[2019] UKFTT ** (TC)**

TC *****A/V

Corporation Tax – whether "redress payments" made pursuant to settlement with regulator were non-deductible penalties (McKnight), whether wholly and exclusively incurred for the purposes of the trade, whether any deductible as Charitable Donations under s 189 CTA 2010

FIRST-TIER TRIBUNAL
TAX CHAMBER

Appeal numbers: TC/2020/209, 210, 213, 215 & 1390

BETWEEN

SCOTTISHPOWER (SPCL) LTD
SCOTTISHPOWER RENEWABLES (UK) LTD
SCOTTISHPOWER (DCL) LTD
SCOTTISHPOWER ENERGY RETAIL LTD **Appellants**

-and-

THE COMMISSIONERS FOR
HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

TRIBUNAL: JUDGE CHARLES HELLIER
JOHN WOODMAN

The hearing took place between 25 and 29 October 2021. With the consent of the parties, the form of the hearing was by video on the Tribunal video platform. A face to face hearing was not held because of the covid 19 pandemic.

Prior notice of the hearing had been published on the gov.uk website, with information about how representatives of the media or members of the public could apply to join the hearing remotely in order to observe the proceedings. As such, the hearing was held in public.

David Goldberg QC and Laura Inglis instructed by Linklaters LLP for the Appellant

John Tallon QC instructed by the General Counsel and Solicitor to HM Revenue and Customs for the Respondents

DECISION

Introduction

1. This decision concerns the deductibility, in computing the Appellants' trading profits, of payments made in connection with four investigations conducted by Ofgem into the energy supply businesses of the Appellants. The payments, for which the Appellants used the appellation Redress Payments, were made under settlement agreements made with Ofgem.

2. We use SCPL, SRL, SPDCL and SPERL, to refer to the first, second, third and fourth Appellants.

Background

3. Section 1 of the Utilities Act 2000 created the Gas and Electricity Markets Authority ("GEMA"). The Office of Gas and Electricity Markets ("Ofgem") carries out GEMA's day to day work and investigates matters on its behalf.

4. Section 4 of the Electricity Act 1989 makes it an offence to supply or generate electricity without a licence. The Act vests in GEMA the power to grant such a licence. Such a licence may incorporate conditions imposed by GEMA and must, by section 8A of that Act, contain the Standard Licence Conditions (the "SLC"s).

5. Section 3A of the Electricity Act prescribes GEMA's objective in carrying out its functions under the Act. It is:

> "to protect the interests of existing and future customers in relation to the [conveyance of] electricity.";

and section 3A(1A) provides that the interests of those existing and future customers are:

> "their interests taken as a whole".

6. The Act confers a number of enforcement powers on GEMA:

(i) by section 25 it may order compliance with a licence condition or statutorily specified condition (a "relevant requirement");

(ii) section 27A provides that where GEMA is satisfied that an electricity supplier has contravened any licence condition or relevant requirement it may

> "impose…a penalty of such amount as is reasonable in the circumstances"; and

(iii) section 27G, which had effect from 18 February 2014 (which was after one of the payments to which this decision relates), provides that where GEMA is satisfied that there has been any such contravention and as a result consumers have suffered loss or inconvenience, it may make a Consumer Redress Order requiring action to remedy the consequences of the contravention.

7. Section 27A requires GEMA to publish notice of a proposed penalty, to consider representations made in relation to the proposal before imposing the penalty, and once the penalty has been imposed, to give notice that it has done so. There are similar provisions in relation to Consumer Redress Orders.

8. Section 27B requires GEMA to publish a policy statement in relation to the determination and imposition of penalties and their amounts. Section 27E provides for an appeal to the High Court against a penalty or its amount.

9. Penalties are paid to the Treasury via the Consolidated Fund.

10. There are similar provisions in Gas Act 1986 in relation to the supply of gas.

11. In its policy statement on penalties and Consumer Redress Orders of 6 November 2014, GEMA said that its vision for its enforcement work was to achieve a culture where businesses acted in line with their obligations. The strategic objectives for enforcement were to:

> "deliver a credible deterrence…
>
> ensure visible and meaningful consequences for businesses who fail consumers or do not comply
>
> achieve the greatest possible impact"

12. Its central objectives were to obtain a fair outcome for consumers and deter future non-compliance. At para 2.4 it said:

> "…the Authority [GEMA] considers that non-compliance should normally cost significantly more than compliance and that financial penalties should act as a significant deterrent…The Authority will, therefore, seek to ensure that any financial penalty, and compensation or other payment under a consumer redress order…significantly exceeds
>
> the gain to the regulated person, …and
>
> the detriment caused to customers affected by the contravention or failure."

13. In the section dealing with the process for determining the amount of a penalty or the amount payable under a consumer redress order, it said:

> "5.3 The total amount payable will usually be made up of two elements
>
> (i) the removal of the detriment suffered by consumers and any gain made by the regulated person as a result of the contravention…and
>
> (ii) an amount which reflects the seriousness of the contravention or failure and the need for deterrence (the 'penal element')

14. The notice then set out five steps in the calculation of the elements described in 5.3 and (aiming to ensure 'appropriate redress') the factors to be considered at each stage. Steps 1 to 3 involve the calculation of the detriment or gain, and the assessment of the seriousness and mitigating or aggravating features. Step 4 is to consider an adjustment for deterrence.

15. Step 5 is to apply a "discount in settled cases". This looks to the process of settling a penalty under Ofgem's enforcement guidelines (see below). The section describes the advantages of early settlement: speed, saving resources, messaging, recognising (at 5.24) that settlement is likely to be in the interest of consumers, and

> "…in recognition of the benefits of such agreements the Authority will reduce the penal element of the overall financial liability to be imposed."

16. The size of the discount is said to reflect the stage in the process of imposing a penalty at which agreement is reached with the licensee:

> 30% in the early settlement window,
>
> 20% in the middle settlement window,
>
> 10% in the late settlement window.

17. Section 6 of the notice is a discussion of the interaction of "penalties and compensation and/or other redress payments". It says that the Authority starts from the principle that redress should be provided to customers who have suffered detriment. It notes that this may take the form of a Voluntary Redress Payment, although the Authority could make a Consumer Redress Order where it has identified and calculated consumer detriment. Where the identification of specific customers affect by the breach is difficult or where it is not possible or practical to compensate directly affected customers the Authority might require a payment to "other customers or a consumer fund".

18. After discussing the identification of any gain made by the supplier by a contravention, it indicates that, if the amount paid to consumers is adequate redress, "the Authority will normally remove any additional gain by imposing a financial penalty", and then, at 6.10 :

> "Normally the Authority will also impose an element to be paid as a financial penalty."

19. Ofgem also published Enforcement Guidelines on 12 September 2014 describing how it would use its enforcement powers, how it would provide redress to customers and how breaches would be "punished or deterred". The document explains that an investigation may begin if it considers that there may have been a breach of obligations, and describes the process of investigation. In section 5 it deals with settling a case:

> "To settle a case a company…must be prepared to admit the breaches that have occurred [and] agree not to challenge any finding of breach, penalty or redress order…
>
> It is important to appreciate that settlement in a regulatory context is not the same as the settlement of a commercial dispute. An Ofgem settlement is a regulatory decision taken by us, the terms of which are accepted by the company under investigation…we must have regard to our statutory objective when agreeing the terms…
>
> 5.10 Settlement is a voluntary process. There is no obligation on companies to enter into settlement discussions or to settle…
>
> 5.15 Early settlement results in cases being resolved more quickly and saves resources both for the company and Ofgem. It may also result in consumers obtaining compensation earlier than would otherwise be the case. In recognition of the benefits…we have a discount scheme [it then describes the discount windows recounted above by reference to the period of time after a draft penalty notice or redress order has been served on the supplier before settlement is reached.]"

20. We find the distinction drawn in the second quoted paragraph between a commercial dispute and settlement in a regulatory context rather false. In the settlement of a commercial dispute each side will have different principles or requirements; those of Ofgem are just those to which it adheres (and which will include issues of public policy and consistency).

21. We discuss below the evidence of Mr Sinclair who worked at Ofgem between 2005 and 2010. We accept his evidence that the 2014 Guidelines represented Ofgem's practice in the relevant years preceding their publication.

The Evidence and our findings of fact

22. There was a Statement of Agreed Facts. We had a number of bundles of papers and heard oral evidence from: Alistair Orr, who, at relevant times had been legal director of SPERL; Andrew Ward, who had been the UK Operations Director of the holding company of SPERL at the time of one of the investigations; and Duncan Sinclair who had been co-head of the legal function at Ofgem between April 2005 and September 2010, and who, since then had practised as a barrister with an energy sector regulatory speciality.

