TAX APPEALS COMMISSION

127TACD2020

BETWEEN:

APPELLANTS' NAMES REDACTED

Appellants

V

THE REVENUE COMMISSIONERS

Respondent

DETERMINATION

Introduction

1. The substantive issue in this appeal relates to assessments raised and repayment claims refused for the years 2007 to 2015. The appeals have been designated precedent appeals for 59 other individuals who were partners in ABC for some or all of the years of assessment from 2007 to 2015.

2. The dispute between the parties is whether a deduction can be claimed in respect of the Voluntary Partner Retirement ("VPR") payments made by the Appellants to certain retired partners in computing Schedule D Case II profits from the partnership's trade/profession. The Appellants submitted that the VPR payments were deductible as a normal trading expense incurred in the partnership's business.

3. The Respondent's position is that the VPR payment was not a trade expense as the justification for the payment was based on the relationship between the continuing partners and the retiring partner. As such, there was an allocation or appropriation out of remaining partner's profit pot, an amount that the existing partners agreed to charge against the profit pot pursuant to the legal obligation to pay the retired partner the VPR payment.

4. The significance of the distinction argued by the parties is that if the VPR payments were considered to be made out of profits or gains brought into charge to tax, an exposure to Pay Related Social Insurance (PRSI) and Universal Social Charge (USC) and Health Levies (Levies) would arise for the continuing partners. However, if such payments were expenses incurred '*wholly and exclusively*' for the purposes of the trade, assessable taxable income on the continuing partners would reduce for the purposes of calculating PRSI, and USC and Levies.

Preliminary Issues

Jurisdiction

5. The Respondent's refusal to refund PRSI, and USC and Levies to the Appellants pursuant to TCA, section 864, prompted my concerns that the Tax Appeals Commission may not have jurisdiction to hear such appeals as the matter may be governed by the Social Welfare Acts.

6. In a joint submission, the parties confirmed that the Tax Appeals Commission possessed the jurisdiction to hear the appeal on the basis that TCA, sections 864(1) and 949(1) between them provide a comprehensive right to appeal any decision relating to a claim for repayment of income tax, including health contributions by virtue of Article 3(c) of SI No 51 of 1988. Thus, while Article 3(c) of SI No 51 of 1988 makes reference to the Income Tax Acts 1967, section 432 of ITA 1967 giving the right of appeal against a determination on claims for repayment was mapped to TCA, sections 864 and 949. When read in conjunction with section 23(3)(b) of the Social Welfare Consolidation Act 2005 the effect is to create a right of appeal with regard to a repayment claim for PRSI.

7. On this basis the hearing proceeded.

Capital v Revenue Expenditure

8. During the hearing, Mr ZZ, a witness for the Appellant gave evidence that the VPR payment was made in consideration for a retiring partner to give up his or her legal right and entitlement to the share of profit for three or five years depending on the year of retirement. This prompted concerns that the VPR payment was capital in nature. However, having considered the settled law, the Appellants submitted that the expenditure incurred on VPR payments was not capital expenditure because:

   (a) A partner's entitlement to share in the net profits is not an asset of the partnership;

   (b) A partner's entitlement to share in the net profits is not a liability of the partnership as partners cannot owe money to themselves and the partnership has no separate existence or personality in law separate from the partners who come together to carry on the business in common with a view to profit;

(c) The VPR agreement did not result in any capital asset being acquired by ABC from the VPR individual and no capital asset of the partnership was brought into existence by the expenditure on VPR being agreed or paid;

(d) The effect of the VPR's agreement was to extinguish the partnership share of the partner who retired before he or she was entitled to under the partnership agreement;

(e) The expenditure on VPR being agreed or paid did not bring into existence any advantage for the enduring benefit of the partnership business that was in the nature of a capital asset.

9. Furthermore, the Respondent was satisfied that in resolving the revenue v capital dichotomy, the VPR payments were annual payments of an income nature.

10. Based on the parties' submissions, I was satisfied that the VPR payments were revenue in nature.

Substantive Issue

11. The issue to determine is whether the VPR payment is a trade charge "*payable out of the profits*" deductible for income tax purposes only, and therefore liable to PRSI and the USC and Income and Levies prior to the introduction of the USC in 2011, in the hands of the Appellants or an expense incurred wholly and exclusively for the purposes of the trade having the effect of reducing the Appellants' income for the purposes of calculating PRSI and the USC and Income and Health Levies.

12. As observed above, if the VPR payments were considered to be made out of profits or gains brought into charge to tax, an exposure to PRSI, and USC and Levies would arise for the continuing partners. However, if such payments were expenses incurred '*wholly and exclusively'* for the purposes of the trade, assessable taxable income on the continuing partners would reduce for the purposes of calculating PRSI, and USC and Levies.

Legislation

Taxes Consolidation Act

13. The charge to tax under Schedule D is governed by TCA, section 18(1) and relates to:

    (a) *" the annual profits or gains arising or accruing to —*

    (i) any person residing in the State from any kind of property whatever, whether situate in the State or elsewhere,
    (ii) any person residing in the State from any trade, profession, or employment, whether carried on in the State or elsewhere"

14. The basis of assessment for Case I and Case II is set at TCA, section 65(1) and states:

    "Subject to this Chapter, income tax shall be charged under Case I or II of Schedule D on the full amount of the profits or gains of the year of assessment.

15. For the purposes of calculating its taxable income, the Appellant is seeking a deduction for the VPR payments and has relied on TCA, section 81(2)(a) which provides:

    "Subject to the Tax Acts, in computing the amount of the profits or gains to be charged to tax under Case I or II of Schedule D, no sum shall be deducted in respect of –

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

16. TCA, section 81(2)(a) is structured in the negative and with positive inversion, provision is made for a deduction in respect of any disbursement or expense that is wholly and exclusively laid out or expended for the purposes of the trade or profession.

17. Furthermore, the Respondent identified that TCA, section 81(2)(l) was an impediment that denied the Appellants an entitlement to a deduction at it represented an:

    "annuity or other annual payment (other than interest) payable out of the profits or gains;"

Background

18. All partners in ABC, when appointed, agree to retire at an age stated in the terms of their own contract of admission to the partnership. Historically this was agreed at 65 years of age but was reduced to 62 for new partners appointed between 1 January 1993 and 31 December 1999. On 1 January 2000 this was reduced to 60 in respect of partners appointed after that date.

19. Accordingly, from 2000 onwards, ABC's retirement age for all partners was set at 60. However, as a consequence of the individual contractual rights of partners, certain partners had a pre-existing contractual entitlement to retire at ages 65 and 62 depending upon the year of joining the partnership.

20. As all partners appointed since 1 January 2000 are required to retire at 60 years of age in accordance with their own contract of admission to the partnership, the VPR scheme is applicable only to partners who were appointed prior to that date.

The VPR Agreement

21. The following is the extract of the VPR Agreement opened at the hearing:

THIS AGREMENT is made the 1st day of June 2007 BETWEEN:
parties set out in the First Schedule hereto all of Address, , Dublin, hereinafter called the "Continuing Partners" of one part AND ZZ hereinafter called "the Retiring Partner" of the other part.

WHEREAS:

A. The continuing partners and the retiring partner carry on business in the partnerships "ABC ", 1, 2 and 3 ….. collectively under the style of "ABC".

B. The affairs of the partnerships are at the date hereof regulated by the provisions of a partnership agreement dated the 24th April 1997 ("Partnership Agreement") and these provisions are incorporated into new partnership agreements.

C. It has been agreed by and between the parties hereto that the retirement date of the retiring partner shall be the 1st June 2007.

D. It has been agreed by and between the parties hereto the retiring partners shall retire upon the terms hereinafter provided.

E. The definitions, 'accounting date', 'accounting period', 'agreed rate' and 'profit share unit' have the same meanings as set out in the Partnership Agreement.

Now it is hereby agreed as follows.

1. Retirement.

1.1. Notwithstanding the provisions of the Partnership Agreement the retiring partner shall with effect from the retirement date retire as a partner in the partnership, the Executive Committee of the partnerships having accepted his notification of his proposed retirement.

1.2. Notwithstanding the provisions of clause 2.2 below the retiring partner will not be obliged to attend at the offices of the partnership after the retirement date provided that he will comply with any request for assistance from the continuing partners in respect of clients of the partnerships whom he has advised. In addition, the retiring partner will give all reasonable assistance to the continuing partners in respect of the issuing of fee notes to and the collection of outstanding debts due to the partnerships by any client of the partnership who the retiring partner advised while a partner.

2. Financial arrangement regarding retirement:

2.1. (a) The continuing partners shall be liable to pay and discharge all debts and liabilities of the partnership at the retirement date except:

(i) any debt or liability in respect of income tax attributable to the retiring partner's share of the profits of the partnership.

