

A diamond geezer

Illegal activities may result in a taxable profit, but **KEVIN SLEVIN** considers whether associated expenses are allowable.

It seems generally accepted that liability to tax depends primarily on statutory construction and that moral issues and moralising has no part to play. Thus, a profit made by carrying on a criminal activity is liable to UK tax insofar as the illegal activity in question can be shown to fall within one of the taxing provisions and the courts have resisted any attempts to restrict the application of these provisions to the profits derived from lawful activity. Therefore, tax is charged on the profits of a trade, profession or vocation and the position is unaffected by the fact that the activities are either, in whole or in part, illegal.

If the illegal activities comprise, say, dealing in stolen goods, i.e. buying stolen goods and selling them on, the test to be applied is whether it can be said that the activities in question amount to the carrying on of a trade for the purposes of income tax. Where the activities have some connection with a trader's lawful ordinary business, HMRC will in practice be content for the activities to be merged so as to be regarded as a single trading activity. If the activity is unrelated to a trader's lawful business those activities may have to be treated as a separate trade and taxed as such if they can be properly regarded as a trade.

No time for morality

In such cases, it is not necessary for a tax practitioner to attempt to moralise as to the client's conduct and neither will he be criticised for simply standing back and considering the tax position in isolation. In particular, he should not be construed as condoning matters simply because he advises on the applicable tax treatment of a profit derived from an illegal activity. His job is simply to ascertain whether, in accordance with the normal rules, a trade can be properly said to have existed under the Taxes Acts. (See Rowlatt J, *Mann v Nash* (1932) 16 TC 523, page 528, and the more recent case of *CIR v Aken* [1988] STC 69 for further consideration of the approach.)

KEY POINTS

- Are arguments over morality helping the tax debate?
- The profits from illegal activities may still be taxable.
- Will tax relief for fines or professional fees be obtained?
- The treatment of staff costs relating to illegal activities.
- Payments to employees should still be allowable.



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The existence of a trade will depend upon the facts of each case. One starts with the statute and then turns to case law as regards points of interpretation. Interestingly, although not by any means certain as to the outcome if a case were to come to court today, the indication from the established judgments is that a 'trade' cannot include profits from stealing goods from the rightful owners and selling them. Such activities might not be considered a 'venture in the nature of a trade'. Simply put, it can be argued that because the thief has not made an initial outlay to acquire the goods, monies received from the onward sale of the stolen property are not taxable.

This can be contrasted with the position of a 'fence' who buys stolen property for resale: he (or she) is definitely carrying on a trade of dealing in stolen goods and is liable to tax on the profits. That said, in the writer's view, the position of a thief stealing goods becomes more complicated where, say, Mr Big pays a gang to raid a property for him so as to steal certain valuable goods believed to be situated therein. In that case, Mr Big has made a financial commitment – and is therefore taking a financial risk at the outset – and his activities can be more easily likened to a venture in the nature of a trade. Accordingly, in the writer's view, any profits thereby derived by Mr Big will be taxable. (Clearly, if Mr Big repeatedly employs the same gang members he may well find he has an obligation to operate PAYE although for some reason this line of thinking has not, to my knowledge, been tested in the courts.)

An element of financial risk

Likewise, if Mr Big expends money on equipment to facilitate a theft, say a theft of data through electronic means or a theft of artworks where sophisticated electronic equipment is used to circumvent an alarm system and/or listen in to radio transmissions of security guards and the police, and he simply carries out the 'job' himself, the probability is that the profits of his endeavours will also be those of a venture in the nature of a trade. The act of acquiring equipment involves a financial risk, which indicates that there is a venture in the nature of a trade. Contrast this with the situation of a prowler who simply spots an opportunity to break into a house and 'steal some stuff'. It seems he can go about his business without the need to include his profits on a self-assessment return!

The key point is that there must be some element of financial risk if the activity is to be correctly regarded as a venture in the nature of a trade (ITA 2007, s 989/CTA 2010, s 1118). Other incidences of the profits of illegal activities being taxable include the receipt of profits derived from the illegal operating of gaming machines and profits derived from prostitution.

The foregoing summary represents nothing new, but its purpose is to set the scene as regards exploring the taxation issues where the perpetrators of criminal activities suffer penalties under the law – be it in the form of civil or criminal penalties or incarceration – in the case of a company.

Gotcha!