23. We should say a little about the evidence of Mr Sinclair. Mr Sinclair dealt in his witness statement with the legislation affecting GEMA and with Ofgem's practice in the period after he had left its employ. He expressed a number of opinions relating to the nature of the payments which are the subject of this appeal. So far as relates to the application, meaning and effect of legislative provisions we have been jealous of our role and have taken his statements as suggestions as to what we might consider. In relation to Ofgem's practice after he had left we had regard to the documentary evidence which accompanied his evidence and have drawn our conclusions principally therefrom. In relation to his expressions of opinion we have taken them as submissions delivered by Mr Goldberg (to which practice Mr Goldberg assented).

24. These appeals relate to four sets of payments. We shall address the specific circumstances of each of them separately later in this decision, but at this stage we shall set out the broad factual background to the appeals.

25. SPERL was at relevant times the holder of gas and electricity supply licences. The other three Appellants were holders of electricity generation licences.

26. Between 2010 and 2014 Ofgem opened four investigations into SPERL. SPERL and GEMA entered into four settlement agreements under which the Appellants made the Redress Payments and GEMA imposed £1 financial penalties.

27. The Appellants sought to deduct the Redress Payments (but not the £1 penalties) when computing their taxable profits. HMRC opened enquiries and issued closure notices disallowing the deductions. The Appellants appealed.

28. In outline the investigations were:

(i) into <u>mis-selling.</u> As a result of this investigation SPERL agreed to make payment of £7.5m and a penalty of £1 was imposed;

(ii) into "<u>costs reflexivity</u>". As a result of this investigation SPERL agreed to make payment of £750k and a penalty of £1 was imposed;

(iii) into compliance with the <u>Energy Saving</u> programme (the 'CESP'). As a result of this investigation SPERL and the other three Appellants bore the cost of a payment of £1.8m and a £1 penalty; and

(iv) into <u>complaints handling.</u> As a result of this investigation SPERL agreed to pay £18m and a £1 penalty was imposed.

29. In each case Ofgem opened an investigation and proposed penalties, negotiations took place and a settlement agreement was reached containing an acceptance of the breach, agreement not to appeal, and obligations to make payments totalling those described above.

GEMA's Practice

30. We accept Mr Sinclair's evidence that from about 2010 Ofgem's approach changed from imposing penalties to seeking settlement agreements involving substantial "consumer redress payments" coupled with a nominal penalty. Thus in 2010 some £15m of penalties were imposed with no redress payments and in 2019 the penalties imposed were some £2m but redress payments were some £50m. This change is reflected in a number of statements made by Ofgem after 2010 where it stated that redress payments would be of greater benefit to consumers than the imposition of a penalty.

31. We note however that the object of GEMA is to protect the interests of existing and future customers as a whole, and that while particular forms of redress payments may have the effect of compensating customers affected by a breach, others may have the effect or object of benefitting classes of customer unaffected by the breach. We note that in the mis-selling settlement Ofgem also had regard to future harm which might be caused to consumers. The nature of each payment must be considered separately.

SPERL's Business and its approach to settlement

32. At the relevant times SPERL had about 3m customers to whom it supplied electricity and gas. As part of that activity it sought new customers, sent bills to customers and dealt with queries and complaints. Incorporated into its contracts with customers were terms which reflected some of the provisions of the relevant requirements to which it was subject.

33. From time to time SPERL would have discussions with Ofgem about alleged or small breaches of the relevant requirements. Improvements would be made and compensation would in some cases be paid (with and without input from Ofgem). Ofgem would open investigations only into what it regarded as potentially serious breaches.

34. The process of settlement of an investigation involved hard fought negotiation: there were generally differing views as to whether there had been breaches, which customers had been affected and the detriment (if any) suffered by them. In the mis-selling investigation there was disagreement about the addition of the £1 penalty to the settlement package.

35. SPERL was not compelled to make a settlement agreement by force of law or physically. It could in every case have refused to settle and either accepted a penalty or appealed against a penalty imposed by GEMA. But in each case it chose to make a settlement in negotiated terms under which there were obligations to make the Redress Payments. It did so for the following reasons:

(a) Settlement avoided the risks inherent in litigation, the possible adverse effects on its reputation of a large penalty and the diversion of management time in bringing the investigation to a close or litigating the penalty;

(b) Settlement avoided adverse publicity and damage to SPERL's brand and maintained goodwill with Ofgem. Redress payments made to customers promoted goodwill with them, and

(c) Settlement tended to compensate, and could, where possible, be directed to, those who had suffered harm; SPERL preferred to make payments for the benefit of consumers rather than paying monies to the Exchequer.

The Four Investigations and the payments made on Settlement

<u>(i) the Mis-selling Investigation</u>

36. SLC 25 imposes obligations on energy suppliers in relation to marketing activities. SPERL engaged in marketing activities and at the relevant time some 40% of its sales arose through doorstep marketing, the conduct of which was regulated by this condition.

37. Ofgem opened an investigation into SPERL's compliance with SLC 25 on 2 September 2010. SPERL provided information to Ofgem. Ofgem concluded that SPERL did not have robust arrangements in place for training for, and monitoring, doorstep sales and telesales and that as a result misleading information had been provided to customers. SPERL accepted that SLC 25 had been breached but did not initially agree with Ofgem as to the seriousness of the breach and the quantum of harm caused to consumers.

38. Negotiations followed. Ofgem suggested a significant penalty. Towards the end of 2011 discussions came close to agreeing a settlement payment by SPERL of £17.5m. That amount exceeded SPERL's estimate of the consumer detriment caused by its actions, but SPERL contemplated paying it to bring the investigation to an end. The negotiations broke down because SPERL did not agree with Ofgem's desire to include a £1 penalty in addition to the £17.5m settlement package, and because it considered that the proposed sum exceeded the consumer detriment.

39. Negotiations later resumed and on 10 October 2013 a settlement agreement was made between SPERL and Ofgem pursuant to which:

(i) SPERL agreed to pay £7.5m to vulnerable customers. These were identified through SPERL's 2012 Warm Homes Discount scheme. They were not limited to those who had been affected by the mis-selling. Each such customer was to be paid an 'equal' amount of at least £50 (it turned out to be £52).

(ii) SPERL agreed to set aside £1m to make compensation payments to customers affected by mis-selling. These were to be calculated by reference to the extra cost a customer to whom electricity had been mis-sold would have incurred as a result of changing supplier. The agreement provided that these payments would not be used towards other payments to consumers to which SP was otherwise committed or had made.

(iii) SPERL agreed that any money not paid out of the £8.5m allocated under those first two headings would be paid to Scottish Power Energy Trust ("SPET"), a charitable trust which supported people affected by fuel poverty (and over which SPERL had no control).

(iv) GEMA imposed a £1 penalty.

40. The agreement was subject to ratification by GEMA's settlement committee and included: the forms of letters to be sent to the Warm Home Discount recipients of the £52, procedure for the identification of customers affected by mis-selling and the calculation of the payments to be made to them, a draft Notice to be published by GEMA dealing with its intention to impose a penalty and an agreed Press Notice.

41. The letters to the Warm Home Discount recipients recited that Ofgem accepted that SPERL had not deliberately misled or mis-sold but that SPERL accepted that it had not met the regulator's standards of conduct. They said that the payment was "not being made because we think that you have been directly affected by [these] issues, but because we want to make payments to you as part of our apology".

42. The letters to the potential recipients of compensation (those who signed up with SPERL as a result of sales contact in a given period) contained a similar

acknowledgement of non-deliberate failure and described the £1m as compensation for customers who lost money as a result of SPERL's failings.

43. GEMA published its formal draft Notice on 4 December 2013. It:

(i) stated that GEMA found that SPERL was in breach of SLC 25;

(ii) stated that the breaches had been admitted by SPERL; and that while there was no evidence that the contraventions had been deliberate or wilful they could not be regarded as inadvertent or accidental; and

(iii) set out the background to charging a penalty, saying that it considered "that a penalty is necessary in order to create an incentive to ensure compliance and to deter future breaches by SPERL or other licensees, and

(iv) Set out factors relevant to the level of the penalty. Those included its view: that the breaches were serious, of the period of the breach, that customers may have been harmed and of the gain made by SPERL as a result of sales tactics in breach of SLC 25.

44. These matters, it said, warranted a "significant penalty" but, having regard to SPERL's agreement to pay £8.5m to consumers, the steps SPERL had taken to put things right and its agreement to settle the investigation, it proposed a penalty of £1. The penalty would have been higher if SPERL had not: taken steps to ensure future compliance, settled and admitted the breaches, and agreed to the £8.5m payment.

