



TC01552

Appeal number TC/2011/01649

CORPORATION TAX – EXPENSES – Legal costs of bringing defamation proceedings – Legal costs paid solely by the Appellant company but both the Appellant company and its sole director named as claimants in the defamation proceedings – Defamation proceedings alleging that defendants had published a defamatory statement to the effect that the Appellant company’s sole director had lied to clients – Whether legal costs of defamation proceedings were “wholly and exclusively laid out or expended for the purposes of the trade or profession” (ICTA s.74) – yes in the particular circumstances of the case – Appeal allowed

FIRST-TIER TRIBUNAL

TAX

KEY IP LTD

Appellant

- and -

**THE COMMISSIONERS FOR HER MAJESTY’S
REVENUE AND CUSTOMS**

Respondents

**TRIBUNAL: DR CHRISTOPHER STAKER (Tribunal Judge)
MR JAMES MIDGLEY (Tribunal Member)**

Sitting in public in London on 22 September 2011

Mr K Shovell of the Appellant

Ms N Parslow for the Respondents

DECISION

Introduction

5 1. This is an appeal against a closure notice under paragraph 32(1) of Schedule 18 to the Finance Act 1998 dated 24 November 2010 in respect of the Appellant company's company tax return for the period ended 30 June 2008, concluding that legal costs of £459,924 incurred by the Appellant company in bringing certain defamation proceedings were not fully allowable as a deduction under s.74(1)(a) of the Income and Corporation Taxes Act 1988 ("ICTA").

10 2. The defamation proceedings were a High Court action brought in the name of two claimants. One claimant was Key IP Ltd ("Key IP"), the Appellant company in the present case. The other claimant was Mr Kenneth Shovell, Key IP's sole director and sole shareholder. There were two named defendants to the defamation proceedings. One was a company called Adventis Group plc ("Adventis"). The other was Mr
15 Charles Philpott, the CEO of Adventis.

3. The particulars of claim in the defamation proceedings alleged as follows. Mr Philpott sent a letter dated 3 March 2008 to certain shareholders of Adventis, stating that he was aware of e-mail communications to certain institutional shareholders of Adventis, seeking support for the requisitioning of an extraordinary general meeting
20 (EGM) to pass a resolution removing the chairman of its board, Mr Peter Mitchell. That letter went on to say that these e-mail communications included assertions to the effect that there was a rift between the executive team of Adventis and its chairman Mr Mitchell, and that Mr Mitchell lacked the support of the executive directors. The letter then went on to say that the "assertions are wholly untrue" and that a positive
25 relationship existed between Mr Mitchell and the executive directors. It was alleged that the addressees of the letter knew that Mr Shovell of Key IP had sent e-mails to institutional investors in Adventis, seeking support for an EGM at which Mr Mitchell would be removed from the board, and asserting that there was a rift between the executive directors and Mr Mitchell as chairman, that Mr Mitchell lacked the support
30 of the executive directors, and that his removal was justifiable. The particulars of claim then alleged that the addressees of the letter would understand the letter to mean that Key IP and Mr Shovell had lied to Adventis shareholders about the state of relations between the chairman and executive directors of Adventis, or at least had made such statements without taking care to ensure that they were true. In these
35 defamation proceedings, Key IP and Mr Shovell sought damages for libel, malicious falsehood and/or misstatement.

4. The closure notice that is the subject of the present appeal concluded that:

(1) The calling of an EGM of Adventis, and the stated aim of the EGM, were
40 not activities connected with the trade of Key IP given that Key IP was not a member of or shareholder in Adventis.

(2) Mr Shovell could not propose an EGM of Adventis on behalf of Key IP, given that Key IP was not a shareholder in Adventis, but could do so in a

private capacity, given that he personally was a shareholder. In initiating the legal action, Mr Shovell sought to protect the value of Adventis shares, and therefore to protect this own shareholding. No benefit could accrue to Key IP which was not a shareholder.

5 (3) There was a separation between Mr Shovell's private investments, and his business activities as agent of Key IP, and the defamation action and its subject-matter related to the former.

