Analysis

Regulatory payments by banks and corporates

Speed read

The government has proposed offences for corporates who fail to implement adequate measures to prevent the facilitation of financial crimes. Such offences are part of a wider trend of rules focusing on ensuring the 'good' behaviour of corporates. Corporates will need to be prepared to face potentially the kind of scrutiny banks have previously faced and to consider the tax treatment of the costs involved. That includes not just fines or compensation, but the expense of investigations and costs incurred on behalf of employees accused of misconduct. The tax treatment may depend on properly identifying the costs and managing proceedings.

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On 5 February 2016, Andrew Tyrie, chair of the Treasury Committee, wrote to George Osborne seeking confirmation that: 'payments imposed on banks by regulators … cannot be deemed to be "compensatory" and therefore deductible'.

Mr Tyrie's concern was that taxpayers were bearing part of the burden of payments imposed by regulators, even where the bank had committed a breach of regulations.

Finance (No. 2) Act 2015 s 18 introduced rules (CTA 2009 ss 133A–133N) limiting the ability of banks to deduct compensation payments to customers; and deeming them to receive taxable amounts (equal to 10% of any non-deductible payment) in order to offset deductions for associated administrative costs. Mr Tyrie's concern (in a subsequent letter dated 6 April 2016) was that these rules failed to address payments to regulators and so taxpayers could still be 'on the hook for some aspects of a bank's misconduct'.

Proving that politicians are not immune from receiving a politician's answer, Mr Osborne did not confirm or deny Mr Tyrie's concern but simply noted (in a letter confusingly dated 4 April 2016) that payments made to regulators are 'generally deductible' and that 'this is a longstanding general position'.

What are the costs?

Mr Tyrie may have focused on a particular class of payments, but his letters highlight the costs faced in any regulatory investigation. Those costs can be categorised as:

- fines or compensation arising from regulatory breaches;
- administrative costs of the investigation; and
- payments in respect of employees accused of misconduct.

The treatment of these costs is considered below.

Not just banks

Various new and planned rules focus on the behaviour of corporates, including the government's recent proposal for an offence where corporates fail to implement adequate measures to prevent financial crimes (and an offence of this type with regard to tax evasion is imminent).

It is worth emphasising, therefore, that the tax treatment of such payments will increasingly be important to corporates, as well as banks.

Fines

Deductions against trading profits are allowed for:

- expenses incurred wholly and exclusively for the purposes of the trade; or
- losses connected with or arising out of the trade.

In relation to fines, HMRC's position (set out in its *Business Income Manual* at BIM38500) is that: 'where a penalty is intended as a punishment then it will not be allowable'.

HMRC refers to the case of *McKnight v Sheppard* [1999] 71 TC 419, which concerned the payment of a fine to the Stock Exchange disciplinary committee. The House of Lords explained that the fine was not deductible because it was punitive in nature.

This position has also been tested in respect of non-statutory fines. In *McLaren Racing Ltd v HMRC* [2014] UKUT 269, McLaren was obliged to make a payment by the FIA, the body entrusted to oversee the rules of Formula 1, under an agreement between the relevant parties. The Upper Tribunal decided that the payment was not deductible because: 'the nature of the payment was such as to prevent its deductibility, namely that it was designed to punish McLaren'.

Given that fines incurred under a private agreement may not be deductible, it is unsurprising that payments have also been treated as non-deductible where they represent an agreed penalty to settle proceedings (see *IRC v Warnes & Co Ltd* [1919] 12 TC 227 and *IRC v Alexander von Glehn & Co Ltd* [1920] 12 TC 232); or where they comprise foreign penalties, including where the payer submitted to the foreign jurisdiction voluntarily (see *Cattermole v Borax & Chemicals Ltd* [1949] *31 TC* 202).

Compensation payments

Mr Tyrie assumes that if a payment to a regulator is not punitive, it will inevitably (and potentially unfairly) be treated as deductible. This distinction is not, however, entirely accurate.

The reason a penalty is not deductible is because the 'purpose is to punish the taxpayer' and that purpose would be diluted if 'the taxpayer were allowed to share the burden with the rest of the community' (Lord Hoffmann in *McKnight*).

This is supported by *G4S Cash Solutions (UK) Ltd v HMRC* [2016] UKFTT 0239, in which the court denied deductions for parking fines incurred in the course of transporting cash. Although the court suggested that such payments were not deductible by their nature, the arguments were not wholly convincing. The simpler conclusion (which the court felt compelled to make in establishing a point of principle) was that deductions should be denied because: 'the legislative policy is that of punishment and deterrent'.

This does not mean that if a payment is not punitive, it will necessarily be deductible. Other than compensation payments by banks to customers, which are addressed in F(No.2)A 2015, whether a payment is deductible will depend on the nature of that payment.

