# *McKNIGHT v SHEPPARD*[1]: OBSERVATIONS

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The Court of Appeal decision in *McKnight v Sheppard* was a welcome victory for the taxpayer. However, the authorities in the particular area of application of the "wholly and exclusively rule", namely the deductibility of expenses and fines in legal (or quasi-legal) proceedings, have been left in something of a muddle.

The facts were these: the taxpayer (Mr Sheppard) was the sole proprietor of a stockbroking firm. He incurred legal expenses and was fined for misconduct and gross misconduct at disciplinary hearings before Committees of the Stock Exchange Council in relation to alleged breaches of Stock Exchange rules. The fines had been substituted for four six month suspensions. In fact, the fines were not considered by the Court of Appeal. A deduction for these fines (one of £30,000 and one of £20,000) was denied both by the Special Commissioners and the High Court[3] and the taxpayer did not pursue the point in the present appeal.

The question which the Court addressed was, therefore, solely whether the legal expenses incurred by Mr Sheppard in conducting the disciplinary proceedings before the Stock Exchange Council Committees were deductible for Schedule D, Case I purposes. The legal expenses were held to be deductible, on the footing that:

1. The Special Commissioners had determined, as a finding of fact, that "... the sole object "to be served by" the legal costs was to avoid the destruction of the taxpayer's business. The fact that his personal reputation was inevitably involved also did not make the preservation of

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1 [1997] STC 846.

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3 [1996] STC 627 at 635 (paragraph 62 of the Special Commissioner's decision) and 645j.

his reputation a "purpose" of the expenditure".[4] The Court of Appeal observed that "it may be exceptional ... for someone placed in the taxpayer's position to be so indifferent as to his personal reputation that its preservation was not a purpose [of the expenditure]. Nevertheless, that was the finding of the tribunal of fact ... Moreover ... it was not inescapable that one purpose of the expenditure was the preservation of the taxpayer's personal reputation."[5] In other words, the subjective purpose in the taxpayer's mind was the preservation of his business. He did not care about his personal reputation and *Mallalieu v Drummond*[6] was distinguishable on that basis.

2. Furthermore TA 1970, section 130(a)[7] and section 130(e)[8] did not impose two separate tests but rather the test in section 130(e) was subsumed in the "wholly and exclusively test" in section 130(a).[9]

3. Furthermore, and most importantly, the "wholly and exclusively test" in section 130(a) did not, either on the words of that provision or as a matter of authority, require that expenditure be sufficiently connected with the carrying on and earning profits of a trade in order to be deductible.[10]

4. Expenditure to prevent oneself being disabled from carrying on and earning profits in a trade is deductible on the authority of *Morgan v Tate & Lyle Limited*.[11]

This article concerns point 3. It followed that, given the findings of fact by the Special Commissioner, the expenditure was incurred by Mr Sheppard for the purpose of preventing a discontinuance of his trade. It was entirely irrelevant as to whether or not that expenditure was incurred for the purpose of earning profits.

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4 Paragraph 97 of the Special Commissioner's decision, quoted at 849h.

5 850g.

6 57 TC 330.

7 Now TA 1988 section 74(a).

8 Now TA 1988 section 74(e).

9 At 851 i.

10 851a-e.

11 35 TC 367.

Therefore the legal expenditure incurred by Mr Sheppard was incurred for the purposes of his trade and was deductible.