45. In accordance with the Settlement agreement SPERL paid:

(i) £7,316,385 to vulnerable customers (each receiving what Mr Orr described as a round sum amount) identified under the Warm Homes Scheme (the remaining £183,615, being uncashed cheques, was paid to the SPET charity,

(ii) £554,013 in cashed cheques or credits directly to affected customers, and the balance of the £1m to SPET,

(iii) £1 as a penalty to the Consolidated Fund.

<u>(ii) Costs Reflexivity</u>

46. SLC 27.2A requires that differences in terms and conditions between payment methods should reflect the relative costs of the different methods. SPERL charged customers different rates depending on their payment methods.

47. Ofgem opened an investigation into SPERL's compliance with SLC 27.2A in March 2011. Ofgem came to the conclusion that SPERL did not have robust procedures to justify price differentials. Negotiations followed on the terms of a settlement and issues such as the identification of harmed customers and the extent of such harm. SPERL considered that no consumer detriment arose from the breach.

48. Ofgem's initial proposal was for payment of £8.5m; SPERL'S initial estimate was £250,000. SPERL eventually accepted that it had breached SLC 27.2A. It was agreed that it would be difficult to identify customers who had suffered as a result of the breach.

49. In May 2014 a settlement agreement was made between SPERL and GEMA under which:

(i) GEMA would issue a Notice of Decision stating that SPERL had breached SLC 27.2A, but that there was no evidence that there were "deliberate actions in relation to the breach".

(ii) SPERL agreed to pay £750,000 to Energy Best Deal, a public awareness campaign run by Citizens Advice

(iii) in the Notice of Decision GEMA would say that it was appropriate to impose a £1 penalty "which was lower than it would have been…if SPERL had not engaged in the settlement process…provided an admission of liability, and…made a payment of £750,000 to Energy Best Deal."

50. In accordance with the settlement agreement, SPERL made the £750,000 payment and paid the penalty of £1.

(iii) Energy Saving: CESP

51. This affected all four Appellants

52. The relevant legislation, the CESP Order, required electricity generators and suppliers to achieve reductions in carbon emissions by promoting energy saving actions to domestic customers. The carbon emissions reductions to be achieved were set in terms of CO_2 emissions reductions. Each of the Appellants had a set target. In addition, another company which has since left the Scottish Power group and was not a party to this appeal was affected. SPERL carried out the delivery of the obligation on behalf of all of them. Pursuant to an intercompany agreement each accepted part of the cost of such delivery.

53. SPERL outsourced the greater part of its obligations to Carillion, but Carillion failed to meet the targets. SPREL also considered that Ofgem's administration of the scheme adversely affected its ability to comply with it.

54. The Appellants failed to meet the prescribed targets: they were four months late. In May 2013 Ofgem opened an investigation into the companies' compliance with the CESP Order. Negotiations followed and, after two other major suppliers had settled similar investigations for larger amounts, a settlement agreement was made. Under it:

(i) GEMA issued a Notice of Decision which stated that SPERL had breached the order and it intended to charge a £1 penalty. The Notice does not suggest that the breach was deliberate and refers to mitigating activity undertaken by SPERL;

(ii) £2.4m would be paid by the companies to the SPET (the same charity as received payment under the mis-selling agreement) ; and

(iii) GEMA imposed a penalty of £1 on SPERL.

55. Pursuant to the intercompany agreements the payments made by the Appellants were:

(i) By SPERL, £1,306,584,

(ii) By SPDCL, £251,267

(iii) By SCPL £112,239, and

(iv) By SRL, £20,884.

The balance was paid by the company which has left the group.

(iv) Complaints Handling

56. SLC 25 requires suppliers to take reasonable steps to achieve matters such as fair accurate and prompt behaviour. SLC 27 requires that bills be sent out within 6 months and errors be corrected speedily. The Gas and Electricity (Consumer Complaints Handling Standards) Regulations 2008 dealt with complaints handling standards and

procedures and were applicable to SPERL. They[1] were “relevant requirements” for the purpose of enforcement by Ofgem.

57. In November 2014, after having made some earlier enquiries, Ofgem opened an investigation into SPERL’s compliance with these requirements. SPERL had had problems with billing and complaints handling which arose from the implementation of a new unified computer system in place of some 80 old systems. This was a mammoth task involving some 5 million customer accounts (there were 3m customers but some had accounts both for gas and electricity). SPERL sent out hundreds of thousands of bills each week using these systems, and had some 2,000 people (in 2020) engaged in query and complaint handling.

58. After 8 months of planning, the IT transition process took some 18 months. SPERL engaged IBM to support the project (one of the only two firms of consultants considered to have the requisite knowledge and capabilities) but when the implementation was underway SPERL discovered that IBM was splitting its resources with *npower* who were conducting a similar exercise. The lack of resource from IBM led to difficulties and SPERL engaged Accenture and Deloittes. Despite careful planning problems occurred at various stages which led to breaches of the relevant requirements. Ofgem noted that complex projects such as this were “challenging” but considered that SPERL had not done enough to identify and mitigate risks.

59. After the opening of the investigation, negotiations followed between November 2014 and April 2016 about the alleged breaches and the terms of settlement. In the early stages of the investigation SPERL made a number of commitments to improve aspects of its billing and complaints handling. It failed to meet these requirements and in March 2015 Ofgem imposed a 12 day ban on its sales and marketing activities.

60. SPERL agreed that it had breached the requirements. Before the negotiations had started SPERL had written off some £8m of consumers’ bills in recognition that it had breached its duties and in recognition of consumer harm.

61. On 25 April 2016 SPERL and GEMA entered into a settlement agreement. In accordance with the agreement GEMA issued a Notice of Decision stating:

(i) that SPERL had contravened some of the conditions and requirements noted above. The breaches were not trivial but GEMA considered that SPERL had not sought to breach the requirement;

(ii) that SPERL admitted the breaches and had agreed to make £18m of ‘consumer redress payments’ of which:

> (a) compensation of up to £15m would go to priority or Warm Homes Discount “Qualifying” customers whose bills had been issued more than 6 weeks late or had made a relevant complaint. Each would receive between £50 and £150; and
>
> (b) £3m plus any of the £15m unused would be paid to charities to be agreed within the next 2 months (and if not agreed to the Treasury via the Consolidated Fund);

(iii) that GEMA would impose a £1 penalty

Those customers already compensated by SPERL who were Qualifying Customers also received the payments at (ii)(a) above.

[1] By virtue of Sch 6A Electricity Act, and section 43 Consumers , Estate Agents and Redress Act 2007

62. SPERL agreed to these terms despite the fact that its estimate of the detriment suffered by customers was materially less than the settlement figure (Ofgem had calculated detriment using a cost for leisure time of £9.50 per hour) and that it considered that it had already voluntarily compensated affected customers. It agreed to the settlement for the reasons we describe above and because the payments would so far as possible be directed to customers who had suffered detriment.

63. The settlement agreement (like the other three) distinguished between the penalty of £1 and the redress payments. Clause 4 made provision for the reporting of the people identified as qualifying customers, the credit to them of between £50 and £150, and provided that such payment should not release SPERL from making payments arising out of the IT migration it would otherwise have made to non Qualifying Customers who had experienced problems. SPERL also agreed to take steps to improve its complaints handling procedures

64. In accordance with the agreement SPERL paid or credited:

(i) £14,709, 208 to Qualifying Customers (being £73 to each such customer),

(ii) £3,290,741 to two charities (Energy Action Scotland and National Energy Action) over which SPERL had no control but were concerned with energy supply to consumers, and

(iii) A £1 penalty

The Law and the authorities on deductibility

65. Section 54(1)(a) Corporation Tax Act 2009 prohibits the deduction of an expense which could otherwise be taken in to account in the computation of a company's taxable trading profits if it is "not incurred wholly and exclusively for the purpose of the trade".

66. HMRC argue that the Redress Payments were not deductible on two grounds. First, they say that the payments were imposed as a penalty to punish the Appellants and that the authorities show that such penalties are not allowable.

67. Second, they say that the activity of conducting elements of their trade in a wrongful manner not an activity within the legitimate scope of the trade of supplying electricity and gas, and that the payments brought about by that activity cannot therefore have been made for the purposes of that trade.

Penalties

68. We were referred to four cases in which the deductibility of a penalty had been discussed: *CIR v Alexander von Glehn [1920] 2KB 553 (CA)*, *McKnight v Sheppard* [1999] 1 WLR 1333 (HL), *HMRC v McLaren Racing Ltd* [2014] STC 2417 (UKUT) and *BES Commercial Electricity Ltd v HMRC* [2021] UKFTT 456 (TC .