(ii) the retiring partner's share of any debt or liability in respect of any claim, not provided for in the accounts, arising from any wrongful or negligent act or omission of the retiring partner to the extent that such claim is not covered by insurance of which notice has been received by the partnerships prior to the retirement date.

The continuing partners shall keep the retiring partner and his estate and effects indemnified against such debts and liabilities except as aforesaid and all acts, proceedings, costs, claims and demands in respect thereof provided always that the continuing partners may at their absolute discretion waive either in whole or in part any such liability.

(b) With effect from the retirement date the retiring partner covenants separately with each of the continuing partners and the partners from time to time in the partnerships (or in any business which may after the date of this agreement succeed to the business of partnerships) to indemnify them and keep them indemnified from all and against all taxes which may after the date of this agreement be levied or assessed on the partnerships or any one or more of the continuing partners which are properly attributable to the retiring partner's share in the profits including capital profits or losses of the partnerships

2.2. (a) In respect of the accounting period during which the retirement date occurs, the retiring partner shall be entitled to the profit share to which he would have been entitled under the Partnership Agreement and shall, on account of such profit share be entitled to all usual drawings, tax payments and debits up to the retirement date. The calculation of the profit share of the retiring partner to the retirement date shall be based on the results of the said accounting period and apportioned to the retirement date. The continuing partners covenant with the retiring partner that the financial statements in the respect of the said accounting period shall be prepared on a basis consistent with that used for previous accounting periods.

(b) Notwithstanding the terms of clause 2.3 hereof, any balance of profits in respect of the accounting period during which the retirement occurs shall be paid to the retiring partner on the same day that such payments are made to the continuing partners together with interest thereon calculated at the agreed rate in respect of the period commenced on the retirement date until the date of payment. In the event that no such payments are made to the continuing partners the said balance of profits together with said interest thereon shall be paid to the retiring partner not later than 12 months from the retirement date.

2.3. The capital of the retiring partner shall comprise the amount standing to his credit in the capital, current and tax retention accounts of the partnerships at retirement date less any loans or other amounts due by the retiring partner to the partnerships at the retirement date and the capital so determined shall be payable to the retiring partner on the following terms:

(a) The amount payment under clause 2.2 (b) if any and the credit balance on his tax retention account shall be deducted from the capital and the balance of the capital shall be repaid to the retiring partner in 10 equal instalments over the period of five years from the retirement date, the first instalment to be paid on the retirement date, the second after six months and thereafter at six month intervals under the full balance has been repaid. However, subject only to where applicable the retiring partner, covenants with the continuing partners to use the instalments to immediately discharge any borrowings incurred by him in respect of his capital contribution to the partnerships under the letters of commitment where appropriate or otherwise. In the event that the partnerships have committed to make a direct payment to the bank account of the retiring partners such payments are deducted from the capital outstanding to the benefit of the retiring partner.

(b) The retiring partners' tax retention account shall be utilised to pay the income tax liabilities attributable to his share of profits prior to retirement date and any excess tax retention shall be paid to the retiring partner after full settlement of such tax liabilities.

(c) Interest on the unpaid capital balance including unpaid tax retentions shall be payable and calculated half yearly at the agreed rate.

(d) The continuing partners confirm that no balancing charge will arise on any capital allowances claimed by the retiring partner in respect of his share of profits in the partnership after his retirement. It is agreed that no deferred tax accounts will we created which would affect the balance of capital.

2.4. (a) In the event that prior to retirement date the partnership accepts an offer for all or a significant part of the business of the partnerships and the sale proceeds are not received until after retirement date, the retiring partner shall be entitled to the same share of the profit accruing to him from such disposal that he would have been entitled to had the sale proceeds been received prior to the retirement date.

(b) In the event that within 36 months of the retirement date the partnerships accept an offer for all or a significant part of the business of the partnership, such date shall be deemed to be the date of sale and the retiring partner shall be entitled to a share of the profit accruing from such disposal reduced as follows:

(i) by 50% where such sale takes place within twelve months of retirement date;

(ii) by 75% where such sale takes place between 12 and 24 months of retirement date;

(iii) by 87.5% where such sale takes place between 24 and 36 months of retirement date and his proportion of such reduced profit arising shall be based on his profit share units at retirement date. The retiring partner shall have no entitlement to share in any such disposal which occurs after thirty-six months of retirement date.

(c) All amounts due to the retiring partner in respect of such disposals at 2.4(a) and 2.4(b) shall only be payable to the retiring partner on receipt of the disposal proceeds by the partnership.

2.5. In the event that prior to the retirement date the partnerships decide on retirement terms for partners including terms for annual payments to partners following their retirement which would in the case of the retiring partner be more favourable to the retiring partner, then the retiring partner shall be entitled to benefit from those improved terms and the provisions of this agreement will be amended accordingly.

2.6. The continuing partners shall within 30 days of the retirement date:

(a) Procure that the retiring partner is released from any personal liability to the partnerships' bankers as to partnership indebtedness to those bankers which exists at the retirement date; and

(b) have the retiring partner's name removed from all ABC bank accounts. The indemnity provided at clause 2.1(a) above shall, for the avoidance of doubt, apply to any liability of the retiring partner to the partnerships bankers in respect of ABC indebtedness."

3. ANNUAL PAYMENTS

3.1. The continuing partners shall pay the retiring partner by equal monthly instalments commencing during the month of retirement date and ending during the month prior to the retiring partner's sixty fifth birthday. The monthly instalment shall be payable at month end and shall be arrived at by multiplying the retiring partner's average profit by his monthly instalment percentage. The retiring partner's average profit and monthly instalment percentage are calculated by references to clause 3.2 and 3.4 respectively. Any tax statutorily deductible from such monthly or annual payments shall be deducted and recognition shall be given in writing to the retiring partner for any taxation so deducted.

3.2. For purposes of clause 3.1 average profit shall be the average of the profits of the retiring partner for the three years ending on the accounting date immediately prior to the retiring partner's retirement date. Profit comprises the retiring partner's unit allocation of profits, excluding special allocation of profit, as reported in the financial statements of the partnerships subject to adjustment, if any, under clause 3.3. No weighting or indexation shall be applied in the calculation of average profits.

3.3. For the purpose of clause 3.2 above average profit shall be revised to exclude profit allocations in respect of phantom unit, if any, in existence for the retiring partner during the three years used to calculate average profits.

3.4. For the purpose of clause 3.1 the retiring partner's monthly instalment percentage shall be calculated by dividing his total profit percentage by the number of instalments payable. Total profit percentage shall be determined in accordance with the following:

(a) For a partner retiring on his sixtieth birthday his total profit percentage is equal to 260%.

(b) For a retiring on this sixty second birthday his total profit percentage is equal to 160%

(c) For a partner whose retirement date is between his sixtieth and sixty second birthday the total profit percentage of 260% is reduced by 0.1369863% for each day between his sixtieth birthday and his retirement date.

(d) For a partner retiring post his sixty second birthday his total profit percentage is zero.

3.5. In the event of the retiring partner dying during the term of the annual payments provided in clause 3.1 the continuing partners hereby agree to continue to make the payments provided for hereunder to the estate of the retiring partner. For the avoidance of doubt in the event of the retiring partner dying prior to his retirement date no obligation under clause 3 would arise.

4. COVENANT

For the period of the payment set out in clause 3 above, the retiring partner will not from the retirement date:

(a) either on his own behalf or on behalf of any other person, firm or covenant canvass or solicit any of the clients of the partnerships without the prior written consent of the managing partner at ABC or act as auditor on behalf of any such client or solicit any employee of the partnerships to leave the employment of the partnerships;

(b) make public or disclose to any person, firm or company any information as to the practice, business, dealings or affairs of the Partnerships or any of its clients which came to his knowledge in his former capacity as a partner;

(c) accept an appointment in a client company as a director or consultant without the prior agreement of the managing partner of ABC.

5. CONSULTANCY ARRANGEMENTS

This agreement provides for no consultancy arrangements with retiring partners. In the event of the continuing partners seeking to employ the retiring partner on a consultancy basis such consultancy arrangements shall be agreed between the departmental head seeking the consultancy from the retiring partner in conjunction and in agreement with the managing partner for the time being of ABC. The rate of remuneration associated with the consultancy shall be determined in agreement between the managing partner, the head of department in question and the retiring partner.

6. TERMINATION

The continuing partners may by notice in writing immediately terminate this agreement if the retirement partner shall:

(a) be in breach of any of the terms of this agreement which in the case of a breach capable of remedy is not remedied by the retiring partner within 20 days of receipt by the retiring partner of a notice from the managing partner of ABC specifying the breach and requiring its remedy or;

(b) be guilty of gross misconduct and/or any serious or persistent negligence in respect of any of his obligations hereunder.