Nourse LJ was quite clear in rejecting the notion that deductible expenditure must be incurred for the purpose of earning profits: "... neither [Counsel for the taxpayer], nor [Counsel for the Crown] could refer us to any case in which it had been distinctly held that the expenditure must not only be wholly and exclusively incurred for the purposes of the trade, but also sufficiently connected with the carrying on and earning of profits in the trade. That is not surprising. As I understand the authorities, they all adopt the single test which the words of section 130(a) require to be adopted. The second requirement suggested by [Lightman J in the Court below at *[1996] STC 626 at 642]* is only an aid to deciding whether the first has been satisfied or not. (See *Strong & Co of Romsey Limited v Woodifield* 5 TC 215)." This observation by the learned Judge is slightly surprising, since Lord Davey, in construing the statutory predecessor of section 130(a), in *Strong v Woodifield*, observed that the words "for the purpose of the trade appear ... to mean for the purpose of enabling a person to carry on and earn profits in the trade ... it is not enough that the disbursement is made in the course of, or arises out of, or is connected with, the trade or is made out of the profits of the trade. *It must be made for the purpose of earning the profit.*"[12] As it happens, this dictum was not specifically adopted or approved by the Lord Chancellor,[13] who, while agreeing with Lord Davey that the expenses of the innkeeper who incurred damages and costs on account of injuries caused to a visitor staying at one of his houses by the falling of a chimney were not deductible, so decided on the footing that such expenses could only be deducted "as are connected with [the trade] in the sense that they are really incidental to the trade itself. They cannot be deducted if they are mainly incidental to some other vocation, *or fall on the trader in some character other than that of trader.*"[14] Thus the expenditure incurred by the innkeeper fell on him in his capacity as occupier of a building, rather than *qua* innkeeper. It was for this reason, rather than the "purpose of earning profits test" propounded by Lord Davey, that the expenditure was not deductible. Therefore, it is true to say that *Strong v Woodifield* is not authority which bound the Court of Appeal in *McKnight v Sheppard* "for the purpose of any profits test" since Lord Davey's dictum did not, technically, form part of the *ratio* of the House of Lords judgment. However, the

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12 5 TC 215 at 220. Italics supplied.

13 With whom the other three Judges, Lord James of Hereford, Lord Robertson and Lord Atkinson concurred.

14 5 TC 215 at 219. Italics supplied.

test was specifically adopted by Wrottersley J in *Spofforth and Prince v Golder*,[15] in denying a trading deduction to a partnership in respect of costs incurred in defending a criminal action against one of the partners, it being vital to the interests of the partnership that the partner was not convicted. In the Judge's mind, in that case, the test was quite clear: "is the disbursement made not one merely made in the course of, or arising out of, or connected with, or made out of the profits of the profession, but also for the purpose of earning the profits of the profession? ... It is not by any means a harsh test to apply to a taxpayer. But it appears to me definitely not to cover anyhow the payment of the cost of defending Mr Spofforth against the criminal charge preferred against him."[16]

Given that *Strong v Woodifield* was expressly referred to in the judgment of Nourse LJ and that *Spofforth* was referred to in the skeleton arguments,[17] the conclusion that there was no authority for the "purpose of making profits test" is slightly surprising (albeit that neither the *obiter dictum* of Lord Davey in *Strong v Woodifield* nor *Spofforth and Prince v Golder* would have bound the Court of Appeal). Having said that, the rejection of this test should not be mourned. The test requires a line to be drawn as to expenditure which is "within the normal course of trade" (and hence incurred for the purpose of making profits and hence, in turn, deductible) and expenditure "outside" the normal course of a trade (which is not incurred to earn profits and is not deductible). On this view, for example, it is quite conceivable that legal expenses incurred in defending a professional misconduct charge may be deductible if the actions complained of are held not to constitute professional misconduct (i.e., the actions may constitute a proper mode of behaviour for the professional concerned) but will not be deductible if the conduct is held to be reprehensible and improper behaviour on the part of the professional concerned. In some cases, the line may be a fine one; when does a robust optimism as to the prospects of success in potential litigation become the unjustified encouragement of a client to litigate? The difficulty was recognised by Lightman J in the High Court in *McKnight v Sheppard*:[18] "in some cases where a trader has expended legal fees in defending civil proceedings, the deductibility of that expenditure may be obvious without awaiting the result of the proceedings. But in other cases it may be necessary to await the outcome of the proceedings to enable a decision to be made whether the conduct of the trader which was the occasion for the proceedings was outside the ordinary lawful course of the trader's

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15 26 TC 310.

16 Ibid at 314.

17 See 847i.

18 [1996] STC 627 at 644g.

business." A notion that the deductibility of legal expenses depends upon a concept of an "ordinary" lawful course of a trader's business is wholly unsatisfactory in the context of trading deductions, when what is or is not the "ordinary" course of a trader's business is circumscribed by, as in the case of *McKnight v Sheppard*, a disciplinary tribunal with considerations wholly other than tax in mind. The deduction of expenses should not depend upon fine distinctions, and arbitrary fine distinctions at that.

In any event, *McKnight v Sheppard* must be seen to be a decisive and clear rejection of the "purpose of making profits test", despite Nourse LJ's questionable observation that there is no authority for that proposition.

