis that they represent a cost relating to the previous (unlawful) exploitation of the intellectual property — that is to say, the exploitation would presumably itself have been a profitable endeavour (were it not for the subsequent intellectual property claim). From a tax point of view, the fact that a cost of this kind arises after the profits have been realised does not prevent it from being deductible, so long as it is a necessary incident of the earlier profitable activity.

Where there is litigation, it will presumably be uncertain whether or not damages will be paid: thus the damages are a contingent liability of some earlier business activity. A contingent expense of this kind may not be deductible for tax purposes until its amount is determined with some degree of reliability (*James Spencer & Co v. IRC* (1950) 32 TC 111, Ct of Sess; *Southern Railway of Peru Ltd v. Owen* [1957] AC 334, HL). The modern approach is to ascertain, "Would the contingent liability be recognised as an expense of the current year as a matter of commercial accountancy practice?" (*Herbert Smith (a firm) v. Honour* [1999] STC 173). Clearly very difficult issues can arise in this regard, and Counsel's Opinion as to the likelihood of recovery in the litigation, and the likely amount of damages, may well affect the tax treatment.

Capital or income expense?

As indicated above, only expenses of an income nature are deductible when computing the profits of a trade or profession for tax purposes, although expenses of a capital nature may produce other tax benefits, for example they may increase the capital gains tax (“CGT”) base cost. An expense will be of a capital nature if it secures an enduring benefit for the business. There is a distinction between expenses incurred to maintain the existing capital assets of a business without enhancing their value (income) and expenses incurred to improve an asset or to enhance the value of an asset (capital). If title to a capital asset is disputed, the expense of defending or improving title to the asset is a capital expense, since it tends to enhance the value of that asset. In contrast, if there is a general threat to the business whereby it may lose title to all its assets, then the cost of resisting that threat will be an income expense: that might include a winding up petition or other insolvency proceedings.

The expense of a business extricating itself from a contract, or damages resulting from breach of contract, are generally costs of an income nature, even though in one sense they could be set to result in benefits of an enduring nature: the distinction may be that in most of these cases no asset is acquired, but rather a liability is removed. For example, payments of damages to employees unlawfully dismissed are income expenses (and normally deductible). Exceptionally, where a contract stipulates for a capital sum to be paid, and there is a breach of that contract so that damages are paid instead, then those damages could be a capital expense: it may depend on whether or not a capital asset is in fact acquired, so that if nothing is acquired then it may be an income expense.

In relation to capital expenses relating to a particular capital asset, these will be allowable when computing the gain on the eventual disposal of that asset. Section 37(1)(b) of the Taxation of Chargeable Gains Act 1992 ("TCGA 1992") provides for the deduction of -

> any expenditure wholly and exclusively incurred on the asset by him or on his behalf for the purpose of enhancing the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal, and any expenditure wholly and exclusively incurred by him in establishing, preserving or defending his title to, or to a right over, the asset.

That would include the costs of litigation, where for example title to an asset is disputed and the outcome of the litigation is favourable (even if the outcome is unfavourable, the costs of defending title would be an allowable expense for CGT purposes assuming that at least some interest in the asset is retained after the litigation). See also above for the situations in which the loss of title to an asset as a result of litigation amounts to a CGT disposal of that asset (in which case the costs of defending title would be an allowable expense in relation to that disposal).

Deductibility of costs incurred by successful and unsuccessful parties

There are cases in which costs are deductible even though the underlying penalty or damages would not be. This was the issue considered in *McKnight v. Sheppard* [1999] STC 669, HL. Mr Sheppard was in business as a stockbroker; he had suffered disciplinary proceedings and been ordered to pay fines and suspended for 6 months. He incurred considerable legal costs in conducting an appeal which was partially successful: the order for suspension was set aside, although fines were still imposed. He claimed a tax deduction for the fines and the legal costs. The fines were not tax deductible, because they were in the nature of a penalty imposed upon Mr Sheppard personally (that is, they were an expense of the proprietor of the business: see above). Mr Sheppard's costs of conducting the appeal against the suspension were held to be deductible. In particular, Lord Hoffman was impressed by the point that if the allegations prove groundless then the costs should always be deductible business expenses because there has been *no* misconduct by the proprietor of the business. Lord Hoffman could see no policy reason for the costs of a successful defence and the costs of an unsuccessful defence to be treated differently for tax purposes. Accordingly, a successful party to litigation concerning a business matter would normally be able to deduct any irrecoverable costs as an expense of its trade or profession (the position would be different if the litigation relates to the acquisition of a capital asset, in which case the costs would be part of the acquisition cost of that asset for CGT purposes, in accordance with s.37(1)(b) TCGA 1992). An unsuccessful party to litigation would be entitled to deduct costs of litigation and the contribution to the other side's costs, so long as the costs would have been deductible had the litigation been successful.

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[1] From a paper contributed by the author to a seminar of the Chancery Bar Association chaired by Park J, on 24th February 2003.
[2] EC Sixth Council Directive on the common system of valued added tax, Directive 77/388/EEC.
[3] *Polysar Investments v Inspecteur* (Case C-60/90) [1993] STC 222, ECJ.
[4] In that case the German revenue authorities did not even suggest that VAT was due on the costs award.
[5] It should be borne in mind that all forms of property, including, for example, the rights of a party under any contract (*Marren v Ingles* [1980] STC 500, HL), constitute assets for capital gains tax ("CGT") purposes. CGT applies to all disposals of assets, except in a case where the proceeds of disposal are subject to tax as income.
[6] "CGT" here will also refer to corporation tax on chargeable gains.
[7] Unless it is subject to income tax treatment: that would be the case for a business trading in property.
[8] Note that this decision is currently under appeal to the House of Lords.