69. In *von Glehn* the Court of Appeal held that a penalty imposed by statute during the first World War for exporting goods without taking all reasonable care to secure that the ultimate destination was not enemy territory and the costs of an unsuccessful defence were not deductible. Lord Sterndale said (565-6) that he did not think that the fine (he did not distinguish between the fine and the legal costs) was money laid out or expended for the purposes of the trade, it was not:

> "a loss connected with the business but a fine imposed upon the company personally…for a breach of the law."

It was difficult, he said, to put the distinction in exact language.

70. Warrington LJ said (569-570) that the disbursement of the fine was not made in any way for the purpose of the trade or earning profits of the trade, it was made because the company had been guilty of an infraction of the law.

71. Scrutton LJ said (562) that it seemed to him obvious that the penalties were not an expenditure for the purpose of earning profits: "they were unfortunate incidents which followed after the profits had been earned".

72. In *McKnight* the House of Lords held that the expenses incurred by a stockbroker in defending himself against proceedings before the disciplinary committee of the Stock Exchange were deductible. Those proceedings had resulted in the imposition of a fine and the Special Commissioner and the High Court had dismissed his appeal against the denial of a deduction of the fine. The deductibility of the fine was not pursued beyond the High Court, but the deductibility of the costs was. But Lord Hoffman in the House of Lords discussed the fine's deductibility as well as that of the legal expenses.

73. Lord Hoffman, who gave the only speech, said that, although he had no doubt that the decision of the Court of Appeal in *von Glehn* was right, he found the Court of Appeal to have been "curiously inarticulate" about why the fine was not money expended for the purposes of the trade. He found Scrutton LJ's reasoning that the payments "followed after the profits had been earned", circular: that being not a reason, but another way of saying that they could not be deducted.

74. He noted that the fine in *von Glehn* "was, as the Court of Appeal accepted, incurred in the course of the company's trade" (in other words that the actions giving rise to it were part of the trade), and continued (1337H):

> "There must therefore have been something in the nature of the expense which precluded it from being deductible. I think…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 a deduction. But the reason in my opinion relates to the particular character of the 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 MR meant when he said that the fine was imposed "upon the company personally"."

75. Untutored by Lord Hoffman's exposition we would have regarded the Court of Appeal's judgement in *von Glehn* as looking at the purpose for which the expense of the penalty was incurred and holding that although it arose from the company's trade, at least one of the purposes for which the expense was incurred was that of the legislative body which imposed the penalty. The expense might have flowed from the company's trade and therefore been incurred for such purpose but that was not the exclusive purpose for which it was incurred and so the expense was not deductible: the fact that the expense arose in part from the later actions of the legislative body was indicative of the legislative body's nontrading purpose which gave rise to the expense.

76. Lord Hoffman, however, saying that the purpose of the penalty is to punish the taxpayer, rests his conclusion that the expense is not deductible on "legislative policy", referring to the dilution of that policy. That must refer to the policy of the legislation pursuant to which the fine was imposed. Because the policy of that enactment is to punish there must be a principle of interpretation that the penalty should not be deductible where allowing deduction would dilute that policy. That principle must be different from that of the restriction in section 54.

77. Lord Hoffman pursues and expands this line of reasoning in the following paragraph of his speech in which he addresses the disallowance of the fines borne by Mr Sheppard:

> "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 may be 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, 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."

78. In this paragraph Lord Hoffman elaborates on the nature of the policy. He says that where damages which are compensatory rather than punitive are paid pursuant to a rule of law there is no wider principle requiring them not to be deductible. In the preceding sentence he adds an additional qualification:

> "such claims against a newspaper are a "regular and almost unavoidable incident of publishing it" and the damages are compensatory rather than punitive".

79. It seems to us that the "regular and unavoidable" part of the description of such claims goes to the satisfaction of the words of the following sentence "defamed in the course of carrying on the business" and are not an indication of a conclusion that for the policy of non-dilution not to apply, the events giving rise to the claim be regular and unavoidable, <u>and</u> the damages be compensatory.

80. We conclude from these passages that there is a rule of statutory interpretation which requires the disallowance of the expense of a penalty if it has been imposed to punish the taxpayer and does not compensate another person (see [121 to128] below).

81. The third case was *McLaren*. McLaren designed, manufactured and raced Formula One cars. It derived its income from an agreement with the sport's governing body and a promoter of Formula One racing. It breached some of the terms of the agreement by receiving and using confidential information relating to another team and paid a large penalty.

82. The Upper Tribunal did not adopt Lord Hoffman's approach as its primary ground for holding that the penalty was not allowable. Instead it held that the activity for which the penalty was levied was not carried on in the course of its trade (although it was silent as to how any profit from that activity would be taxed). It held that a deliberate

activity contrary to contractual obligations and which could lead to the destruction of the trade was not part of the trade, describing the infraction as "egregious".

83. We address how this approach may be reconciled with Lord Hoffman's recognition that the Court of Appeal in *von Glehn* had found that the activity giving rise to the penalty had been incurred in the course of the company's trade in the part of the decision dealing with the wholly and exclusively test.

84. Having so held, the UT also considered whether the penalty would also not be deductible for reasons similar to those given by Lord Hoffman in *McKnight*. It referred to the passage in Lord Hoffman's speech where he said that the purpose of the penalty was to punish the taxpayer and a court could easily conclude that deductibility would dilute the legislative policy and said:

> "[68] …But that is not to say that the legislative…policy must be under threat of dilution before a penalty can be seen as non-deductible; rather, the dilution of the legislative policy is a (strong) example of a special circumstance in the nature of the expense which makes it non-deductible.

85. It held that the penalty was designed to punish McLaren; it was not compensatory. At [70] it said that the size of the penalty, the fact that it exceeded the value of the championship points taken from McLaren and the fact that it was an alternative to exclusion from the World Championships all lead to the conclusion that it was intended to punish.

> "That last fact is important: it could hardly be maintained that exclusion from the championship would be other than punishment; the payment of a large fine to avoid that punishment can only be seen, we consider, as acceptance of an alternative punishment."

86. Mr Goldberg notes that in these words the UT did not affirm a general proposition that <u>any</u> sum paid to avoid a punishment was itself a punishment. Rather he says, the UT were considering two alternatives which were already penal in nature: exclusion from the championships or a large fine. The UT did not need the alternative of exclusion to establish the penal character of the fine: it was merely illustrating the penal character a fine was generally acknowledged to possess. We agree.

87. *BES* was decided after the hearing of this appeal. We were grateful to both parties for their written submissions on it.

88. *BES* involved facts similar to those in this appeal. Following an investigation GEMA concluded that BES had breached certain licence conditions. Ofgem wrote to BES reciting the failures and saying that if the case was contested it would impose a penalty of £1.4m but offered the discount for early settlement we have described above. BES opted for the earliest settlement and highest discount and entered into a settlement agreement with GEMA under which it would make compensation payments to affected consumers, payments to a charitable trust and pay a penalty of £2. As in the instant case GEMA's Notice of Decision recorded that in the circumstances of the redress payment and the compensation arrangements the penalty would be £2. The FTT said that if BES had not settled GEMA would have imposed a larger penalty.

89. The FTT recited Lord Hoffman's explanation of *von Glehn* that non-deductibility was based "not on the ordinary meaning of 'wholly and exclusively' but on a public policy restriction" and cited his statement that "non deductibility depends upon the nature of the expenditure and the specific policy of the rule under which it became payable". It proceeded to ask what was the nature of the payments.

90. The test of deductibility, it said, did not depend on the effects of the payment but on the reason for them, and that was that Ofgem required them as an alternative to a more substantial penalty.

91. It concluded [73] that the package of payments was a penalty. Ofgem had simply directed payment to third parties rather than to the Treasury: "[a}n analogy would be with the disposal of a criminal offence whereby the court has the option of a custodial sentence, a fine, a Compensation Order (payment to the victim) or community service all of which are punitive, albeit third parties might benefit. We find that the Compensation Arrangements are the equivalent of such a Compensation Order."

92. We shall return to the FTT's reasons for finding that the package of payments was a penalty, but at this stage record that we respectfully concur with its approach to the question of deductibility via the "public policy restriction" stemming from Lord Hoffman's speech in *McKnight*.

Wholly and Exclusively for the purposes of the trade

93. Given Lord Hoffman's explanation of *von Glehn,* the issue of whether not any of or part of the Redress Payment were made wholly and exclusively for the purposes of the trade arises only if or to the extent they are not penalties with the attributes he specifies.