Having explored the basics, now let's turn to some aspects of the situation where the criminals have been caught. There does not seem to be a lot on this in the textbooks (possibly because not enough criminals get caught) covering the practicalities. Space does not permit an extensive summary of the position, so let's focus on the situation of a company where its officers and/or employees have been carrying on in a manner which has been accepted as being an infraction of the law by the company.

Rather than focusing on the nature of their illegal activities, we can assume that the company has already been investigated, admitted its guilt, and has been forced to pay a substantial fine. Further legal action against individuals may or may not be pending, but it is assumed for this article that the illegal actions taken were carried out primarily to achieve a corporate aim rather than for the benefit of the individual perpetrators. Assume also that while some officers of the company and a number of senior employees may personally face criminal proceedings, they have not acted to steal from the company – rather they were seeking to enhance its position in one way or another, although indirect benefit will perhaps have flowed to them in the form of increased bonuses.

Perhaps, here, I should add that what follows does not relate to any specific company or group of individuals and any similarity with the affairs of any company is purely coincidental.

Tax relief for fines and fees?

It is well established through case law (see the cases of *CIR v EC Warnes & Co Ltd* (1919) 12 TC 227 and *CIR v Alexander*

von Glehn Ltd (1920) 12 TC 232) that penalties incurred as a result of breaching the law are not allowable for taxation purposes. HMRC's *Business Income Manual* (at paragraphs BIM38515 and BIM38520) helpfully summarises the position. The inability to claim tax relief appears to be generally accepted despite the fact that the principal case law is nearly 100 years old. Indeed, reference was made to these cases as recently as 1999 in the case of *McKnight v Sheppard* [1999] STC 669. It is not, therefore, intended to rehearse the detail of the arguments here.

The aforementioned case, which concerned a stockbroker fighting to keep his business alive in the light of certain allegations made against him and which can therefore be distinguished from cases involving criminal actions, contains useful comment on the reasoning for disallowance of fines generally. In particular, it indicates that a fine or penalty is not deductible where its purpose is to punish the person concerned: '...it may easily be concluded that the legislative policy would be diluted if that person were allowed to share the burden [of the fine] with the rest of the community by a deduction for the purposes of tax...'. It is also generally accepted that it matters not whether the fine imposed is a civil penalty or one which arises under a criminal prosecution.

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The question of deductibility

The case of *McKnight v Sheppard* includes helpful guidance by making it clear that it does not automatically follow that the costs of a legal defence are not deductible simply because the fine to which the legal costs relate is disallowable. The question of non-deductibility of legal costs depends upon the nature of the particular expenditure. In effect, the judgment confirms that the facts of each case need to be addressed to see if the relevant considerations for allowability exist. Briefly, the decision in *McKnight v Sheppard* was that the legal expenses incurred in respect of disciplinary proceedings arising out of the conduct of the business could be allowed even though a fine was levied (importantly in an amount which had been reduced on appeal to the professional body).

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PROFESSIONAL COSTS

Fee description	£
Initial legal fees disputing the fact that illegality had taken place	400,000
Legal fees negotiating the penalty to the regularity authority	900,000
Accountancy fees incurred measuring extent of criminal activity re penalty negotiations	800,000
Total	£2,100,000

However, nothing in the *McKnight v Sheppard* decision gives support for the argument that all legal fees incurred in mounting a defence against legal proceedings taken by the police or by a regularity body are tax deductible. If illegal activities are found to have been carried on, the high probability is that HMRC will seek to disallow such costs. Acceptance of the position by the company without being subject to a court hearing does not alter the position. This can be contrasted with case where the outcome is a 'not guilty' verdict or an 'all clear' ruling from a regularity body where legal fees incurred may well be allowable.

It might be thought that where the profits from an illegal activity are taxable then any expenditure arising as a consequence of carrying on the trade should be tax deductible. The courts do not take this approach, however. Broadly, the approach is that the expenditure arising as a result of legal action, etc. taken against the trader is incurred not in earning profits for the company, but as a consequence of breaking the law of the land. The expenditure cannot be said to meet the wholly and exclusively test.

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Professional costs

Let's assume that ZYX (2017) Ltd is a trading company whose staff to have been colluding with others to corrupt long-established trade practices for the financial benefit of the company (and indirectly for their benefit in terms of increased bonuses). The company has accepted that it has breached the law. Assume, also, that the investigation took 30 months to reach its current position and during that time substantial external professional costs were incurred as shown in **Professional Costs**.

