# TC02136

**Appeal number: TC/2011/1881**

***Income tax – deductibility of legal fees – expenditure of capital or income nature? – whether incurred wholly and exclusively for the purposes of the trade? - appeal allowed***

**FIRST-TIER TRIBUNAL**
**TAX CHAMBER**

**LINSLADE POST OFFICE & GENERAL STORE (a firm)** **Appellant**

**- and -**

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

**TRIBUNAL: JUDGE PETER KEMPSTER**
**SUSAN LOUSADA**

**Sitting in public at Bedford on 18 June 2012**

**Mr Karia (P. Karia & Co, accountants) for the Appellant**

**Mrs Weare (HMRC Appeals Unit) for the Respondents**

DECISION

1. Mr Shabir Visanji carried on business in partnership with various family relatives between 1982 and 2006. The Tribunal papers record the appellant as being the partnership (rather than Mr Shabir Visanji or any other partner) and, as the dispute concerns the correct tax treatment of an item of expenditure in the partnership books, we continue that terminology in this decision. By a decision issued on 26 July 2011 the Tribunal granted permission to the Appellant for its appeal to be accepted out of time.

2. The Respondents ("HMRC") disallowed a deduction for legal expenses in the amount of £36,174 claimed by the Appellant in its accounts for the year ended 30 April 2005, which form the basis for the tax year 2005-06. The facts are not in dispute and are as follows.

**Facts**

3. In proceedings commenced in the High Court in December 1996 Mrs Shabnam Rehemtulla – who is the sister of Mr Shabir Visanji – alleged that she was a partner in the Appellant partnership. The details of her claim are explored below but the outcome of the proceedings was that Mrs Rehemtulla's claim was dismissed in September 2001. She sought to appeal that decision in October 2001 but was unsuccessful. The defendants in the proceedings were named as Mr Shabir Visanji and his brother Mr Salim Visanji – who were the undisputed partners in the Appellant partnership at the relevant time. The defendants retained solicitors and counsel. Mrs Rehemtulla conducted the proceedings as a legally aided claimant and no award of costs was made against her in favour of the successful defendants. The legal costs of the defendants were claimed as a trading deduction by the Appellant partnership.

4. Mrs Rehemtulla's statement of claim was drafted on a number of alternative bases but in essence she alleged that she had contributed funds to the capital of the partnership, had become an equal partner in the business, and was entitled to a share of profits and assets accordingly. The statement of claim concludes:

> "AND THE PLAINTIFF CLAIMS:
>
> 1. Sale of the Premises
>
> 2. Payment to her of one half of the net proceeds of such sale
>
> 3. A declaration that there was from 1982 a partnership between the Plaintiff and the First Defendant in the aforesaid business
>
> 3A. Alternatively a declaration that there was a partnership between the Plaintiff and the First and Second Defendant to the extent pleaded in paragraph 5A above
>
> 4. Dissolution
>
> 5. An account of what money is due to the Plaintiff
>
> 6. Payment of such money

7. Further or on [*sic*] the alternative damages

8. All necessary accounts and enquiries

9. Statutory interest or compound interest pursuant to the rules of equity and/or interest by Section 35A of the Supreme Court Act 1981 at commercial rates to be assessed."

**Statutory provisions**

5. Sections 33 & 34 Income Tax (Trading and Other Income) Act 2005 provide:

> "33 **Capital expenditure**
>
> In calculating the profits of a trade, no deduction is allowed for items of a capital nature.
>
> 34 **Expenses not wholly and exclusively for trade and unconnected losses**
>
> (1) In calculating the profits of a trade, no deduction is allowed for—
>
> (*a*) expenses not incurred wholly and exclusively for the purposes of the trade, or
>
> (*b*) losses not connected with or arising out of the trade.
>
> (2) If an expense is incurred for more than one purpose, this section does not prohibit a deduction for any identifiable part or identifiable proportion of the expense which is incurred wholly and exclusively for the purposes of the trade."

**Submissions**

6. For the Appellant Mr Karia submitted that the legal fees were a deductible trading expense. He cited the authority of *Southern v Borax Consolidated Ltd* (1940) 23 TC 597 which concerned the deductibility of legal costs incurred in resisting an action to dispute the title of the taxpayer company to real property which the company held. Lawrence J accepted that the expenditure met the "wholly and exclusively" test (contained in earlier legislation but effectively the same as governs the current appeal) and then stated (at 602 – 605):

> "On the other question as to whether this is a payment properly attributable to capital or to revenue, in my opinion the principle which is to be deduced from the cases is that where a sum of money is laid out for the acquisition or the improvement of a fixed capital asset it is attributable to capital, but that if no alteration is made in the fixed capital asset by the payment, then it is properly attributable to revenue, being in substance a matter of maintenance, the maintenance of the capital structure or the capital assets of the Company.
>
> …

> It appears to me that the legal expenses which were incurred by the Respondent Company did not create any new asset at all but were expenses which were incurred in the ordinary course of maintaining the assets of the Company, and the fact that it was maintaining the title and not the value of the Company's business does not, in my opinion, make it any different."