7. ACKNOWLEDGMENT

It is hereby agreed and acknowledged by the parties hereto that the retiring partner is not entitled to any pension, bonus or other fringe benefit (apart from expenses properly incurred by him in the course of carrying out any duties for the continuing partners) from the partnerships. Furthermore, it is agreed that that the retiring partner shall be responsible for all tax liabilities in respect of the annual payments provided for on foot of this agreement and hereby indemnifies and agrees to keep indemnified the continuing partners in relation to the same.

8. ENTIRE AGREEMENT

This Agreement constitutes the entire agreement between the parties in relation to the retirement of the retiring partner. With effect from the Retirement Date, the Partnership Agreement should no longer apply to the Retiring Partner

9. MISCELLANEOUS

9.1. With effect from the retirement date and save as provided for otherwise in this agreement the retiring partner shall waive any right or entitlement to any of the assets of the partnerships.

9.2. As soon as practicable following the retirement date the continuing partner shall procure the removal of the retiring partner from any leases, tenancy agreements or equivalent to which the retiring partner is a party whereunder he holds his interest on trust for the partnerships and pending such removal the indemnity contained in clause 2.1 (a) shall apply.

9.3. The retiring partner acknowledges that there will be no provision of accommodation or right to accommodation in the offices of the continuing partners after retirement date. Without prejudice to this the continuing partners agree that a reasonable request from the retiring partner for use of office for occasional meetings or for personal purposes associated with carrying out any requirement of the continuing partners shall where possible be facilitated.

22. The agreement was signed 1st June 2007 by Mr ZZ and Mr YY on behalf of the continuing partners and their signatures were witnessed by a Ms WW.

Expert's Report

23. The Appellants engaged a Mr PP who prepared an expert report which was accepted by the Respondent and read into evidence. The relevant part of the report is summarised below:

(a) There are no statutory or other specified guidelines / principles as to the preparation of accounts for professional partnerships in Ireland.

(b) Generally Accepted Accounting Principles (GAAP) is not a required basis for the preparation of annual accounts for professional partnerships such as ABC in Ireland.

(c) The accounting policy re VPR, adopted by ABC is appropriate and acceptable in accordance with ordinary conventions of commercial accounting. The underlying everyday accounting convention of annual accounts is the matching, using accrual accounting, of expenditure and income.

Evidence – *Witness for the Appellant Mr ZZ*

24. Mr ZZ, the former managing partner gave evidence as follows:

(a) From 1980 until 2007 he was a partner in the various firms which ultimately became ABC. Between 1999 and 2007 he was the managing partner of ABC and had primary responsibility for the administration of the VPR scheme and in 2007 he personally availed of VPR and took early retirement at the age of sixty.

(b) As a result of a series of mergers which culminated in the establishment of ABC on 1 January 199x, a number of challenges arose including overlapping specialisms and a preponderance of older partners. At the same time there were talented people coming up through the ranks but there were very limited opportunities to bring these individuals through the partnership as the standard retirement age across ABC was 65 years of age.

(c) In 199x, he and his predecessor discussed the age profile of the partners and also that "*over partnering*" was becoming a problem in the recently amalgamated firm. These problems became the catalyst for devising the VPR Scheme.

(d) There were concerns that the 'ABC' franchise could be lost if the issue of the large volume of older partners was not addressed.

(e) As and from 1 January 199x the retirement age applicable to newly admitted partners became 62 years of age. From 1 January 200x the retirement age applicable to newly admitted partners became 60. The net effect of these changes was that from the early 90s there had been a shift in the retirement age which ABC considered to be optimal and yet there was a substantial cohort of partners who had a contractual entitlement to remain as partners until their 65th birthdays.

(f) When the partnership agreement was drafted, goodwill was taken out as a predecessor firm had a significant problem with goodwill that nearly destroyed the practice.

(g) In 199x/199y ABC considered the issue of the partner progression problem as there were at that time approximately 15 or 20 people between the ages of 30 and 40 that were required to be brought up to partner level and therefore a plan was required to be put in place to facilitate such promotions.

(h) The issue identified by ABC was the number of older partners were approaching 65 and were retiring within two or three years of one another. This would block the possibility of introducing new people and the other existing good partners would become disenchanted. In particular staff notice "*a company of old men*" and the associated lack of career progression would disincentivise young talent coming through. Therefore, this matter needed to be addressed. As such as at 31st December 200x there were 12 of the 20 partners in the 65-year retirement category who were over 55 years of age.

(i) There was a natural break in ages between the 12 potential VPR candidates with an entitlement to retire at 65 years of age and the remaining partners. This break made it possible to plan a proposal in specific terms for partners over 55 years of age at 31 December 200x and the issue of how to address those individuals could be structured in the future and made more appropriate to that group.

(j) ABC had to be managed in the interest of all the stakeholders at a moment in time having regard to all circumstances. Therefore, the moral courage of the management to act in the best interest of the practice was a condition precedent.

(k) Phase I VPR commenced shortly thereafter and applied to the six oldest partners in the practice and all the partners in Phase I had a legal entitlement to retire at the age of 65.

(l) The purpose of phase 1 VPR was to allow for expansion in order to accommodate "*the young bright men coming up"* and to create a scheme which left the pool interesting for existing partners, the new partners and a reward for the potential partners that would like to take VPR because of their age. This scheme was intended to make room for the new partners by expanding the practice and as such a payment was required to encourage potential VPR candidates to give up their legal right and entitlement to their share of profit for three or five years depending when they opted for VPR.

(m) It was not possible simply to double the number of partners, as apart from not making commercial or financial sense, the existing partners would not approve of it. The career prospects were much better in a practice that is not over partnered as room would not exist to climb up the ladder in an over partnered firm. If ABC was not made attractive, it would not be possible to attract the talent which would become the future generation of partners. As a consequence, ABC developed the reputation of being the best in class to work for.

(n) If a partner was going to leave early, his legal profit share entitlement was left behind. As such it was reasonable, particularly in respect of Phase 1 VPR, that the retiring partner would receive a payment in lieu of the profits foregone. The VPR substituted for what had been given up.

(o) The VPR formula was based on the historic three-year profit before a partner left the practice. However, the VPR programme could not be so generous as to jeopardise the wellbeing and fabric of the practice going forward but it had to offer some reward to the retiring partner for the profits left behind.

(p) Due to the increasing profit profile it could have been argued on the surface that VPR was expensive to the partnership and beneficial to the retiring partners. However, while the retired partners benefitted beyond what looked to be the case at the outset, the practice also benefited to a more substantial degree. The reality of VPR was a "*win win"* as the profits were increasing.

(q) Having a fixed factor in the calculation of the VPR was a necessary risk to make Phase I and Phase II attractive enough to encourage a partner to ask to be considered for VPR.

(r) The rationale for proposing 2.6 times profits rather than just offering €50,000 was to create an opportunity and space for new partners. This was a great deal for the partnership if the profits kept improving.

(s) ABC needed a certain number of partners in each of the disciplines of the practice to ensure that they were properly covered and properly developed with people who had the ability and energy. If the standard deteriorated and there was a drop in partners or where there was an inadequate number of partners to deal with the expanding business, ABC's professional insurance would come into question. Therefore, to ensure at all times that ABC was only creating opportunities which were necessary for the people who were coming up and that the retiring partners were creating space for this. ABC was always conscious of the apparatus of the practice and its ability to carry on its business.

(t) The need for proper partner numbers was also for risk management purposes. There was a risk management department headed up by a partner. For example, in the audit of FGH Group, it was required to have 3 partners who had a speciality. Failure to have the correct compliment of partners would expose ABC if something went wrong. This fed into VPR as VPR created the opportunity to bring in new partners with a better understanding of modern technology, modern standard statements for accounting practice and modern international accounting standards. Anything that destroys the practice was indefensible.

(u) If there were no new partners domestic opportunities would be missed such as Irish budding entrepreneurs.

(v) Mr ZZ read an excerpt from minutes dated 11 May 2007 which read as follows "*ZZ noted that DE had requested to take VPR effective 31 May 200x. He stressed the importance of VPR in reducing the age profile of the partnership in a controlled manner so as to continue to fuel the creation of a successful practice*."

(w) It was the view of the executive that it was in the best interests of the practice that partners cease to be partners in ABC on reaching the age of 60.

(x) The need for the creation of "*headroom*" or capacity to grow the practice was not in the context of profits. Profit underpins all the logic to create room to "*appoint brilliant young people who weren't yet partners and give them space to expand the practice further*."