10 (4) The bringing of the legal action was in part to address the injury that Mr Shovell suffered to his personal feelings, as well as to protect his personal and professional reputation, and his ability to carry out his personal investment activities.

(5) The particulars of claim in the defamation proceedings emphasised the separation of the claims of the two claimants.

15 5. However, the closure notice "recognise[d] that there was a business element in the expenditure on the legal action, namely to preserve the professional reputation of Mr Shovell as the director of Key IP Limited to enable him to act for the company". The closure notice concluded that the legal fees for the defamation proceedings therefore had a "duality of purpose" (a business purpose for Key IP as well as a private purpose for Mr Shovell), and that therefore the full amount of the expenditure could not be
20 claimed as a deduction under s.74 of ICTA. It went on to conclude, however, that under s.54(2) of the Corporation Tax Act 2009, a deduction was allowable for the proportion of the expense which was incurred wholly and exclusively for the purposes of Key IP's trade. The closure notice disallowed 75% of the expenditure on the legal fees for the defamation action, and allowed 25% as a deduction.

25 6. The closure notice also found that the disallowed portion fell to be treated as a sum falling to be charged under s.419(2) of ICTA, that is to say, as a loan to a participator in Key IP.

30 7. The Appellant sought a statutory review of the closure notice. A decision on the review dated 24 February 2011 upheld the closure notice in principle, but considered that the assessment should be varied to the extent that only 50% of the expenditure of the legal fees would be disallowed. That decision stated "I consider that there were indeed two purposes behind the litigation, defending the company's reputation and also your own". It went on to say that "I am not persuaded that the action was taken to protect your personal shareholding in Adventis plc, but I recognise that in a trade
35 such as yours ... your personal 'honesty and integrity' is of 'critical importance'".

40 8. The Appellant contends in this appeal, first, that the whole of the legal expenses should be treated as an allowable deduction, secondly, that even if there was a duality of purpose, the proportion of the expenditure that was personal to Mr Shovell was 5% or less, and thirdly, that any proportion that was personal to Mr Shovell could not be treated as a sum falling to be charged under s.419(2) of ICTA.

The relevant legislation

9. Section 74 of ICTA (which has been repealed but the provisions of which remain applicable to the years in question) provided that:

5 (1) Subject to the provisions of the Corporation Tax Acts, in computing the amount of the profits to be charged to corporation tax under Case I or Case II of Schedule D, no sum shall be deducted in respect of—

10 (a) any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade or profession; ...

The hearing, evidence and submissions of the parties

10. At the hearing, Mr Kenneth Shovell, the sole shareholder and sole director of the Appellant company, appeared in person. HMRC was represented by Ms Parslow.

15 11. The Tribunal had before it a joint document bundle, an authorities bundle, a skeleton argument of the Respondents, a witness statement and speaking notes of Mr Shovell, and other documents in the case.

12. Mr Shovell gave oral evidence on oath, in which he adopted his witness statement, gave further evidence, and was cross-examined by Ms Parslow and asked questions by the Tribunal. The evidence of Mr Shovell was as follows.

20 13. Mr Shovell qualified as a chartered accountant in 1990, and ultimately became an equity partner heading the intellectual property group in the London Office of a major accountancy firm. In 2000, he left to form his own one-man consultancy business, Key IP. He is the sole director and shareholder of Key IP, and Key IP is the only company that he serves.

25 14. Key IP has many high net worth clients who invest in technology and professional service companies. Key IP evaluates investment opportunities mainly within these sectors, and introduces clients to companies identified as meriting investment. It also introduces large institutions to subscribe for shares in those companies or to buy out the holdings of existing shareholders. The type of work that Key IP does, focusing on
30 small and risky companies, means that it is extremely important that clients feel that they can trust Mr Shovell. From time to time Key IP also earns substantial fees from Mr Shovell providing consulting expert accountancy advice in commercial disputes, in which integrity and skill are also paramount.