This means that one is now left with the Lord Chancellor's test in *Strong v Woodifield* as the statement of the current law, namely the notion that, expenditure, to be deductible, must be incurred by the trader *qua* trader. However, this leads to equally artificially fine distinctions. The Lord Chancellor in *Strong v Woodifield* considered that, while the innkeeper who was the subject of that case, failed in his appeal because he incurred the expenditure *qua* householder, not *qua* innkeeper, losses "sustained by a railway company in compensating passengers for accident travelling might be deducted".[19] However, "if a man kept a grocer's shop, for the keeping of which a house is necessary, and one of the window shutters fell upon and injured a man walking in the street, the loss arising thereby to the grocer ought not to be deducted".[20] It is difficult to see a conceptual difference between the railway company and the innkeeper in *Strong v Woodifield*. It is true that the railway company could only have incurred its expenditure *qua* railway company since it could not have been carrying passengers on a train in any other capacity. However, the innkeeper did not own or operate the inn in any other capacity than innkeeper. There is nothing in the Case Stated in *Strong v Woodifield* to suggest that the innkeeper was, for example, putting up guests in what was otherwise his private dwellinghouse. The conceptional distinction which denies a trading deduction for compensation paid by a hotelier but permits such a deduction to a railway company appears to be remarkable and wholly unsatisfactory. However, such artificial distinctions are, on the authorities, even on the Lord Chancellor's test in *Strong v Woodifield*, alive and well and have not, unfortunately, been resolved by the Court of Appeal rejecting the "purpose of making profits" test in *McKnight v Sheppard* (because they did not have to be). So expenditure incurred to compromise an action was held to be deductible on the footing that the company settled the action to avoid a large and serious liability in

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19 At 219.

20 Ibid.

costs and an adverse effect on its reputation.[21] However, had the action gone ahead and the company been made to pay a fine for a proven infraction of the law, that would not have been deductible, since it is no part of a trader's activity to do such actions which infringe the law.[22] A payment made to satisfy an award for damages falls foul of the same rule. However, if *McKnight v Sheppard* is authority for the proposition that expenses incurred to prevent one being disabled from carrying on business are deductible, it is difficult to see why there should be a distinction between a payment to compromise an action or legal expenses incurred in relation to the proceedings after which the fine was ultimately imposed on the one hand and the fine itself or damages on the other. Indeed, this was recognised by Lightman J in the High Court: "I can see no relevant distinction in this case between the payment of expenses and payment of the fines."[23] This is especially the case in *McKnight v Sheppard*, where the fines were imposed in lieu of suspension. There may well be a public policy justification for the distinction, in that Parliament may see it as undesirable to afford a trading deduction for fines/penalties, as opposed to legal expenses incurred in the proceedings resisting their imposition, but this is better enshrined in statute as a specific non-deductible item rather than reflected in an unsatisfactory (and untenable) conceptual distinction. The authorities are further muddled by *Knight v Parry*,[24] where a taxpayer was denied a deduction for both the legal expenses incurred and damages and costs paid in a civil action brought by the taxpayer's former employer. Goff J denied the deduction on two grounds:

1. The purpose of the expenditure was not a purpose wholly and exclusively referable to the carrying on of the taxpayer's trade (of being a solicitor) but for the purpose of seeing that he was not precluded from doing so.[25]

2. In any event, the purpose of the expenditure (in defending the action and incurring the costs) was a dual one, namely to protect himself against the

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21 *CIR v Great Boulder Proprietary Gold Mines Limited* 35 TC 75 at 94.

22 See *IRC v Alexander Von Glehn & Co Ltd* 12 TC 23.

23 [1996] STC 627 at 645h.

24 [1973] STC 56.

25 In that the action for breach of contract anticipated a Law Society hearing to decide whether or not the taxpayer had been guilty of unprofessional conduct in soliciting clients away from his former employer. If the civil hearing had made a finding that solicitation had occurred, this would have made it most likely that the Law Society would have suspended or struck off the taxpayer.