(y) An important partner with banking experience who left the practice because of VPR would have worked with a younger budding bright person who took over and expanded ABC. ABC hired experience people short term from London who later became leading exponents in the area of banking. Many of those hires had financial services experience and solved a great problem for ABC. As a consequence of the expansion and the VPR, ABC could make them partners.

(z) Some of the older partners had "*grown old early*". When a person was identified as causing a problem by not keeping up-to-date technically or was sending directors out to take major meetings and not going himself, such an individual was becoming a danger to the practice and therefore there was an obligation to encourage him to take VPR.

(aa) ABC saw an immediate benefit of VPR as it had experienced expansion. The benefit of a person leaving through VPR and being replaced by a new partner was "*enormous*".

(bb) One particular capital tax partner who decided to leave the practice for a lifestyle change "*did not get a shilling*". There were seven such Individuals during his time who did not avail of the VPR.

(cc) The conception of VPR was described as "*the answer to the thing that is going to crucify us and choke us like a viper*."

(dd) The policy of seeking to encourage earlier retirement recognised the need to continue to appoint new partners to build and renew the partner group with a view to driving ABC's business forward by granting a financial incentive to partners to retire early in the best interests of the business. Over time it was also recognised that the retirement of partners at the relatively young age of 60 would likely result in those partners seeking business or employment opportunities elsewhere, thus creating a group of former partners in the marketplace who would be likely to support ABC in its own ongoing business endeavours.

(ee) The VPR scheme was both optional and discretionary as no partner was required to avail of the VPR scheme but similarly no partner had a right to avail of the scheme and ABC could in its absolute discretion, decide to approve or reject an application to avail of VPR based upon the interests of the business. The objectives, rationale and operation of the scheme were driven solely by the interests of the business and not by the needs, requirements or desires of any individual partners.

(ff) On receipt of an application to avail of VPR, the executive committee considered the overall requirements of the business and the exit date proposed by the participant may be refused or subject to renegotiation based on what was in the best interest of the business. This usually occurred informally and the formal written application was usually made by reference to the negotiated proposed exit date. The terms of each phase of the scheme ensured that the executive may temporarily or permanently suspend the scheme in the interests of the practice and an application by an individual partner may be refused in the interests of the business as a whole.

(gg) Where an eligible partner’s application for VPR was accepted, once they reached the date of exit, the usual provisions of the partnership agreements around payment of their share of net profits up to date of cessation and payment of all sums standing to the credit of their capital account applied.

Evidence – *Witness for the Appellant Mr XX*

25. Mr XX, one of the Appellants and current partner gave evidence as follows:

(a) He has been a partner in ABC since 1 December 200x and since 1 June 201x he was designated as the partner responsible for oversight and coordination of ABC's tax affairs. He confirmed that the evidence of Mr ZZ accords with his understanding of the purpose and operation of VPR.

(b) VPR created opportunities for him and it was his obligation to create opportunities for the people coming behind him and to make sure ABC was in a much stronger position than when he had joined. Therefore, in order to attract the best people in a very competitive environment for highly skilled people there was a need to over commensurate remuneration.

(c) The appointment of new partners and the renewal of the practice was concerned with how ABC’s business evolved and how it reinvented itself in light of current and future market requirements.

(d) ABC could not just double the number of partners or just simply appoint another eighty partners as there would be a significant dilution of earnings. With a dilution of profits, competitors such as MM or NN could “*cherry pick our best partners because we diluted the profits to such an extent that they can go off and get paid €300,000 or €400,000 more with one of our competitors*.”

(e) The capacity to attract the right talent to make them partners required more than organic growth.

(f) Without any re-investment, the practice would be driven into the ground and as a result ABC constantly focused on the renewal of their practice by having young people in the practice and VPR played a role in that. VPR also provided a degree of flexibility to accelerate or create opportunities to bring people through.

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(g) A VPR partner exiting the business freed up capacity to bring through one or more partners and particularly more than one is better. Effectively two younger partners who have more energy, eager to get out in the marketplace and grow their portfolios so effectively that fed into some of the organic growth that came through because they drove more business. However, with additional partner numbers and the right calibre of people at the right age, effectively those younger partners were getting a smaller share of the profits and there was an incentive for them to drive the profits so they could get a larger share themselves and that became a self-fulfilling prophecy.

(h) Organic growth differed to VPR growth as organic growth involved looking at the existing business and through the efforts of the existing compliment of people, the revenue derived from existing clients, the additional turnover and resources. Effectively it was the year on year growth that ABC generated in the absence of making acquisitions.

(i) However, the appointment of younger partners that were more active in the market took the effect of generating additional revenues due to this increased activity. VPR enabled ABC to appoint specialists in areas where they did not previously have a business or offer a service that contributes to the growth through expansion of their services.

TAX APPEALS COMMISSION

Appellants' Submission

26. In determining the appropriate tax treatment, the Appellant submitted that the VPR payments could only fall into one of three categories, namely:

    (a) a division of profit between partners also referred to as an "*allocation*" of profit;

    (b) a business expense deducted in order to ascertain profit, or

    (c) a non-business disbursement paid out of profits.

27. There is no fourth category and there is no space between these categories.

28. The essence of partnership profit is the profit earned by the partners from their carrying on business in common. The VPR recipients did not earn the VPR payments which they received as they had retired from the partnership and were no longer carrying on the partnership business and therefore not entitled to a share in the partnership profits.

29. The fact that the amount of the VPR payments have been calculated by reference to figures for past performance represents, on the facts, neither a further share of past profits of the partnership nor a share of the partnership profits after the VPR individual had retired from the partnership. The VPR recipients had no entitlement to any partnership profits after retirement.

30. When an individual partner retired, that partner ceased to conduct the partnership business and as a result no longer contributed to the profits of the partnership. Moreover, that individual ceased to be entitled to a share in the partnership profits. Whether or not the continuing partners and any new partners admitted to the partnership maintain the partnership profits at any particular level depends on the business that they then continue to conduct in common after the departure of the VPR individual.

31. The annual VPR payments were wholly and exclusively laid out or expended for the purposes of their profession and therefore are not prohibited from deduction by TCA, section 81(2)(a). Moreover, that being an allowable deduction in the Schedule D Case II computation, those payments could not then be payable out of the profits or gains to be charged to tax under that Schedule and therefore are not prohibited from deduction by TCA, section 81(2)(l).

32. The Respondent's case is that the Appellants are liable to PRSI, and USC and Levies on payments received by the VPR individuals who themselves are also accounting for PRSI, and USC and Levies in addition to income tax on that income because the payments are

alleged to be charges on income rather than deductible business expenses. In other words that the payments were made out of profits or gains brought into charge to tax.

33. In reviewing the historical position and operation of charges, a distinction was drawn between TCA, sections 237 and 238 which deal administratively with annual payments and provide for deduction of income tax at source.

34. Under TCA, section 237, the payer deducts tax at the standard rate and retains that sum. Under TCA, section 238 the payer deducts tax at the standard rate and pays that sum to Respondent. In each case the payee is credited with having paid tax on his receipt at the standard rate.

35. The procedure TCA, section 237 applies to annual payments made by a person out of taxed income. These are annual payments which are wholly unconnected to a taxpayer's business and in respect of which no tax deduction from the computation for Case I or II of Schedule D is permissible for example, the annual payment to a merchant's mother in law.

36. However, because the payor, the merchant is providing the payee, the mother in law with an income which is liable to income tax, the legislation provides an element of relief to the payor to avoid the payment being taxed twice in its entirety. The means by which this relief is provided is that the payor is in effect not charged to income tax on that payment with the recipient being liable for income tax and levies etc. However, because the payment is a charge on income and not a deduction from income of the payor, that payment is liable to PRSI, and USC and Levies on that portion of his income out of which the charge is payable.

37. The procedure under TCA, section 238 deals with annual payments not made out of taxed income and requires the payor to act, in effect, as a collection agent for the Respondent it must deduct income tax at the standard rate from the payment and pay the collected tax to the Respondent as TCA, section 238(2), provides that the annual payment is "*not payable….out of profits or gains brought into charge*". The VPR payments made by the Appellants in this case were fully deductible business expenses and were, therefore, "*not payable….out of profits or gains brought into charge*". As such they fell out of the Case II computation for income tax and are not liable to PRSI, and USC and Levies.

38. The clear distinction drawn between TCA, sections 237 and 238 whereby the former applies to annual payments made wholly out of profits and gains and the latter applies to other annual payments reflects a clear difference between those two types of annual payments.