35 15. Key IP first became involved with Adventis in 2004 when he was asked to raise funds to enable it to float on the AIM. In 2006 and 2007 he introduced two institutional clients, Oceanwood and Noble, who invested in blocks of Adventis shares. These two institutional clients accounted for a significant proportion of Key IP's turnover. In 2006, Adventis issued a stock exchange press release citing Oceanwood as an important strategic investor and thanking Key IP for enabling this
40 successful placing.

16. In 2007 and 2008, Mr Philpott, the CEO of Adventis, had communications with Mr Shovell, in which Mr Philpott indicated that Mr Mitchell should be removed as chairman of Adventis, and indicated that the Finance Director of Adventis was of the same view. Mr Shovell subsequently had various communications with others on the subject, in particular, with Key IP's institutional clients who were shareholders of Adventis. On 8 February 2008, Mr Shovell sent an e-mail to various addressees, including Mr Philpott and Oceanwood, setting out views that had been expressed and proposing Mr Mitchell's removal from the board. Then, on 3 March 2008, Mr Philpott sent the letter alleged by the Appellant company and Mr Shovell to be defamatory (see paragraph 3 above). The particulars of claim in the defamation action alleged that the recipients of that letter included Oceanwood and Noble.

17. In his oral evidence, Mr Shovell said that it was significant that unlike in a typical defamation action, the letter alleged to be defamatory in this case had been sent to only seven or so recipients. Furthermore, the letter did not mention Mr Shovell or Key IP by name. The public at large would not know about the letter, and it would not affect his personal or social reputation generally. It was only those few recipients of the allegedly defamatory letter with whom Mr Shovell had previously communicated in relation to a proposal to remove Mr Mitchell from the Adventis board who would understand that the letter referred to Mr Shovell and to Key IP, and who would understand the letter to be saying that what Mr Shovell had been saying on the subject was incorrect. Mr Shovell said that the tone of the allegedly defamatory letter, which stated that Mr Philpott was "writing to put the record straight", and that what was said in the e-mail communications was "wholly untrue", implied that Mr Shovell was deliberately saying things that were untrue, in order to achieve his own agenda of removing Mr Mitchell from the board of Adventis.

18. Mr Shovell said that he was very concerned about this, given that recipients of the letter included Oceanwood and Noble. He said that his relationship with Oceanwood was particularly affected. He said that Key IP advised clients on risky investments, and that it was absolutely fundamental to Key IP's work that its clients trusted Mr Shovell not to exaggerate or mislead when advising on risky decisions.

19. Mr Shovell further gave evidence as follows. The decision to litigate was horrific. Given that such a substantial portion of Key IP's fees came from transactions involving Oceanwood and Noble, he felt that he had no choice but to bring a defamation action. However, an up-front estimate of the costs of bringing a defamation action was in the region of £750,000. Had Key IP lost the action, and in that event been forced to pay not only its own costs but those of the defendants, this would have led to the financial ruin of Key IP. He would not have taken that risk just to vindicate his own personal hurt feelings. He only did so because Key IP's ability to operate successfully depended on his reputation being cleared of the accusation allegedly made by the letter. It affected Key IP's relationship with Oceanwood and Noble. Key IP did not engage in marketing, and its work came generally from recommendations. Some of Key IP's work also consisted of expert witness assignments. Mr Shovell therefore considered that the allegedly defamatory letter was a "sword of Damocles", which could resurface at any time in the future, and affect Key IP's ability to obtain or retain clients.

20. The proceedings in the defamation action were issued in March 2008. A trial commenced in April 2010. The trial was expected to last some two weeks. About a week into the trial, the matter was settled. Under the terms of the settlement, the parties to the defamation action were each to bear their own costs. Neither Key IP nor Mr Shovell obtained any damages. Rather, the terms of settlement provided that a letter would be sent to Adventis shareholders, stating with reference to the 3 March 2008 letter that “Adventis and Mr Philpott withdraw any suggestion that Mr Shovell did not act honestly in his earlier communications with Adventis shareholders, and accordingly the letter is withdrawn”, and that “Mr Shovell and Key IP Limited withdraw the allegations of dishonesty which they have made in this litigation”.