94. In *The Herald and Weekly Times Ltd v Federal Commissioner of Taxation* [1932] 48 CLR 113 (HCA), the High Court in Australia decided that the cost of damages for defamation paid by a newspaper publisher were a deductible expense. Gavan Duffy CJ and Dixon J said (at 119) that such claims against a newspaper were a regular and almost unavoidable incident of publishing the paper and

> "that whether money is expended for the production of income cannot be determined by considering the immediate reason for making payment and ignoring the purpose for which the liability was incurred."

95. Thus, when a builder pays an invoice for a ton of sand, the deductibility of the expense is to be determined by reference to his purpose in acquiring the sand rather than the need to settle the invoiced liability. The money in that case was spent to answer the libel claims and whether or not it was deductible depended on how the claims were incurred, not on the mechanism for payment:

> "When it appears that the inclusion in the newspaper of matter alleged 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 reasons remain for denying that the money was wholly and exclusively expended for the production of assessable income…",

and Mann J had held that claims for libel were an "ordinary incident" of conducting a newspaper.

96. In *McLaren* the Upper Tribunal held ([61]) that a deliberate activity which was contrary to contractual obligations and the rules and regulations governing the conduct of the trade and which was not an unavoidable consequence of carrying on a trade and which could lead to the destruction of the trade was not an activity in the course of that trade. We take this to mean that such an activity could not be part of a trade, otherwise the reasoning is circular.

97. We noted above that the penalty in *von Glehn* was for a breach of the law and yet Lord Hoffman recorded without disapproval that the Court of Appeal had accepted it as incurred in the course of the company's trade. The UT's decision in *McLaren* must therefore rest upon what it described as the "egregious" nature of the breach in that case, in particular that it could lead to a destruction of the trade and arose from deliberate rather than unintentional wrongdoing, notwithstanding that the wrongdoing was contractual rather than unlawful.

98. In *G4S Cash Solutions (UK) Ltd v HMRC* [2016] UKFTT 239 (TC) which concerned the deductibility of parking fines, the FTT said [241]:

> "The trade is not that of breaking the law. The breach of the law is a deliberate activity which is undoubtably for a commercial gain which comes about as a result of activity in the course of the trade but is [not part of the trade] … The payment was at least in part to meet the legal obligations"

99. This, it seems to us, must be a finding that a breach of the law gave rise to a legal obligation, and its satisfaction was not a trading activity

100. In *CIR v Great Boulder Proprietary Gold Mines Ltd,* 33 TC 75 (ChD) , a company had entered into transactions connected with the formation of other companies. Actions for damages were brought against the company in connection with the formations which the company paid to settle. The High Court affirmed the Special Commissioner's decision that the payments were deductible. One of the arguments made by the Revenue was that the sums were not expended wholly and exclusively for the purposes of the trade of promoting other companies: the payment was really one for fraud and deceit and being fraudulent or deceitful was no part of the company's trade.

101. Donovan J rejected this argument on the grounds that fraud or deceit had never been admitted or proved and because the monies were expressly paid for an undertaking not to sue. He said it was not possible to assimilate the payment to the *von Glehn* penalty. He deliberately said nothing about whether it was possible to deduct damages paid for fraud and deceit. At the end of his judgment he said that the Special Commissioners' finding that the company had settled the actions because it had thought it cheaper to settle rather than to run the risk of litigation justified their finding that the expense was incurred wholly and exclusively for the purposes of the trade.

The Parties' arguments

102. Mr Tallon says that the Redress Payments had the nature of penalties whose purpose was to punish SPERL: the legislative policy of the Electricity and Gas Acts would be diluted if they were deductible. The payments were the result of regulatory action by Ofgem in respect of a breach of relevant requirements. Ofgem was not acting for particular customers or customers of SPERL but as a regulator, having in mind the interest of all consumers present and future, and the enforcement of the relevant conditions. The payments were not made as compensation to customers pursuant to a commercial dispute but as a result of Ofgem's policy to deter non compliance.

103. Even if the payments were not non deductible by reason of being punitive penalties, the expense was not incurred wholly and exclusively for the purposes of SP's trade because: (i) the behaviour which resulted in infringing the regulatory requirements imposed by a licence was not an activity "within the legitimate scope" of the essence of the trade of supplying gas and electricity: payments made because the trade had been conducted in a wrongful way were not made wholly and exclusively for the purposes of the trade, (ii) the purposes of the payments, namely, to settle a liability arising from

activity outside the trade and to put an end to enforcement action and avoid penalties, were not purposes of the trade.

104. Mr Goldberg accepts that there is ample authority affirming that penalties cannot be deducted in computing trading profits, but he says that the Redress Payments were not in the nature of penalties. They did not have that character because (i) a penalty was something unilaterally imposed whereas these payments were made pursuant to voluntarily incurred obligations, (ii) their object was to compensate rather than to punish: they were directed to consumer benefit rather than paid into the Consolidated Fund, (iii) they were not made pursuant to any "rule" whose policy would be infringed by deductibility, and (iv) they were not regarded as penalties by Ofgem which distinguished between the £1 penalties and the Redress Payments in their Notices. They were in payments to purchase the cessation of an investigation so as to enable the company to get back to its business.

105. He says that the Redress Payments were made wholly and exclusively for the trade. They were the result of matters which were a regular and practically unavoidable incidents of carrying on the business of supplying energy on the scale of the Appellants' business. It was virtually impossible to carry on such a business without making customer redress payment from time to time. The behaviour which gave rise to the payments was ordinary trading activity: sales and marketing, setting tariffs, complying with emissions targets, and billing and complaints handling; those activities were the essence of its trade. The activities were not unlawful and the breaches were not deliberate. Expense which resulted from a non deliberate wrongful act was not prevented thereby from deduction.

106. In the alternative Mr Goldberg argues that those payments which were made to charities are deductible under section 189 Corporation Tax Act 2010. We address this argument after considering the penalty argument and the argument that, if all or any of the Redress Payments were not penalties, they were expenses incurred wholly and exclusively for the purposes of the relevant Appellant's trade.

Discussion

107. After addressing a list of specific findings which Mr Goldberg asked us to make, we shall start 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. If they are not the question arises as to whether the expense was incurred for the purposes of SPERL's trade. If the expense of a payment is not deductible for either or these reasons, we then discuss whether it is deductible as a charitable donation.

(i) Mr Goldberg's List

108. In relation to the first two of these questions, Mr Goldberg asked us to make ten particular findings. It may be helpful in any later appeal if we address them all in one place. They are not all primary factual matters and it is better that we address them here.

Contention 1: The Redress Payments were made under and in accordance with the settlement agreements

109. We so find.

Contention 2: SPERL's entry in to each of the Settlement Agreements was voluntary and was the result of negotiation.

110. To the extent that "voluntary" means without compulsion by force or by law, we so find. The terms of the settlements and the amounts of the payments were the result

of negotiation (as the history of the mis-selling agreement and the reduction in the amounts originally suggested by Ofgem show). The agreements were not "imposed" on the Appellants: they agreed to their terms in the expectation that if they did not a penalty greater than £1 would be imposed.

Contention 3: The Redress Payments were deducted in computing the profits of the relevant trade in accordance with the ordinary principles of commercial accounting.

111. We so find.

Contention 4: The Redress Payments flow directly from acts forming the essence of SPERL's trade of selling energy, done for no other purpose than earning revenue, so that the making of the Redress Payments [w]as a consequence of not meeting the high standards expected of energy suppliers is a regular and almost unavoidable incident of supplying energy.

112. We accept that the essence of SPERL's trade was selling gas and electric energy. We accept, for the reasons set out below, that the acts (or inactions) which gave rise to the Redress Payments were part of that trade's activity and that they were done for the purpose of earning income from that trade. We find that the payments were a consequence of not meeting the standards required of energy suppliers (we express no opinion as to whether those standards are "high"). We find that infraction of the standards is not uncommon but that serious breach, as was the case in relation to the Redress Payments, is less common. We consider that the breaches of the CO_2 and complaints handling rules were practically almost unavoidable. We are not able on the evidence to say the same in relation to mis-selling or cost reflexivity.

Contention 5: The Redress Payments were made wholly and exclusively for the purpose of SP's trade.

113. Save to the extent, if relevant, that the Redress Payments were penalties, we find that the purposes for which the actions were taken which gave rise to the payments were wholly and exclusively for the trade.

Contention 6: The Redress Payments were made as a result of behaviour which did not involve any deliberate wrongdoing.

114. We accept that the behaviour which gave rise to the settlements was not conducted with the intention of breaching the relevant requirements. The behaviour was not inadvertent or accidental.

Contention 7: The Redress Payments did not engage any statutory process which would have been engaged if they were penalties.