39. TCA, Section 81(2)(l) only applies to annual payments payable out of profits and gains brought into charge and so the Respondents were wrong historically to argue that TCA, section 81(2)(l) applied to all annual payments. Clearly, an annuity or payment cannot be "*payable out of the profits or gains*" if it has already been reckoned in the calculation of the profits themselves. The prohibition in TCA, section 81(2)(l) is not against a deduction in respect of annuities or annual payments, *per se*, but only such payments made out of the profits or gains. It would appear, however, that this argument is no longer being made but it is, with respect, not clear whether and if so, why it is said that TCA, section 81(2)(l) applies to the instant payments if TCA, section 81(2)(a) is satisfied.

40. As was held in *Ushers Wiltshire Brewery Limited* [1915] A.C. 433, at p. 453: "*where a deduction is proper and necessary… it ought to be allowed… provided there is no prohibition against such allowance*". That principle is not in any way adapted or overridden by section 81(2)(l).

41. In *Gresham Life Assurances v Styles* (1892) 3 TC 185, which predates 1922 and therefore forms part of law in this State, Lord Halsbury LC in his speech to the House of Lords focused, appropriately, on the precise terms of the statutory antecedent of TCA, section 81(2)(l) at p.314:

> *"Now, if I understood the contention before your Lordships aright, it rested on the fourth rule relating to assessment under Schedule D which prohibited any deduction being made on account of any annual interest or any annuity or any other annual payment, and as those sums were annuities or annual payments it was said that they were not to be deducted in estimating the amount of the profits and gains arising as aforesaid.*
>
> *And if the rule had stopped at the point up to which I have quoted it I should have concurred with the contention of the surveyor. But the rule does not stop there. In order to be a prohibited reduction, it must be sought to be made on an annuity or other annual payment payable "out of such profits or gains".*
>
> *Now to my mind it is very clear what is the intuitus, both from the enactment and from the rules under which the duties are to be ascertained. The thing to be taxed is the amount of profits and gains. The word "profits" I think is to be understood in its natural and proper sense-in a sense which no commercial man would misunderstand. But when once an individual or a company has in that proper sense ascertained what are the profits of his business or his trade, the destination of those profits, or the charge which has been made on those profits by previous agreement or otherwise, is perfectly immaterial. The tax is payable upon the profits realized, and the meaning to my mind is rendered plain by the words "payable out of profits."*

It would be an extraordinary thing to suggest that where a business consists of granting annuities it is to be taxed upon a different principle from any other commercial concern, and no one I suppose could doubt that in any other commercial concern the cost of the thing sold to the trader is one of the expenses incident to the carrying on of the trade.

..

The whole point seems to me to depend upon the words "out of profits and gains". Profits and gains must be ascertained on ordinary principles of commercial trading, and I cannot think that the framers of the Act could be guilty of such confusion of thought as to assume that the cost of the article sold to the trader which he in turn makes his profit by selling was not to be taken into account before you arrived at what was intended to be the taxable profit.

As I have said, the confusion has arisen from the use of the words "annuity or other annual payment" without considering that this particular commercial adventure consists in selling annuities, and that which they pay therefore is to them the cost of the article supplied. You can no more refuse to take that cost into your consideration when ascertaining the balance of profits and gains than you could the cost of the coals or the corn to the coal merchant and to the corn merchant, in ascertaining what are the profits from his trade."

42. It was submitted that the Respondent did not earnestly challenge the Appellant's construction of TCA, sections 237, 238 or section 81(2)(l). As a consequence, this case can be distilled down to one simple issue namely whether the amounts paid by the Appellants, who together comprise ABC, to retired partners under the VPR scheme was an expense incurred by ABC wholly and exclusively for the purposes of the profession.

Is the VPR Payment an Expense of ABC?

43. A partnership, pursuant to section 1 of the Partnership 1890, is "*the relation which subsists between persons carrying on a business in common with a view of profit*." The partnership itself, unlike a company, has no separate legal identity. As Twomey on Partnership explains:

> *"One of the crucial features of a partnership and one which clearly distinguishes it from a company is that a partnership is not a separate legal entity."*

44. Whereas a company is owned by shareholders and managed by directors who are employees of the company, the partners in ABC together constitute the practice and they manage the business not as employees but as co-owners of the business itself.

45. The introductory words of Chapter 14 of Twomey on Partnership are:

"Since the purpose of a partnership, by its very definition, is the making of a profit, an important issue in every partnership will be the right of a partner to his financial entitlements from the firm."

46. The partners of a firm each have a right to share in the profits of a firm either equally in accordance with section 24(1) of the 1890 Act or in accordance with the agreement reached between those partners. In this case, the partners of ABC agreed that the profits of their business be divided between them in accordance with the number of units allocated to a particular partner in a particular year. The mere fact that a partnership makes, for example, €1m profit in a particular year does not provide a basis for assessing the partners themselves. The partners are each taxable only on that portion of the profit to which they themselves are individually entitled. The extent of the entitlement is determined by the partners themselves and, as the evidence in this appeal showed, it is determined in Appellants' case, by the number of units allocated to a particular partner in a particular year. It is this sharing of profits which is referred to as an "*allocation*" or "*appropriation*" of profits.

47. In Feeney, the Taxation of Companies, 2019, the author explains the basic taxation position of partnerships as follows:

"TCA 1997, s 1008(1) provides that each partner is to be taxed on his share of profits or gains from the partnership trade as if that share were profits or gains of a "several" trade, i.e. a trade carried on solely by him.…"

48. When the Case I or Case II profit or loss for the partnership has been determined for any period of account, the profit or loss is allocated between the persons who were partners during that period. That allocation is made in accordance with the terms of the partnership agreement as to the sharing of profits or losses, i.e. profits or losses as disclosed by ABC's accounts.

49. Twomey on Partnership states the following about the nature of the right which a partner has to share in the profits of a firm:

"Dispute between partners may involve a wide variety of potential actions ranging from a claim for damages to an application for the appointment of a receiver to the firm. However, regardless of the form of action, two important characteristics of the partnership relationship should be borne in mind, as they commonly influence the outcome of the litigation.

First, one of the grand characteristics of partnership is the fact that it is not a separate legal entity, it is an aggregate of all the partners. For this reason, the partners are not treated as debtors and creditors of the firm while the partnership continues, since to do so would involve a person owing himself a debt……

Another important characteristic of the partnership contract is that it requires a high degree of confidence and trust between the partners."

50. The Respondent initially asserted that the VPR individuals were being "allocated" profits. However, at the hearing, the Respondent clarified that the VPR individuals were not receiving an allocation or attribution of profits and are not taxable under TCA, section 1008. It was submitted, however, that this common ground is central to a proper consideration of this appeal.

51. In stark contrast to the present case, in both *MacKinlay* and *Morgan & Self*, TC00046, there was a finding of fact that the recipients of the payments in those cases received an allocation of profits. That simple fact is of fundamental significance.

52. In *MacKinlay*, the House of Lords held that the payment of relocation expenses to a partner of the firm Arthur Young was an allocation of profits to that partner. Accordingly, this case turned on the fact that the outlay, being an allocation of profits, was not an expense at all. The payment was merely the allocation of profits to the partner:

    "A partner, on the other hand, whether he be senior or junior is in quite different position [to that of an employee]. What he received out of the partnership funds falls to be brought into account in ascertaining his share of the profits of the firm…"

53. *MacKinlay* is also an authority for the proposition that even if payment were made to a partner of a firm that payment is not an allocation of profits of the firm if it is a payment "*entirely collateral*" to his capacity as a partner. That exception, however, only arises for consideration when a payment is made to a partner of the firm, and applies so as to distinguish the payments which are made to a partner acting in his capacity as partner and those which are not. If the recipient is not, as here, a partner, the question does not arise.

54. In *Morgan & Self v HMRC*, it was also found as a fact that there was an allocation of profits to the individuals in question and the cases were expressly determined on that basis.

55. Notwithstanding that both sides in this appeal have agreed that there was no allocation of profits to the VPR individuals to the extent they were not receiving profits of ABC *qua* partners the Respondent seeks, nonetheless, to rely upon the fact that the VPR individuals were at one point in time partners. The precise basis upon which this assertion was made remained unclear.

56. The VPR individuals were all, at one time, partners in ABC. It is also undeniably correct that if they had not been partners in ABC they would not have received any payment

since it was the existence of their contractual rights to share in the profits of ABC as partners which was the entire reason for making the VPR payment to relinquish that right. However, the payments were either made, *qua* partner and thus were an allocation of profits or they were not. If the payments which have been made are not made *qua* partner, then they are made to third parties and must be treated as such.

57. Whilst *MacKinlay* and *Morgan & Self* clearly involved respectively the Court and Tribunal in those cases considering the status in which the recipient received the payment, that was because there was a dispute in those cases as to whether the payments were an allocation of profits to partners. In this appeal, there is no such dispute.