This has led to some fine distinctions. For example, damages against a newspaper for defamation have been

allowed as deductible (*The Herald and Weekly Times Ltd v Federal Commissioner of Taxation* [1932] 48 CLR 113); whereas payments for libellous comments made by one sugar broker about another were not (*Fairrie v Hall* [1947] 28 TC 200). Both payments were essentially compensatory in nature, but defamation claims were 'regular and almost unavoidable incident[s] of publishing' newspapers. Maligning a fellow sugar broker (even if done to improve trade) was not.

In *Strong & Co v Woodifield* [1906] 5 TC 215 (concerning damages to a customer of an inn for injuries caused by a falling chimney), the test was summarised as whether payments were 'for the purpose of enabling a person to carry on and earn profits in the trade'. In that case, whilst the damage may have arisen *during* the course of the trade, it was not sufficiently closely connected to the trade to be deductible.

Notwithstanding *Strong & Co*, HMRC takes a relatively broad approach, advising that a trader should be allowed 'the costs of civil damages for injury to others caused by day to day trading operations'.

Consequently, the answer to Mr Tyrie is that a non-punitive payment to a regulator might be deductible, depending on its nature. Mr Tyrie may have wanted a statement of policy, yet Mr Osborne may have been careful to avoid one because, if anything, HMRC's position is arguably more generous than might be justified by the case law.

Of course, public mood and policy can both change quickly. Whilst provisions like those in F(No.2)A 2015 may be more radical, a change in the attitude of HMRC in scrutinising the character of payments could also signal a material change.

Administrative costs

Mr Tyrie also refers to costs that banks accrue during investigations by a regulator. To the extent that amounts are paid to a regulator for the 'regulator's costs of performing its duties' (see BIM42515), it is difficult to see why such payments should not be deductible. Banks should also be able to deduct their own costs in dealing with regulators.

Indeed, even if a non-deductible penalty is payable, the associated costs may still be deductible. In *McKnight*, the individual could deduct his legal costs because the court decided they were paid to preserve his business reputation. Similarly, in *Cattermole*, although the court was unwilling to spend much time over costs of £28, it observed that: 'it would be extremely difficult to hold that a sum of money paid by the directors … for legal advice as to what they should do is not an expenditure connected with their trade'.

In *McKnight*, Lord Hoffman suggested that, in fact, advisory costs might be deductible as a matter of public policy, given the fundamental entitlement to obtain advice where proceedings are threatened. F(No.2)A 2015 has eroded that policy for banks. Whether companies will end up in the same position remains to be seen.

One area where uncertainty over costs can arise is where there is a duality of purpose. In *MA Raynor (deceased) and Mrs BC Raynor* [2011] UKFTT 813, there was a business and personal motivation in defending a criminal prosecution for polluting a river. As a result, the entire cost was treated as non-deductible.

Such mixed purposes can particularly arise where individuals, along with the company, are subject to regulatory investigations.

Funding of employees

Companies will frequently decide to fund the legal costs and fines of employees accused of misconduct. Although the case law is arguably not clear on the point, HMRC's general position (see BIM42515) is that such payments (if taxed as employment income) should be deductible for the company (irrespective of the nature of the payment by the individual).

It should also be noted that regulatory offences (such as the proposed 'failure to prevent' offences) may address the actions of anyone 'associated' with a company. As such, payments in respect of individuals other than employees may also become increasingly relevant.

If an individual acts not as an employee but, for example, as a contractor (so that payments do not comprise employment income), claims for deduction may be less automatic. The position will depend on the facts. Is the payment made for 'the purpose of enabling a person to carry on and earn profits in the trade'? That may be the case if, for example, the company made the payment in order to protect its business reputation.

When faced with proceedings that involve individuals, a company should consider how such proceedings are managed and how different costs are identified in order to ensure that deductions are preserved for genuine business costs.

VAT on legal costs

VAT will represent a considerable proportion of the cost of a regulatory investigation. Whether VAT is recoverable will largely depend on whether the costs were paid for the benefit of the company. Such issues are especially relevant when a company pays the costs of employees (and other individuals). In *P&O Ferries (Dover) Ltd v The Commissioners of Customs and Excise* [1992] VATTR 221 (which related to the sinking of the vessel *Herald of Free Enterprise*), the corporate owner of the ship, together with seven employees, was charged with manslaughter.

The company paid the legal costs for the individuals and the court considered that recovery of VAT depended on the legal services being:

- used for the purposes of the company's business; and
- supplied to the company.

The court held that, firstly, defending the individuals served the company's purpose in making any corporate offence less likely. Secondly, the services were supplied to the company because the lawyers were chosen by the company, the company worked with the lawyers in planning the defence and fees were paid directly by the company. On that basis, the company was able to recover VAT.

Final thoughts?

It is inevitable that scrutiny of both banks and corporates will increase. The costs involved in such investigations are significant and varied: whether fines, compensation, legal costs or payments for third parties.

Where a corporate is faced with actions from a regulator, it would be worth considering at an early stage exactly how proceedings are to be managed and how any payments are to be made. Whilst Mr Osborne may suggest that HMRC's treatment of such amounts is 'longstanding', the events of the last few years have shown us how quickly established practices can change. ■

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