7. For HMRC Mrs Weare submitted:

(1) The legal fees were not a deductible trading expense. A partner in the business had paid legal fees to defend his interest against his sister, and that did not constitute an expense incurred for the purpose of the trade.

(2) An authority that was close to the facts of the current appeal was *C Connelly & Co v Wilbey* [1992] STC 783 where a partner in a firm of chartered accountants served a notice of dissolution on his partner. The High Court stated (at 790):

> "The second question relates to the solicitors' fees. I have already referred to the solicitors' narrative of the work carried out by them. It was entirely concerned with the litigation in the dissolution action brought by Mr Worrall against Mr Burton. One point made by Mr Burton, which at first sight appeared to me to have some validity, was that at its inception the litigation was brought about by the notice to quit partnership premises and the steps taken or threatened by Mr Burton as a consequence, as he said, to protect partnership assets, that is, the files, papers and equipment in Glossop. However, the reality is that this was a dissolution action and a dispute between the two partners, and that was how it continued. I cannot regard expenses incurred by Mr Burton to protect his interests in the partnership as a trading expense of the practice."

**Consideration and conclusions**

8. We consider it is important to identify the nature of the dispute that led to the incurring of the legal fees. The plaintiff (Mrs Rehemtulla) alleged that she was a partner in the firm but that claim was dismissed – she was never a partner. Thus the High Court proceedings should not be characterised as a partnership dispute. That distinguishes the current case from *Connelly v Wilbey* which was clearly "a dispute between the two partners". The High Court proceedings were instead a failed claim by an outsider (Mrs Rehemtulla) against the assets and profits of the firm. Thus the true nature of the proceedings was a defence of an unjustified claim in order to preserve the assets of the business.

9. In *Cooke v Quick Shoe Repair Service* (1949) 30 TC 460 – which case Mrs Weare very fairly brought to our attention - a partnership purchased a shoe repair business as a going concern; the purchase agreement provided that the vendor would discharge all liabilities of the business outstanding at the date of sale, but the vendor failed so to do; to preserve goodwill and to ensure continuity of supplies the purchaser paid certain sums in discharge of the vendor's liability; the partnership claimed the

payments as deductible revenue expenditure. Croom-Johnson J, having considered various authorities including *Southern v Borax Consolidated,* found in favour of the taxpayer (at 465):

> "The cases show that, if money is expended with a view to preserving an asset, the result of it is, once the Commissioners are satisfied of that circumstance, it may be a deductible expenditure."

10. The fact that the preservation of the business assets may be so significant as to go to the possible survival of the business itself is not sufficient to tip the nature of the expenditure from revenue to capital – see *Morgan v Tate & Lyle Ltd* (1954) 35 TC 366 (campaign against nationalisation of the sugar refining industry). That case also confirms that the "wholly and exclusively" test was there satisfied – *per* Lord Morton (at 409 onwards):

> "I would ask: If money so spent is not spent for the purposes of the Company's trade, for what purpose is it spent? If the assets are seized, the Company can no longer carry on the trade which has been carried on by the use of those assets. Thus the money is spent to preserve the very existence of the Company's trade.
>
> …
>
> … money expended to prevent seizure of the Company's assets is accurately described as money expended for the purpose of enabling the Company to carry on and earn profits in the trade, since without its assets it could not carry on its business."

11. *Quick Shoe* and *Tate & Lyle* are both fully consistent with the decision in *Southern v Borax Consolidated* which found that the legal fees in dispute were "expenses which were incurred in the ordinary course of maintaining the assets of the Company" and were deductible.

12. Accordingly, we find that the purpose of the disputed legal fees was to preserve the assets and trade of the Appellant partnership, that expenditure was revenue in nature, and also incurred wholly and exclusively for the purposes of the partnership's trade.

**Decision**

13. The appeal is ALLOWED.

14. 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.

**PETER KEMPSTER**
**TRIBUNAL JUDGE**

**RELEASE DATE: 17 July 2012**