58. A person either receives a payment *qua* partner or one does not, there is no midway point between these binary possibilities. It is fundamental to appreciate that the issue for consideration is not the tax implications of a payment made to a partner *qua* partner but the implications of a payment being made to a third party who is not a partner.

The Relevance of Accounting Treatment

59. The Supreme Court has made it clear that the profits of a trade must be computed in accordance with the ordinary principles of commercial accountancy. In *Cork and County Property v Revenue Commissioners* [1986] IR Griffin J held, at 569, that:

> *"The method of computation of the balance of profits and gains for tax purposes has been considered in a number of cases. The passage most frequently cited is that of Lord President Clyde in Whimster and Co. v. The Commissioners of Inland Revenue (1925) 12 T.C. 813, at p. 823:—*
>
> > *"In computing the balance of profits and gains for the purposes of Income Tax, or for the purposes of Excess Profits Duty, two general and fundamental commonplaces have always to be kept in mind. In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business during such year or accounting period and the expenditure laid out to earn those receipts. In the second place, the account of profit and loss to be made up for the purpose of ascertaining that difference must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the Income Tax Act, or of that Act as modified by the provisions and schedules of the Acts regulating Excess Profits Duty, as the case may be. For example, the ordinary principles of commercial accounting require that in the profit and loss account of a merchant's or manufacturer's business the values of the stock-in-trade at the beginning and at the end of the period covered by the account should be entered at cost or market price, whichever is the lower: although there is nothing about this in the taxing statutes."*

That statement of the law has in very many cases since been approved — for example, by the Judicial Committee of the Privy Council in The Minister of National Revenue v. Anaconda American Brass Ltd. [1956] A.C. 85; and in the House of Lords by Lord Guest in Duple Motor Bodies Ltd. v. Inland Revenue Commissioners [1961] 1 W.L.R. 739.

In Odeon Assoc. Theatres v. Jones [1971] 1 W.L.R. 442, it was necessary for Pennycuick V.C. to consider the principle upon which the profit of a trader falls to be ascertained for the purpose of income tax. Having quoted passages from the speeches of Lord Parker and Lord Sumner in Usher's Wiltshire Brewery Ltd. v. Bruce [1915] A.C. 433, he said at p. 453:—

> *"The expression 'ordinary principles of commercial accountancy' is not contained in that paragraph but it is contained in other passages of high authority. I will endeavour in a moment to explain in rather more detail what that expression means. The effect of the principles laid down in Usher's Wiltshire Brewery Ltd. v. Bruce and other cases, including those in which the expression 'ordinary principles of commercial accountancy' is used is this: first one must ascertain the profits of the trade in accordance with ordinary principles of commercial accountancy. That, of course, involves bringing in as items of expenditure such items as would be treated as proper items of expenditure in a revenue account made up in accordance with the ordinary principles of commercial accountancy. Secondly, one must adjust this account by reference to the express prohibitions contained in the relevant statute, those being now contained in section 137 of the Income Tax Act, 1952. That is to say, an item of expenditure, even if it would be allowed as a deduction in accordance with the ordinary principles of commercial accountancy, must be struck out if it falls within any of those statutory prohibitions."*

60. Whilst the facts, expert evidence and law in respect of the accounting treatment of the VPR payments was not ultimately disputed by the Respondent, it would be wrong to imply that it was thereby rendered unimportant.

61. The fundamental point was that any taxpayer’s profits are determined in accordance with the accounts that have been prepared provided that those accounts accord with the ordinary principles of commercial accountancy.

62. In addition, the payments must also survive each of the statutory prohibitions contained in TCA, section 81(2). However, each of the partner’s liabilities to tax under TCA, section 1008 is for their individual share of the profits of ABC as calculated in accordance with their accounts. Had the VPR payments not been deducted in the Appellant’s accounts or had those accounts not been agreed to have been properly prepared then the

Appellant's right to deduction could have been challenged on that basis. Accordingly, the effect of the agreement which was reached in respect of the accountancy matters is that if these payments are not precluded from deduction by section TCA, 81(2) the Appellant must succeed on its appeal.

Section 81(2)

63. It is common ground that TCA, section 81(2) contains a list of separate prohibitions and that if the payments fall within any of those paragraphs they are precluded from deduction. It is fully accepted that, as a matter of principle, if one surmounts paragraph (a) it must also surmount paragraph (b) etc. However, in the specific circumstances of this appeal, if the Appellant surmounted paragraph (a), the payments could not logically fall foul of paragraph (l).

Section 81(2)(a)

64. Assistance in interpretation of the rules of trade deductions is provided in the binding authority of the High Court in *MacAonghusa v Ringmahon* VI ITR 327 where Budd J summarised the principles which arise from the English cases of *Mallalieu* and *MacKinlay* for the purpose of Irish law. Reliance was therefore placed on the following finding by the Court at p.20:

> *"To ascertain whether the payment was made for the purposes of the taxpayer's trade it is necessary to discover his object in making the payment. Save in obvious cases, which speak for themselves, this involves an inquiry into the taxpayer's subjective intentions at the time of the payment."*

65. The question, therefore, is whether the Appellants' subjective intention was to incur this expense wholly and exclusively for the purpose of the profession but, that subjective intention must be ascertained by reference to the objective evidence available.

66. The Court went on to hold that:

"The object of the taxpayer in making the payment must be distinguished from the effect of the payment…."

67. In this regard the evidence must be considered bearing the following in mind:

(j) The very essence of a partnership is that the partners are in business in common with a view to a profit. Not only is it not surprising that the Appellants would have a purpose of driving profit forward but that purpose is a quintessential business purpose. That purpose is, like the purpose of warmth and decency brought by the dress in *Mallalieu v Drummond*, inherent in every partnership expenditure. If partnerships were to be denied deduction of expenses because the partners hoped that the expenditure would increase their profits, then no partnership would ever be able to deduct any expenses.

(k) It is of fundamental importance that the purpose of the expenditure is carefully distinguished from the effect of that expenditure. First, the evidence was clear that the purpose was to provide headroom for the promotion of further partners who would drive the business forward. The hoped-for effect of doing so would be to increase the profits of ABC and therefore of the partners but this was an effect and not a purpose. Secondly, as Mr XX explained there is a clear business purpose in maintaining a high level of income for partners, namely the ability to attract and retain talent within the business. There was unchallenged evidence that if the earnings of the partners were to fall below the market rate applicable in other similar service firms, ABC would lose partners to other firms and would not be able to attract and retain the best partners and staff.

Conclusion

68. The Appellants readily accepted that the partners who retired early under VPR were happy to do so as otherwise they would not have accepted the offer as the scheme was entirely voluntary. But the clear evidence of Mr ZZ and Mr XX was that the purpose of the scheme was not to make the retiring partners happy but to make the partnership more profitable. Critically, however, this desire for profitability was not an end in itself but was the means by which ABC could drive its business forward by retaining and attracting partner talent. The uncontested evidence was that ABC needs to offer sufficient financial award to new partners in order to make partnership in ABC an attractive proposition and that a dilution of the profits available to any individual partner would have a detrimental effect on their ability to retain partners.

69. At its very simplest, the VPR scheme allowed ABC to entice one high earning partner to retire early so that it could free up an element of the profit-share in order to bring two young and enthusiastic individuals through to partnership in order to drive the business forward. The Appellant submitted that this was a quintessentially business expenditure and the evidence was clear that this approach was amongst one of the factors which led to the significant success and growth of the business.

Respondent's Submission

70. The issue of dispute between the parties is whether the payments to retired partners under the VPR scheme are deductible as a normal trading expense in arriving at Case II profits. It is not in dispute that the VPR payments are annual payments of an income nature. This accords with the principles for resolving the revenue v capital dichotomy.

71. The VPR agreement was negotiated at the time when the VPR recipient was a partner and therefore not wholly and exclusively for the purpose of the trade. As such, the VPR was not a trade expense because the justification for the payment was based on the partner relationship between the continuing partners and the retiring partner. Therefore, the partners who continue in practice have agreed to make payments to the retired partners from a profit pot.

72. As a consequence, there was an allocation or appropriation out of remaining partner's profit pot, an amount which was clearly profit. So, in effect, the existing partners agreed that their profit pot would be charged with the legal obligation to pay to the retired partner.

73. TCA, section 1088 clearly states that "*no deductions shall be made other than those expressly provided for by the Income Tax Acts*" and "*the tax under Cases I and II of Schedule D shall be charged without any deduction other than is allowed by the Tax Acts*" pursuant to TCA, section 81(1). TCA, section 81(2)(l) denies a trading deduction for annual payments payable out of the profits or gains and section 81(2)(a) denies a trading deduction for "*any disbursements or expenses not being money wholly and exclusively laid out or expended for the purposes of the trade or profession*". Therefore, the VPR payments were payable out of the partnership profits and that they are not wholly and exclusively incurred for the benefit of the Appellants' profession.