115. The Redress Payments formed part of Ofgem's publication of its Decision Notices in relation to the penalties of £1. Those notices were required by statute. Ofgem's refusal in the case of the mis-selling investigation to remove the £1 penalty indicates that the Redress Payments would not have been made if the penalty had not been accepted. Thus, it was only if the statutory process for the £1 penalty was followed that Redress Payments would have been agreed. In that sense a statutory process was engaged in relation to the Redress Payments.

Contention 8: The SLCs and the [Complaints Handling Rules] which Ofgem have decided have been breached here could just as well be, and sometimes are, terms of the supply contracts between SPERL and its customers, so that the payments made as a consequence of breaching those requirements must have the same character as damages for contractual breach.

116. We accept that some of the relevant conditions were or could have been reflected in the terms of the supply contracts with consumers. Not all would be suitable for such inclusion: the CO_2 requirement and the requirement to keep records to show cost reflexivity would not fit easily into that mould.

117. Even if a relevant requirement was, or could have been, also part of the terms of contracts with consumers, the payments made as a result of the breach of the relevant conditions were not of the same character in cases where they did not provide compensation only to customers for loss suffered by the customer. Most payments did not provide such compensation. The fact that ordinary compensation and compensation arising from the settlement agreement might have had different origins did not in our view prevent the latter from being compensation for loss suffered.

Contention 9: The Redress Payments were, as their name suggests, compensatory and not penal in nature and, in effect, took away from SPERL an element of financial gain which it had recorded in its accounts.

118. We have concluded that only some parts of some of the payments were compensatory, and that the other parts or payments were penal. We do not regard the payments as having the effect of only taking away a profit accounted for by SPERL: they were not of amounts shown in total to be related to any savings made by SPERL as a result of its breaching a relevant requirement. To the extent they were compensatory there was no evidence that SPERL's savings if any equalled the loss suffered by customers or by consumers generally.

Contention 10: The Redress Payments were made for the same purpose and had the same consequences for SPERL as all other compensation payments made by SPERL, whether in accordance with its published complaints handling procedure or by agreement or otherwise.

119. Generally we consider that compensation payments made by SPERL in accordance with its published complaints handling procedure or by agreement ("ordinary compensation") will be expenses incurred in the activities, and for the purposes, of the trade. In the case of the Redress Payments it seems to us that, whilst they were incurred in the course of activities carried on for the purpose of the trade, they were also made for the purpose of closing down the investigation and avoiding adverse publicity and so differed from ordinary compensation. But it seems to us that those two purposes were, like those of the settlement agreements in *Great Boulder*, both purposes of the trade.

(ii) Penalty and Punishment

120. Mr Goldberg relies upon Lord Hoffman's explanation of why the fine in *McKnight* was not deductible but the legal costs were:

> "Once it is appreciated that in a case like this non-deductibility depends on 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 can be quite different."

121. Mr Goldberg draws the conclusion from this passage and Lord Hoffman's earlier description of a penalty as having the purpose of punishing the taxpayer, that three conditions must be satisfied for an expense to be a non deductible penalty:

> (i) it must be a penalty,
>
> (ii) its purpose must be to punish, and
>
> (iii) there must be a 'rule' under which it becomes payable which has (or possibly to which there may be attributed) a specific policy of denying a deduction.

122. We accept that the first two of these conditions flow from Lord Hoffman's speech, although they leave at large the question of what is a penalty. Although punishment may be inherent in any penalty in what follows we address the two issues separately.

123. In relation to the third proposition Mr Goldberg says that there was no "rule" under which the Redress Payments became payable: they were payable simply because SPERL had agreed to make them. Mr Tallon retorts that if some rule is required to be identified, then it is the object of Ofgem to deter non compliance visibly and meaningfully.

124. Mr Goldberg's third condition turns around the need for a 'rule'. There are, as Mr Tallon pointed out, in the same and the succeeding paragraph of Lord Hoffmann's speech two other places where Lord Hoffman uses this word. The first of these lies in the passage where he explains why *Herald* was correctly decided. Having observed that defamation claims were a regular and almost inescapable occurrence and the damages compensatory rather than punitive, he says:

> "There seems to be no reason of policy why a <u>rule</u> which allows recovery of damages [by a plaintiff defamed in the course of the business] should prohibit deduction."

125. This "rule" must refer to the rule of tort which provides for such damages.

126. The second is in the following paragraph where Lord Hoffman is discussing the deductibility of Mr McKnight's legal costs. There he discusses (and rejects) the proposition that, as a matter of policy, an unsuccessful defendant should have to bear his legal costs 'personally' or without deduction. He says:

> "But I think there would be great difficulties in giving effect to such a <u>rule</u>."

127. Here he can only be speaking of a rule which would be part of a policy which affected deductibility. At least so far as concerns his own costs we cannot see how it could have been the rule of contract under which Mr Sheppard became liable to pay his lawyers, and we can think of no statutory provision to which Lord Hoffman could have been referring other than the Taxes Acts.

128. It seems to us that we should not try to interpret Lord Hoffman's words as if they were in a statute. In relation to *von Glehn* it appears that, unless he is referring to interpretation of the Taxes Acts, he is considering the provisions of the statute imposing the penalty, in *Herald*, the rules of tortious defamation, in relation to Mr Sheppard's fine, the rules of the Stock Exchange, and in relation to Mr Sheppard 's costs, the public policy of deductibility. But in each case he reads in a public policy restriction to the circumstances of the expense. In relation to Mr Sheppard 's costs the possibility of that restriction can only be an overlay onto the provisions in the Taxes Acts for deductibility. The issue in this appeal is whether such a policy can be so read into the Electricity and Gas Acts or into the Taxes Acts so as to deny deductibility of the Redress Payments: if they were punishing penalties it seems to us that such must be the case.

<u>Penalty</u>

129. Mr Goldberg separates penalty and punishment.

130. The essence of a penalty seems to us to be some suffering, expense or loss which arises from the breach of a law, agreement or rule by which a person's conduct is governed where such suffering expense or loss is not simply compensation to a party injured by the breach. Thus: a penalty awarded in a football match arises as the result of

an infraction of the rules to which players accept they are bound and does not necessarily compensate the opposing team; the penalty which *McLaren* suffered for its breach arose from the breach of the governing agreement and did not compensate the other teams; but ordinary damages for tortious conduct, like those in *Herald*, whilst they may be said to arise from a breach of a civil obligation, compensate the injured party and would not normally be called a penalty). Whether or not a payment is a penalty with the characteristics we have described (and ignoring for the moment the question of punishment) is in our view, an objective matter independent of the purpose of the person receiving or extracting it. Whether or not a payment is compensation is, it seems to us, also an objective matter and dependent on whether it is calculated to make amends for something suffered or lost by the recipient at the hands of the payer.

131. On this basis we would describe *non-compensatory* Redress Payments as penalties even though we do not consider that they can be said to have been "imposed": they were expenses occasioned by a breach of the rules by which the suppliers were governed. We consider below whether, if we are wrong and they are not properly described as "penalties" because they were not "imposed", they are nevertheless non-deductible on policy grounds.

<u>Punishment</u>

132. As we have said, it may be that punishment is part of the normal meaning of penalty. Punishment is the execution of an act which causes suffering, loss or expense for the purpose of ensuring future compliance with the rules. That purpose must be found in the purpose of the person who causes the penalty to be suffered. Whilst ordinary contractual or tortious damages might possibly be said to punish the payer, the nature of a payee's purpose in extracting them is generally to be compensated rather than to punish. That seems consistent with Lord Hoffmann's view of the damages in *Herald*.

133. Thus the purpose of GEMA in entering into the settlements is, it seems to us, relevant to whether there was a purpose of punishment in its agreement to the settlements, but not relevant to whether or not the suffering was compensation.

134. We think it clear that GEMA intended the obligations to make the Redress Payments to be punishments:

(a) GEMA's statements that its enforcement objective was to deliver credible deterrence and that non compliance should cost more than compliance indicates that its purpose was to ensure future compliance with the rules;

(b) GEMA's statement that any penalty (and therefore any amount paid in settlement where absent settlement GEMA would have sought a penalty) should remove any gain made and contain an amount reflecting the seriousness of the contravention indicates a policy of deterrence; and

(c) that settlement was offered as an alternative to the imposition of a penalty and described a penalty as being necessary to create an incentive to ensure compliance to our minds suggests punishment.

135. We reach this conclusion despite the move since 2010 on the part of GEMA towards redress payments and away from straight penalties. The purpose of a penalty was, it seems clear from the legislation and Ofgem's statements, to punish; the direction of payments to benefit consumers did not remove that object but added to it the benefit which redress payments could bestow on consumers generally. GEMA's statutory object of protecting present and future consumers as a whole is served by providing (in the form

of payments for the benefit of consumers) a deterrent for non-compliance as well as by directing payments in ways which benefit consumers as a class.