21. Mr Shovell said that after this settlement was entered into, Key IP went on to earn certain fees through work which in his view it would not have been able to secure without the defamation proceedings having been brought.

22. When asked why Mr Shovell personally had been named as one of the claimants in the defamation proceedings in addition to Key IP, he said that it was not a distinction that was consciously considered at the time. He said that in fact it was to Key IP’s advantage, and his own personal disadvantage, to be added as a separate claimant in his personal capacity, since in the event of the proceedings being lost, a costs order may have been made against him personally as well as against Key IP. He said that any reasonable person with knowledge of what had transpired would understand that his communications concerning the proposal to remove Mr Mitchell from the board of Adventis were made in his capacity as officer of Key IP, and not in a personal capacity. However, he considered that it was also in Key IP’s interest for him to be a party in a personal capacity, to cover the eventuality that the court did consider that Mr Shovell was acting in his personal capacity. Key IP could not operate without Mr Shovell, since it was a one person company, and it was therefore in the company’s interest to have the 3 March 2008 letter retracted, regardless of whether Mr Shovell was acting in a personal capacity or in his capacity as officer or agent of Key IP.

23. Mr Shovell said that this was not altered by the fact that the particulars of claim sought aggravated damages for the claim brought in Mr Shovell’s personal capacity. As a matter of law, a company cannot claim aggravated damages. The additional claim for aggravated damages in the case of Mr Shovell’s personal action was added by junior counsel when the particulars of claim were being drafted. He was previously unaware of the possibility of a claim for aggravated damages, and this possibility was immaterial to his prior decision to bring the defamation proceedings. He said that the addition of the claim brought in his personal capacity would have added little at all to the overall legal costs of bringing the claim. The claim for aggravated damages involved the addition of just a few standard words to the particulars of claim. Most of the case was concerned with proving that the 2 March 2008 letter was untrue, which would have been required to be proved whether Mr Shovell was also a claimant or not. He considered that the addition of himself as a second claimant may have added as little as one percent to the overall cost of bringing the claim.

24. In cross-examination, Mr Shovell acknowledged that the claim could have been brought by Key IP alone without him personally being a second claimant, but said that it was to Key IP's benefit that he be added as a second claimant. He acknowledged that his relationship with Noble was not affected as much by the 3
5 March 2008 letter as his relationship with Oceanwood. However, he said that Key IP stood to lose income from existing clients if they perceived that he had lied in relation to such a matter, and he was concerned that this view might leak out more widely in the industry. For this reason, he considered the 3 March 2008 letter a "sword of Damocles". It was put to Mr Shovell that his personal reputation was a personal asset
10 that he could take with him if he went to work elsewhere than at Key IP. He responded that he had no intention of trading otherwise than through Key IP, and that Key IP had no value without him, and would be wound up if he left. He said that the hurt to his personal feelings was insignificant compared to the potential loss to Key IP's business.

15 25. On behalf of HMRC, Ms Parslow submitted as follows. It is accepted that if an identifiable portion of the legal fees spent on the defamation proceedings were wholly and exclusively for the purposes of Key IP's trade, then that identifiable portion is an allowable deduction. It is a matter for the Tribunal to determine whether or not the legal fees spent on the defamation action were "wholly and exclusively" for the
20 purposes of Key IP's business. There is no particular legal test for determining whether expenditure was the "the purposes of" a trade. Expenditure may be "wholly and exclusively" for the purposes of a trade if an incidental non-trade benefit or personal advantage is merely an unavoidable effect of, rather than a reason for the expenditure. The onus of proof is on the Appellant, on the civil standard of a balance
25 of probabilities, to show that the self-assessment as amended by HMRC is excessive. In this case, the litigation had a dual purpose, to protect the business reputation of Key IP, and to protect the personal reputation of Mr Shovell. The benefit to Mr Shovell was not an incidental effect of the former purpose, but rather, an independent purpose. If part of the fees were attributable to Mr Shovell, then they appropriately fell to be
30 taxed under s.419 ICTA as a loan to a director.