> charge of unprofessional conduct[26] and also to defend himself against the claim for damages in contract and tort, which claims could succeed even if professional misconduct was not established (which it was not) and indeed did succeed as a matter of contract (although the solicitation was held not to have occurred).[27]

The learned Judge cited *Spofforth and Prince v Golder*[28] and *Norman v Golder*[29] as authority for the proposition that expenditure incurred in order to ensure that one was not precluded from continuing to trade was not deductible as a trading expense. *Spofforth and Prince v Golder* has already been discussed above and could well be seen as authority for that proposition, at least so far as criminal proceedings are concerned. *Norman v Golder*, however, was a case concerning the deductibility of medical expenses of a trader, which were, unsurprisingly, held not to be deductible, on the footing that there was clear duality of purpose in the incurring of those expenses, namely to ensure that the trader could recommence trading and to ensure that the trader regained his health. *McKnight v Sheppard* clearly rejects the proposition that expenditure incurred to ensure that a trader is not precluded from trading is not deductible. Indeed, this proposition does not appear to have been questioned at all by the Crown before the Special Commissioners, the High Court or in the Court of Appeal. Thus *Knight v Parry* cannot be authority for the proposition that expenditure incurred to ensure that one is not precluded from trading is not deductible. *Knight v Parry* and *Spofforth and Prince v Golder* may be, respectively, authority for the propositions that expenditure incurred to defend criminal proceedings and civil proceedings (as opposed to professional disciplinary hearings) is not deductible but this appears to be yet another entirely arbitrary distinction. This was once again recognised by Lightman J in *McKnight v Sheppard* in the High Court:[30] "... I can see no reason for adopting, as regards expenditure in defending disciplinary proceedings, any different rule from that applicable in respect of costs of defending civil proceedings." *Knight v Parry* was mentioned by Lightman J but dismissed and apparently ignored as being of any significance. Certainly as a matter of policy, there appears to be no reason whatsoever to distinguish in principle between Court proceedings and professional disciplinary proceedings. Indeed, in *Knight v Parry,*

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26 In that if the Court had held that the taxpayer had indeed solicited clients, it would have been very difficult to resist the charge before the Law Society.

27 [1973] STC 56 at 60d, e.

28 26 TC 310.

29 26 TC 293.

30 [1996] 627 at 645b.

the civil action only took place before the Law Society hearing at the invitation of the Law Society. However, *Knight v Parry* (and *Spofforth and Prince v Golder*) are only reconcilable to *McKnight v Sheppard* on the second ground of the judgment, namely that the taxpayer had duality of purpose in incurring the expenses, to protect himself against the charge of unprofessional conduct and to resist a civil claim against him in contract and tort. The learned Judge held that the second purpose "clearly takes the case out of the statutes. If the taxpayer had seen fit to admit liability in breach of contract and offer to pay damages or had paid a sum of money into court then there would have been only one purpose; but he did nothing of the kind. Therefore there were two purposes [and therefore the expenditure is non-deductible]."[31] This ground has the merit of being reconcilable to *CIR v Great Boulder Proprietary Gold Mines Limited* (although that decision was not cited in the judgment in *Knight v Parry*) but reinforces the distinction between money paid to compromise an action and expense incurred to resist an action in damages if the action is lost. This is an unwarranted distinction. It may be just as important for a trader to have his name publicly cleared as it was for the Appellants in *CIR v Great Boulder Proprietary Gold Mines Limited* to ensure that no action took place at all. There appears to be no justification for denying a deduction to the former but permitting a deduction for the latter.

The only alternative analysis to that given above is that *Knight v Parry* must be dismissed as being wrongly decided.

Thus the current state of the law perceives a distinction between court proceedings (whether civil or criminal: see *Spofforth*) and professional disciplinary proceedings and this distinction holds good, as a matter of law, in the context of trading deductions despite the reservations expressed by Lightman J in the High Court in *McKnight v Sheppard*. There is also a distinction between payments made to compromise an action (which are deductible) and payments made to satisfy an award for damages, fines or penalties (which are not).

In conclusion, I repeat that these distinctions are both fine and arbitrary. Indeed, it may be said that they illustrate the arbitrary and capricious application of the duality principle enshrined in TA 1988 s.74(a). A coherent solution to this vexed question of the deductibility of expenditure in this area (preferably by legislation to avoid further artificial distinctions having to be made by the Courts to sidestep the more Draconian consequences of the duality principle) is eagerly awaited.

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31 [1973] STC 56 at 60g.