In lieu of a penalty

136. Through Mr Goldberg Mr Sinclair suggested that the amounts of the Redress Payments which Ofgem obtained under the settlements exceeded what might have been sustained as a true penalty under Ofgem's legislative powers. He gave as an example the competition case of *National Grid v GEMA* [2010] EWCA Civ 114 where an initial penalty of £41m imposed by Ofgem was reduced by the Competition Appeal Tribunal to £30m and then by the Court of Appeal to £15m. He says that the round sum settlements reached by Ofgem represent a deal rather than a legally sustainable amount.

137. Although we recognise that that case was in relation to different matters and in a different forum, we accept that it cannot be said that the settlement amounts were in place of certain penalties of the same amounts. No penalty (other than £1) was actually imposed and the penalty Ofgem said it would charge in the absence of settlement would be subject to appeal and could end up being lower. But it seems to us that 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.

139. Lord Hoffman's reasoning for the denial of a deduction in *McKnight* and *von Glehn* rests on public policy. It seems to us that the same public policy which denies a deduction for a punishing non compensatory penalty also denies a deduction for punishing non-compensatory 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. Thus, even if it were the case that, because the Redress Payments were not imposed by law, they could not be penalties, the same public policy considerations - the concern over dilution of the deterrent punishment by allowing deductibility – applies to the non-compensatory Redress Payments.

140. In *McLaren* the UT held that the public policy which applied to deny a deduction for a statutory penalty extended to a penalty arising under the terms of an agreement and that there was no need for the contractual mechanism which gave rise to the penalty to have a serious public interest (see [76]). It is not inconsistent with that finding to hold that payment pursuant to an agreement entered into as part of the imposition of a statutory penalty (of £1) is subject to the same policy of non-deduction unless the payment is compensatory.

141. We conclude that, except to the extent that the Redress Payments were compensatory, they were not deductible on public policy grounds.

142. At [88] above we described the decision of the FTT in *BES* in which it held that the payments in that case were penalties. The FTT regarded the facts: that the settlement process was set out in Ofgem's enforcement guidelines, that those guidelines described a discount being applied to a penalty, and that the heading "Notice of Decision to impose

a penalty" in GEMA's notice used "penalty" and "imposed", indicative of the penal nature of the payments. We were not persuaded that Ofgem's view of the nature of the payments was relevant to whether (ignoring the punishment issue) they were objectively penalties. The FTT also regarded the conditions of the settlement agreement as being "imposed" whereas we, noting that Ofgem's guidelines acknowledge that settlement discussion may not result in agreement and our conclusions that the agreements were negotiated and agreed (albeit under threat of a penalty larger than £1) did not come to the same conclusion. But we found that the payments nevertheless had the nature of penalties because they were suffering arising from a breach of the rules and were intended to punish, and thus not deductible by reason of public policy.

Compensation

143. Given that many of the payments were not directed solely to SP's customers, and having regard to GEMS's statutory objects, we accept that GEMA did not act as the agent of any consumer in agreeing to the payments nor had in mind only the Appellants' customers in the making of the agreements

144. We also note that in each case Ofgem said that it regarded the breaches as serious but whilst not accidental or inadvertent were not from conduct intended to breach.

145. We now take the elements of each payment in turn.

(a) Mis-selling

146. In accordance with the Settlement agreement SPERL paid:

(i) £7,316,385 to vulnerable customers identified under the Warm Homes Scheme,

147. We do not regard the £7,316,385 as compensation. Whilst there may have been customers in the Warm Homes Scheme who were affected by mis-selling, there was no evidence that all the recipients were. The payment was not calculated to address any harm done to the recipients as a result of a breach. The letters to the recipients made clear that the payment was an apology for a breach which may not have affected them.

(ii) £554,013 in cashed cheques or credits directly to affected customers, and the balance of the £1m (ie £445,987) to SPET,

148. The payment to SPET cannot in our opinion be called compensation. The beneficiaries of SPET were not limited to customers of SPERL or to those who had suffered loss as a result of the breach.

149. The £554,013 can properly be described as compensating customers who were mis -sold. The customers did not receive the payments as damages for breach of SPERL's contract with them, but the payments were akin to damages for breach of a tortious obligation not to mislead them. They were calculated to make good the loss the customer had suffered. Whilst these payments were in addition to any payments to which SP was otherwise committed, it seems to us that it is unlikely that such payments were in respect of the same loss as these payments compensated.

(iii)£1 as a penalty to the Consolidated Fund.

150. No deduction was sought for this. It was not compensation.

(b) Costs Reflexivity

151. SPERL agreed to pay £750,000 to Energy Best Deal, a public awareness campaign run by Citizens Advice. Mr Orr said that SPERL had thought that no consumer

detriment had resulted from the breach: the failure was a failure to justify the differences in charging rates.

152. We do not consider that this can be called compensation. The payment was not directed to SPERL customers. It was not calculated to make good any loss they had suffered.

153. No deduction was sought for the £1 penalty.

<u>(c) CO_2 targets CESP</u>

(i) £2.4m paid by the companies to SPET.

154. For the same reasons as those given above, we do not regard this as compensation.

(ii) The penalty of £1 was not compensation.

155. Accordingly, none of the payments made pursuant to the intercompany agreements were compensation.

<u>(d) Complaints handling</u>

156. In accordance with the agreement SPERL paid

(i) £14,709, 208 to affected customers,

These were round sum payments of £73 to each such customer. That indicates to us that they were not calculated to compensate the recipient for loss actually suffered, particularly as SP was not released from the payments of compensation it would otherwise have had to make. We conclude that this was not compensation.

(ii) £3,290,741 to two charities,

We do not regard this as compensation. It was not calculated to make good any loss suffered, and the receipt of its benefit was not limited to, and might not even include, those who had been affected by the breach.

(iii) A £1 penalty, for which no deduction was sought.

157. We conclude that only the £554,013 paid in the mis-selling settlement was compensation. The remaining payments were non deductible penalties.

<u>*(ii) Wholly and Exclusively for the purpose of the trade*</u>

158. Given our conclusions on the issue of penalties, the discussion which follows applies only to the payment we have found to be compensatory, or if we are wrong in those conclusions

159. Lord Hoffman regarded the fine in *von Glen* as having been accepted by the Court of Appeal as incurred in the course of the company's trade, but *Mclaren* is authority that a deliberate activity which was contrary to contractual obligations and the rules and regulations and which was not an unavoidable consequence of carrying on a trade and which could lead to the destruction of the trade is not an activity in the course of that trade because the trade could not encompass such an activity.

160. On the other hand, failures which are negligent or inadvertent or even the result of deliberate actions which give rise to claims for breach of contract or to tortious liability cannot, we think, be treated as not being part of the trade solely because they are in breach of those obligations. The formulation in *McLaren,* where the breach consisted of knowingly using detailed secret plans of a competitor in breach of the rules, suggests to

us that a breaching activity may not be part of a trade if the breach is as the UT said, “egregious”. Being deliberate and being such as to lead to the possible destruction of the trade may be one way in which such a breach may be described. In contrast there was in *von Glehn* acceptance that the company did not knowingly commit a breach of the law.

161. To our minds the trade of SPERL was the sale of gas and electricity to customers. That trade encompassed (notionally) acquiring the gas and electricity, marketing to find new customers, setting tariffs, billing customers, dealing with queries and complaints, and activities needed to comply with licence conditions such as the CO_2 reduction activities. All of these were activities in the nature of trade. All were plainly undertaken in order to earn income. None of them were criminal.

162. The actions or inactions of SPERL which gave rise to the Redress Payments were to our minds part of the activities undertaken by SPERL as part of, and for the purposes of, that trade:

(i) it sought to make new supply contracts by doorstep selling,

(ii) it had procedures to set different tariffs for different payment methods,

(iii) it entered into contracts with third parties to attempt to secure the carbon dioxide savings, and

(iv) it introduced a new computer system to deal with billing and complaints.

163. The way in which SPERL did these things was not in all respects the way it was required to do them by its licence or the Regulations, but its failure to comply was not a criminal offence or breach of the law, nor was it done with the intention of breach: each of the first two Decision Notices indicated that there was no evidence that the contravention was deliberate or wilful, and the third that SPERL did not seek to breach the relevant requirements; the fourth noted that SPERL had some measures in place to prevent contravention.