26. The Tribunal observed to Ms Parslow that the review of the closure notice dated 24 February 2011 apportioned 50% of the legal fees to Key IP and 50% to Mr Shovell personally. Ms Parslow acknowledged that this was apparently on the basis that as
35 there were two claimants in the defamation action, the legal fees could be attributed equally to each of them. The Tribunal asked what the situation would be if Key IP would have spent 95% of the legal fees in bringing the action in its own name alone, and if it had cost only an additional 5% to add Mr Shovell as a second claimant. Ms Parslow said that in that situation it would not be fair to attribute 50% of the legal fees to Mr Shovell personally.

40 27. In his submissions, Mr Shovell submitted as follows. It was in Key IP's interests for him to be added as a Claimant. The cost of adding him as second claimant was much less than 5% of the overall fees. It was not appropriate to apply s.419 to any portion of the fees attributable to him, as Key IP never made a loan to him. The contract of engagement of the lawyers was signed by Key IP. Mr Shovell himself had
45 no obligation to the lawyers or to Key IP in respect of the fees. It would be too late

for HMRC now to contend that it was a benefit in kind. In any event, it is not a benefit in kind for a company to pay the legal fees for an employee who is harmed in the course of his employment by a third party.

Findings

5 28. The Tribunal has considered the arguments and evidence in the case as a whole.

29. The Tribunal found Mr Shovell to be a credible and plausible witness. He gave a detailed and consistent account of the circumstances surrounding the defamation action. His account was supported by detailed documentary evidence.

10 30. It is apparent from his account that he strongly felt that the 3 March 2008 letter suggested to the addressees of the letter that he had lied to Adventis shareholders in on the matter of the relationship between the Adventis executive team and its chairman in order to pursue his own agenda. The Tribunal also accepts his evidence that he genuinely feared that this would cause his clients to lose trust in him, and that
15 from potential future clients if details of the matter spread more widely throughout the profession.

31. HMRC has not disputed the amount of the legal fees spent by Key IP on the defamation action, £459,924. Mr Shovell's evidence was that the defamation action settled after the first week of the trial, but that it was estimated initially that the fees
20 could rise as high as £750,000.

32. The Tribunal accepts the evidence that if Key IP had lost the action, and been faced with paying the defendants' costs, this could have meant the financial ruin of Key IP. The Tribunal accepts that in all the circumstances, Mr Shovell's decision to bring the litigation would have been a very difficult decision. The Tribunal accepts
25 his evidence that he would not have run such a risk merely to vindicate his own personal hurt feelings, especially since the letter only went to a limited number of recipients and did not mention him by name, such that his personal and social reputation was unlikely to be particularly affected.

33. The Tribunal is not called upon to say anything about the merits of the defamation
30 action. The evidence is that it settled on the basis referred to at paragraph 20 above. HMRC did not suggest that the application of s.74(1)(a) ICTA depended on the merits of the defamation action. Rather, arguments proceeded on the basis of whether *purpose* of bringing the defamation proceedings was to protect the business reputation of Key IP, or whether there was also a separate purpose of protecting the personal
35 reputation of Mr Shovell.

34. The Tribunal is persuaded on the particular facts of this specific case that the sole purpose of bringing the defamation proceedings was to protect the business reputation of Key IP. The Tribunal is persuaded that adding Mr Shovell as a second claimant served the purpose of increasing the likelihood of the defamation claim succeeding.
40 However, this would not affect the purpose itself, which was to protect the business

reputation of Key IP. The Tribunal finds that any personal benefit to Mr Shovell was an effect of, rather than a reason for, the expenditure on the defamation action.

Conclusion

35. For the reasons above, the appeal is allowed.

- 5 36. 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
- 10 “Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)” which accompanies and forms part of this decision notice.

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Christopher Staker

TRIBUNAL JUDGE
RELEASE DATE: 8 November 2011