74. The assertion that the taxation treatment follows the accounting treatment is misplaced. The accounting treatment has not changed in light of the Appellants' change in tax treatment from a charge to an expense. The accounting treatment will remain the same whether it is an expense or a charge. The VPR payment was recorded as a non-operating overhead in the accounts of the Appellants, which is an unexpected categorisation for what is asserted to be an ordinary trading expense. Further, that the tax treatment follows the accounting treatment applies in corporation tax legislation only TCA, section 76A and this matter, arose in an income tax context of partners.

75. The accounting evidence is that partnership accounts are not prepared in the same way as company accounts, nor is there the same regulation for partnership accounting by statute or convention or otherwise. Even if an expense was properly taken in accordance with ordinary commercial accounting principles, it was not definitive for the purposes of

taxation if a deduction in the accounts failed a statutory test. It was submitted that the accounting treatment taken was not material to the question in issue.

76. It was uncontroversial that as a matter of first principles, payments to a partner *qua* partner are not deductible in arriving at the profits of a firm's trade. By way of comparison, an expense that may be readily deductible for a corporate entity, such as salaries, may not be so deductible for a partnership as in the case of a partnership making payments to its partners. This is because a partner taking income from a practice is always treated as receiving an allocation of profit. The Appellant relied on the decision of the English Court of Appeal in *R.W. Noble Ltd v Mitchell* (1927) 11 TC 372 which concerned a deferred instalment payment made by a company to secure the early retirement of a director of a company. The Court of Appeal held that the expenditure was revenue expenditure and was wholly and exclusively laid out or expended for the purposes of the trade. The deductibility principles that apply to payments by a company to a director do not apply to a partnership as the Appellant asserted in reference to the *R.W. Noble* case notwithstanding the revenue nature of the payment.

77. The House of Lords *in MacKinlay v Arthur Young McClelland Moores & Co* [1989] STC 898 held that removal expenses of partners who had been required by the firm to move to different branches were not deductible in computing partnership profits. In so doing, it correctly distinguished *Heastie v Veitch & Co* wherein it was held that a payment of rent by a partnership to a single partner who owned the property was deductible from the profits of the partnership and also gave as an example of sums received by a partner for goods supplied from an independent trade carried on by a partner noting that neither are to be regarded as non-deductible simply because they are received by a person who is also a partner in the firm. The *Heastie* case was distinguishable because in *MacKinlay* "[t]*he fact that they were partners and were going to continue to act as such was indeed the very justification for the receipt*" (at p.903).

78. The resolution of the matter lay, according to Oliver LJ,

> *"not in the words "wholly and exclusively" but in ascertaining whether a particular expenditure is, as a matter of fact, laid out 'for' and only for the purposes of the trade or profession" (at p.900).*

79. He emphasised that an employer is in a very different position to a partner commenting (at p.905):

> *"A partner, on the other hand, whether he be senior or junior is in a quite different position. What he receives out of the partnership funds falls to be brought into account in ascertaining his share of the profits of the firm except in so far as he can demonstrate that it represents a payment to him in reimbursement of sums expended by him on partnership purposes in the carrying on of the partnership business or practice—the*

example was given in the course of argument of the partner travelling to and staying in Edinburgh on the business of the firm—or a payment entirely collateral made to him otherwise than in his capacity as a partner (as in Heastie).

It may be that in relation to a particular receipt by a partner of partnership moneys not falling under either of the above heads, his co-partners are agreeable to his retaining it without bringing it into account so that to that extent the divisible profits at the end of the year are notionally reduced by the amount retained; but this cannot alter the fact that what is retained is part of the profits which would otherwise be divisible. What is taxable is the actual not the notional profit and what has to be demonstrated if a deduction is to be allowed for tax purposes in respect of moneys paid to a partner is that it was paid exclusively for the purposes of the partnership business."

80. He concluded, having analysed the relevant case-law, as follows (at p.905):

"It is inescapable as it seems to me, that the expenditure, motivated no doubt by the fact of moving house, which in turn was motivated by the desire to put the partner concerned in a better position to further the interests of the firm, was an expenditure serving and necessarily and inherently intended to further the interests of the firm, was an expenditure serving and necessarily and inherently intended to serve the personal interests of the partner in establishing his private residence for himself and his family and it cannot be said to be exclusively for the purposes of the partnership practice."

81. The distinction drawn between sums paid to a partner *qua* partner and those paid in a different capacity is again discussed by Maguire Irish Income Tax 2019, Bloomsbury Professional (2019) at para 4.504 drawing the following distinction:

"A partner may rent or hire to the partnership for a separate consideration asset which he owns personally. In this case, the rent or hire charge will be deductible as a trading expense in arriving at the firm's taxable profits if it meets the 'wholly and exclusively' test discussed in 5.310 (Heastie v Veitch & Co 18 TC 305): see 5.306 Appropriations and application of profits. On the other hand, a partner may contribute a personally owned asset for use in the partnership trade as part of his total capital contribution to the firm. If there is nothing in the partnership arrangements giving that partner a specific rent or other consideration for the use of the asset, then the contributing partner's reward is simply reflected in his share of the firm's profits."

82. On the authority of *MacKinlay*, payments made for the personal benefit of a partner are treated as appropriations of profit. Maguire at para 5.306 gives examples of appropriations of profits and highlights the capacity in which the sums are received by a partner:

"Appropriations are payment made out of profits, but after the profits have been earned or ascertained. Self-evident examples are a sole trader's drawings, salary and interest on capital paid to a partner, and dividends paid by a company. Payments made for the personal benefit of a partner are treated as appropriations in the usual way (see MacKinlay v Arthur Young discussed above), but payments to the partner in return for services rendered, or goods supplied by him (other than as a partner) are deductible. Thus, in Heastie v Veitch & Co 18 TC 305, the cost of rental payments under a lease granted by an individual to a partnership of which he was a member was held to be allowable."

83. Payments to departing equity partners are likewise not normally eligible for a deduction in calculating ABC's tax adjusted profit as they are still likely to be considered an appropriation of partnership profits. This is illustrated in *Morgan and Self v HMRC* . This case is cited in Ray Partnership Taxation, LNUK, Chapter 3 at para 3.23A, concluding *"[t]he case showed therefore the difficulties faced by a firm trying to deduct any payments made to its partners or former partners when computing the profits of its trade*."

84. The material facts *in Morgan & Self* TC00046 are remarkably similar to those in the within appeal where the First Tier Tribunal concluded that certain additional payments made by a firm of chartered accountants to two departing partners were correctly treated as profit shares and thus not deductible payments for the firm, despite the individuals' argument that the payments were made to them otherwise than in their capacity as partners. The case noted that it was not necessary for profit shares to be made in return for performance (as payments to employees might need to be); it is possible for a partner to receive payments of profit share for something other than performance in a way which is not possible for employees.

85. The Tribunal held (paras. 60 and 61):

"I conclude that the provisions of the constitutional documents, considered in the light of the facts surrounding the retirement of both Mr Morgan and Mrs Self, point very strongly to the conclusion that in fact the further payments were made out of profits.

In the light of that conclusion I return to the legal principles and ask whether the further payments made to the Appellants were received by them in their capacity as partners in the firm or whether they were entirely collateral payments made to the Appellants otherwise than in their capacity as partners. The fact that the further payments were made and received within the context of the partnership agreement, the Rules and the Regulations, which provided that such payments were only made to partners, indicates that the payments were received by the Appellants in their capacity as partners. The fact that they were partners at the time the payments were agreed, and the fact that the payments were offered within the context of their retirement as partners, was the *very justification for the receipt of the payments. It is not relevant that the further payments were received after the dates of withdrawal; the shares of profits calculated under the points basis were received at the same time but it was not suggested that those payments were not profits."*

86. The Tribunal also stated (at para 52):

"From these authorities I derive the principles that, in deciding whether payments made by a partnership to an individual partner are profits of the firm, or expenditure which should be deducted from the profits, it is necessary to decide whether the payments were received by the individual partner in his capacity as a partner in the firm and whether that was "the very justification for the receipt". What an individual partner receives out of the partnership funds is part of his share of the profits unless he can demonstrate that it represents a payment to him in reimbursement of sums expended by him on partnership purposes or an entirely collateral payment made to him otherwise that in his capacity as a partner. Finally, in considering the contractual documents it is necessary to bear in mind that the meaning of words does not always depend upon the words used."