164. We do not think that it cannot be said that all SPERL’s failures were wholly unavoidable: Ofgem found that some of the breaches could have been avoided by setting up robust practices. But the making of mistakes from time to time in the conduct of a business is an ordinary occurrence: we take note that were it not, there would be little market for product liability or professional indemnity insurance. We take the UT’s use of “unavoidable” in *Mclaren* to flow from the description of the libels in *Herald.* But in *Herald* the libel actions were described as “almost unavoidable” (or an ordinary incident of the trade), and the corresponding meaning must have been intended by the UT.

165. In theory no doubt, by publishing a wholly anodyne newspaper the libel actions in *Herald* could have been avoided; no doubt the expenditure by SPERL of greater time and effort in ensuring compliance could have reduced the likelihood of such infractions (and Ofgem considered that to have been the case for example in the costs reflexivity investigation), but experience shows that even the best laid plans of mice and men gang awry. The very act of carrying on a business puts the taxpayer at risk of mistakes made in conducting that business.

166. That is particularly the case in relation to the complaints handling and billing investigation. By appointing reputable, able consultants and managing the process of transition to the new system slowly, we think that SPERL took reasonable steps to avoid difficulties. The problems arose in part at least from the (in)actions of others. Where those others were reputable consultants they may reasonably be described as almost unavoidable.

167. Further whilst the infractions were plainly serious, they did not seem to us to be such as could have led to the destruction of the business: SPERL was able to remedy its systems to Ofgem's satisfaction. There was no suggestion that Ofgem considered withdrawing SPERL's licence.

168. We conclude that the activities which gave rise to the Redress Payments were not an egregious breach of the rules of the type which the UT had in mind in *McLaren* were part of the trade of SPERL; as Lord Sterndale put it in *von Glen,* they were "for the purpose of enabling a person to carry on and earn profits in the trade.".

169. Mr Tallon argues that a reason or purpose for the payments was the reason SPERL entered into the settlement agreements, namely, inter alia, to promote the efficient operation of the business through the avoidance of litigation risk and the diversion of management time. It achieved the putting to an end of the investigation and the avoidance of a higher penalty and took advantage of a discount from the penalty Ofgem indicated it would charge. These he said were reasons for the payment and were not for the purposes of the trade which could not be dismissed as intermediate purposes on the way to some ultimate objective (see *Interfish Ltd v HMRC* [2014] EWCA Civ 876).

170. Section 54 CTA 2009 applies to prohibit the deduction of an "expense incurred" otherwise than wholly and exclusively for the purposes of the trade. The expense of the Redress Payments was incurred because SPERL had breached the relevant requirements. We referred above to the passage in *Herald,*

> "that whether money is expended for the production of income cannot be determined by considering the immediate reason for making payment and ignoring the purpose for which the liability was incurred.",

and we gave the example of the builder's ton of sand. In the instant case the liability arose because of the company's purpose in carrying out the acts which gave rise to the breach. Those we have found were for the purpose of the trade. We accept that it is likely that the company agreed to the settlement for the purposes of concluding the investigation as Mr Tallon relates. But we find (as Donavan J accepted in *Great Boulder)* that that was for the purposes of the trade as well: putting an end to a time consuming investigation avoided expense which would be suffered by the trade. The same must generally be the case for any settlement of a liability which arises from actions taken in the course and for the purposes of a trade.

171. Thus on the basis of our conclusions as to the trade conducted by SPERL, the expense of the compensatory Redress Payments was incurred wholly and exclusively for the purpose of the trade.

172. We have found that the other payments were not deductible on policy grounds. If we are wrong we would find that section 54 did not preclude their deduction.

Charitable deduction

173. SPERL argues that the payments to the charities under the mis-selling, costs reflexivity and complaints handling settlement agreements (the "Trust Payments") were, if they were not otherwise deductible, deductible under the provisions of Part 6 CTA 2010.

174. Section 189 CTA 2010 permits the deduction of "qualifying charitable donations" in calculating corporation tax profits. By section 190 "qualifying payments" are qualifying charitable donations. By section 191:

> "a payment to a charity by a company is a qualifying payment…if each of conditions A to F is met,"

175. The parties agree that the recipients of the Trust Payments were charities and that conditions A to E were met in respect of those payments. That leaves condition F.

176. Condition F is that the payment is not disqualified under section 195. That section provides:

> "(1) A payment is disqualified under this section if-
>
> (a) benefits are associated with the payment, and
>
> (b) the restrictions on benefits associated with a payment are breached."

177. Section 196 provides that "a benefit is associated with a payment if-

> "(a) it is received by the company which made the payment…and
>
> (b) it is received in consequence of the payment."

178. Section 197 deals with the restrictions on benefits relevant to section 195(1)(b), and for present purposes it is enough to record that those restrictions would be breached if:

> "…the total value of the benefits associated with the payment exceeds …5% of the payment.",

and the value of those benefits exceeds £2,500

179. Section 198 provides for the value of a benefit to be taken as its 'annual equivalent' where the benefit relates to a period of less than 12 months, consists of a right to receive benefits at intervals over such a period or is "received" at intervals associated with payments in a 12 month period.

180. HMRC say that the Trust Payments do not qualify for the relief for two reasons.

181. First, they say that the provisions apply only to "donations", and that a donation is a voluntary gift. The Trust Payments they say were not made voluntarily and were not gifts. It cannot be the case for example that a payment ot charity of tortious damages or in repayment of a loan can be called a "donation".

182. We accept that the words of a defined term may colour the interpretation of the definition, but the nature of the provision in section 190:

> "The following are qualifying charitable donations - …payments which are qualifying payments,",

and that of section 191:

> "A payment made to charity is a qualifying payment",

does not permit, in our judgement, a gloss that the payment be made voluntarily or be in the nature of a gift. The answer to the examples of tortious damages and the repayment of a loan seems to us to lie in the associated benefit rule: in each case the effect of the payment is that the payer obtains the release from an obligation to make payment. That is a benefit which may be said to be "received" by the payer; it is associated with the payment, and received in consequence of the making of the payment. Its value will be equal to the payment.

183. Second, they say that the payment was made in the context of a threat of financial penalties greater than the Trust Payments: agreeing to the making of the Trust Payments gave SPERL the benefit of a right to pay a lower sum overall.

184. Whilst we have found it likely that if the settlement had not been reached Ofgem would have (eventually) succeeded in imposing penalties of the same order of magnitude, we were not able to conclude that they would be larger than the Redress Payments. As a result, we do not conclude that SPERL received a benefit by paying a lower sum than it would otherwise have had to pay.

185. But we have concluded that the Redress Payments were the price paid to obtain the ending of the investigations. In the bargains encapsulated in the settlement agreements SPERL agreed to make the payments in return for the ending of the investigation. That was a benefit just as much as a second hand jumper bought in a charity shop for £5 is a benefit associated with and consequent upon the payment of the £5.

186. The ending of the investigations was in our view a benefit "received" by SPERL because after the agreements were made it had the assurance that the investigations would not continue, something it did not have beforehand.

187. The benefit was provided by GEMA and not by the recipient charity. Whilst the benefit provisions are clearly applicable where the benefit is received from the charity, they focus on the receipt of the benefit rather than on the provider and we see no indication in Part 6 that the provider must be the recipient charity for the provisions to have effect.

188. The benefit clearly had a value because SPERL was willing to pay for it. That value was clearly more than 5% of the payment and more than £2,500.

189. Mr Goldberg notes that Ofgem indicates its intention that a company should not gain any benefit financial or otherwise from making "voluntary redress" payments under settlement agreements. That, he says, emphasises the truly voluntary nature of the Trust Payments. In our view, however, those statements must be read together with those referring to the benefits of settlement for the company in the enforcement guidelines.

190. In *BES* the FTT regarded the redress payments as discharging an inevitable liability to a penalty and the benefit of the payments as providing a lesser outlay than that penalty. Whilst we have concluded that it was likely that GEMA would (eventually) be successful in imposing penalties in the absence of the settlement agreements, we have not found that such a penalty was a liability of the company or that it would exceed the amount of the Redress Payments. The benefit we find was the closure of the investigations which included, but was not limited to, the possibility of the imposition of a large penalty.

191. We conclude that the Trust Payments were not deductible under the Charitable Donations provisions of Part 6 CTA 2010.

Conclusion

192. With the exception of the £554,013 paid under the mis-selling settlement, the Redress Payments, although made wholly and exclusively for the purposes of the trade, were in the nature of penalties which were not deductible on policy grounds. The payments to charities were not deductible under section 189.

193. We allow the appeal in relation to the £554,013 but dismiss it in relation to the other payments.

Rights of Appeal

194. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

CHARLES HELLIER
TRIBUNAL JUDGE

RELEASE DATE: 04 February 2022