In the opinion of the writer, a careful analysis of case law shows that no tax relief would be available in respect of the payments totaling £2.1m. However, matters do not stop there. More controversially, it is necessary for the company to examine its own internal costs to see how much should be properly attributed to the conduct of investigation.

Tax relief for staff costs?

The costs of employing directors and staff are frequently assumed to be allowable without question, but it is not uncommon for HMRC to enquire into the treatment of staff costs.

For example, where a company has engaged in a major capital project – say the construction of a new factory – the debit to a company's profit and loss account in respect of salaries and wages may include the cost of the wages paid to workers who normally carry out maintenance work on the company's various premises. However, say two such workers were taken off maintenance work and engaged in the construction process throughout the accounting period. Here, an amount equal to the full cost of employing the workers in question (including National Insurance and pension scheme contributions) should be disallowed as a revenue expense and, instead, the amount in question should be treated a capital expenditure on the construction of the building. Unless this is done, HMRC will argue that the accounts have not been prepared in accordance with generally accepted accountancy practice.

Such an 'add-back' may come as a surprise to some taxpayers, but is not controversial. What may be more of a surprise is that the same approach can and should be applied to a situation where significant time input from directors and staff takes place as a result of a police or other type of investigation into illegal activities. There is a tenable argument that if a company is found to have been guilty of being involved in illegal activities it cannot be said that the remuneration cost of employees and directors who have had to devote substantial time to matters relating to the investigation is an expense 'wholly and exclusively' for the purposes of the trade carried on. As such, the cost should be identified and disallowed as suggested in **Staff Costs**.

Say that the total attributable costs, including proportions of bonus payments, National Insurance contributions, pension scheme contributions and other perks relating to the hours worked over the 30-month period as shown in **Staff Costs** amounted to £1.6m. Should not this sum be added back?

STAFF COSTS

Taking further the example of ZYX (2017) Ltd, on close examination it is found that over the 30-month period of the investigation the following time inputs occurred:

Officer	£
Chairman	average input 30% of hours worked
Managing director	average input 40% of hours worked
Finance director	average input 60% of hours worked
Internal accountant	average input 40% of hours worked
Manager designated as investigation coordinator	average input 85% of hours worked
Internal accounts staff: Two employees	devoted 35% of hours worked
Three employees	devoted 45% of hours worked
Newly recruited manager	devoted exclusively to the investigation
Director IT	devoted 25% of hours worked

In the above example, there is a tenable argument that the sum of £1.6m should be added back (over the different accounting periods overlapped by the investigation) and simply treated as non-allowable for the purpose of calculating the company's taxable profit. The expenditure cannot be said to have been incurred by ZYX (2017) Ltd wholly and exclusively to earn the profits of the trade. They were incurred for the purpose of cooperating in the investigation into the company's illegal activities.

It will be noted above that, in the writer's view, there is no distinction to be made in calculating the add-back as regards existing employees, etc. and extra staff hired for the purpose of facilitating the investigation. It will also be noted that HMRC will not seek to restrict the allowable expenditure still further by applying the duality of purpose argument. As suggested above, it is quite possible to separately identify the costs attributable to the conduct of matters relating to the investigation and to restrict the disallowance accordingly.

Employee issues

It may well be that selected employees are themselves subject to legal action by the appropriate authorities and the employer company may agree to pay all reasonable legal costs incurred by the individuals in question in mounting their defence or in simply in pleading guilty and seeking representation in court. The employees may be fined personally or indeed imprisoned. Here, payments made to or on behalf of employees will be tax deductible as regards the company because they will be regarded as 'employment income' in the hands of the employees concerned and subject to PAYE.

Similarly, arrangements may exist whereby former employees are reimbursed as regards legal issues relating to activities carried on by them as employees of the company. Here again, such payments should be regarded by the payee and payer as employment income in the individual's hands with the appropriate application of the PAYE regime.

In the opinion of the writer, the tax outcome of such payments in respect of legal fees, etc. is not affected by the fact that the employee is found not guilty or the case against him is simply dropped. He is liable to tax on the employment income considered to arise and it is not possible to argue that the employee can claim an equivalent deduction as an allowable expense in view of the very tightly construed provisions applicable to employee expenses claims.

Conclusion

It can be seen from the above that matters are far from straightforward and practitioners therefore need to take extra care in advising on such situations. For the sake of completeness, it is worth mentioning that while issues relating to the requirements of either the money laundering regulations or value added tax can never be far from one's mind in dealing with a case such as that of the hypothetical ZYX (2017) Ltd, these issues have been ignored for the purposes of this short article. ■

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