87. It was concluded (at para 64) that:

"…the further payments were made to the Appellants in their capacity as partners and were not entirely collateral payments made to them otherwise than in their capacity as partners. That means that the further payments were payments of profits and so chargeable to income tax under section 18 of the 1998 Act ; they were not amounts which should have been deducted by the firm in computing its profits under section 74. That means that the appeal is dismissed."

88. As such *MacKinlay* and *Morgan and Self* establish that if you receive a payment as a partner or coming from a partnership relationship, or as it was put in *Morgan and Self*, the fact of being a partner is the justification for the receipt, then it was not a deductible trading expense of the partnership. It was submitted that the justification for the receipt in this case was the partner, when a partner, agrees to retire from the partnership before he was due to do so under the partnership agreement and this was a partnership matter. The justification for his receiving payments was the fact of his partnership relationship and how he agreed it will be terminated.

89. The corollary is that if a payment was received in a wholly different capacity or pursuant to a '*wholly collateral bargain*' as it was put in *MacKinlay* then it may be a deductible expense in computing partnership profits. The concept of '*wholly collateral bargain*' must of necessity mean that the payment was wholly collateral to the partnership which in the case of *MacKinlay* was that of a partner in his capacity as landlord rather than partner. It was not in dispute between the parties that the entitlement to the payment

flows from the VPR agreement which varies or alters the partnership agreement and as such it was not made pursuant to a '*wholly collateral bargain'*.

90. In the *Gresham* case, on which the Appellants relied as a binding authority, the Court used specific examples to contrast against the deductible annuities paid by the life assurance business. The fact that *Gresham* was involved in the buying and selling of annuities was the reason for the decision to grant a trading deduction for the annuity payment. The specific examples of non-deductible annuities included that of annuities paid by a partnership to the widow of a deceased partner which were said to be "*truly payable out of profits earned and therefore ought not to be deducted in estimating the income yielded by the business*" (at p.320).

91. The Appellants argued that the retired partners should be treated as third parties. It was submitted that the widow of a deceased partner was more removed from the partnership or was more of a third party than a retired partner; but even an annuity to that individual was not seen as deductible. Lord Herschell further stated that the UK equivalent of TCA, section 81(2)(l) TCA "*was primarily designed to meet such a case as that in which a trader had contracted to make an annual payment out of his profits; as for example when he had agreed to make such a payment to a former partner*" (at p.325). These examples could not be clearer, and fully support the Respondent's case.

92. It was clear from the evidence that the payments under the VPR scheme deal with the partners *inter-se* as stakeholders in the partnership. Specifically, the payments were made to deal with the division of the profit pool so that changes to the partnership did not cause a dilution of profit for the continuing partners and to ensure that the retiring partner was suitably financially rewarded and/or that the retiring partner was facilitated in an early exit from ABC to facilitate his lifestyle choices. These are personal motives of the partners, not for the purpose of the trade.

93. The competing interests of the continuing partners and the retiring partner under the VPR scheme was repeatedly described in evidence as a "*balancing act*" between those partners as stakeholders in the partnership. It was described in evidence as forming part of the life cycle of the partners in ABC and formed part of the reward structure of the partnership recognising that the retiring partner created profits and built up the practice, had certain entitlements other than to goodwill and that the retiring partner in agreeing to retire early under the VPR scheme was leaving profits behind.

94. The retiring partners would typically have been entitled to share in a larger proportion of the profits due to their seniority. It was not in dispute that they could have appointed another partner or partners but the effect of that would be to dilute the profit share of the continuing partners. It was clear from the evidence that the position of the retiring partner was central to the scheme.

95. It was not in dispute between the parties that the decision by ABC to make the payments was taken under the VPR scheme and the contract under which the payments were made, namely the VPR agreement, was negotiated and made at a time when the retiring partner was still a partner in ABC. The payments flowed from a partner's rights under the partnership agreement. The partnership agreement sets the retirement age that applies to a partner. The partner agreed with the other partners to vary the partnership agreement as it applied to him by changing the date of his retirement which would otherwise apply under the partnership agreement. As part of that agreement, he agreed to retire in consideration for payment that he would receive over a period of time after he retired, with the payment computed by reference to a multiple of his historical profit share as partner.

96. The fact that the payments were made after the partner retired and as a consequence of retiring did not change the fact that the payments were *qua* partner. The retiring partner signed up to a known amount in the form of a "*total profit percentage*" to be paid over a period of between three and five years. In some cases, such as in Mr ZZ's case, some of the payments were subsequently rescheduled by ABC so that they were paid over a longer period than originally agreed. It was submitted that the VPR Agreement made clear that the payment under the scheme was *qua* partner or connected with the partner's partnership rights or the reason for the payment and this was consonant with the evidence of the retiring partner. It did not follow that as the retiring partner was no longer a partner in consequent on that agreement that the payments were not made *qua* partner. It was still paid because of the partnership arrangement and because the recipient was a former partner. It could not be said to be something a third party would or could ever receive, or was a payment of a wholly collateral bargain to the partnership agreement, or that any matter other than the fact of being a partner willing to retire under the VPR scheme was justification for the receipt.

97. The case of *Strong v Woodifield* 5 TC 215 was relied on by both sides. It is authority for the proposition that the '*wholly and exclusively'* test is not satisfied where there is duality of purpose to the expenditure wherein Lord Davey at p. 219 expressed the relevant principles in terms that have been repeatedly adopted by the courts:

> "*I think that the payment of these damages [to a customer of an inn owned by the brewery company who was injured by the fall of a chimney] was not money expended "for the purpose of the trade." These words are used in other rules, and appear to me to mean for the purpose of enabling a person to carry on and earn profits in the trade, etc. I think the disbursements permitted are such as are made for that purpose. 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 profits*".

98. It was clear from the evidence that the purpose of the payments made under the VPR scheme was to deal with the partners *inter-se* as stakeholders in the partnership and specifically to deal with the division of the profit pool so that changes to the partnership do not cause a dilution of profit for the continuing partners. Further purposes of the payments were to ensure the retiring partner was suitably financially rewarded and/or that the retiring partner was facilitated in an early exit from ABC to facilitate his lifestyle choices. This was distinct from the trade of business advisory that was carried on by ABC and the purpose of the expenditure was not for the purpose of actually earning the receipts from the business advisory trade. It related to the partners and not to the business carried on by the partnership. The payments made under the VPR were made out of profits to the partners who agreed to retire early. It was not disputed that there may be advantageous consequences to the VPR scheme in terms of the trade of business advisory but this was not sufficient to satisfy the "*wholly and exclusively*" test. At best there was a duality of purpose and if there was a duality the payment was not deductible in computing trading profits.

99. The Appellant sought to defuse the effect of the evidence given by its own witnesses by suggesting that any purposes identified in the evidence should be considered to be sub-sets of a single purpose of a partnership: namely the making of profit. Anything else was said to be a consequence or effect and not a "*purpose*" properly so-called. The evidence did not support this analysis and was not confined to statements of intention or a description of consequences. It squarely identified purposes which, as noted above, take the VPR payments outside the parameters of the "*wholly and exclusively*" test. This could not be gainsaid by drawing the purpose of a partnership so widely that every other purpose was subsumed into it.

100. The evidence provided the *indicia* of the payment *qua* partner. Further, the evidence demonstrated the VPR payments are annual payments payable out of profits and therefore are not deductible by virtue of TCA sections 81(2)(l) or 1088(1)(b). It was accepted in evidence that the rationale and analysis of the VPR scheme was as set out in the draft scheme documentation notwithstanding that there were changes to the mechanics of the scheme in its final form.

101. Reliance was placed on the following points arising in evidence and summarised in the following extracts of the documents:

'Discussion Document' dated 2nd December 2002:

(a) The VPR scheme documentation demonstrated that the VPR scheme formed part of the partner reward system in the life cycle of the partner in ABC:

(b) ABC opted not to operate a goodwill system and the VPR scheme should reward partners for profits left behind:

(c) The VPR scheme was a balancing act between the competing interests of the continuing and the retiring partners:

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(d) The VPR was described in the scheme documents as only being of benefit if the Appellant's profit continued to at least hold up or increase. The continuing partners undertook the risk of generating enough profit to pay themselves, the retired partners and normal practice capital obligations.

(e) The managing partner with the approval of the partners had the power to defer an application for VPR depending on *inter alia* practice profitability. Specifically, the decision was based on current year profits, and it must of necessity follow that the profit must be known prior to that decision, as well as the expectation of future profits.

Scheme Document dated 16th April 2003

(f) The VPR scheme intended to facilitate lifestyle decisions as part of managing age profile:

(g) The focus was on the stakeholders i.e. the partners:

102. The evidence of Mr ZZ, a retired partner and creator of the VPR scheme was consonant with the scheme documents.

(a) He describes the VPR scheme in the following terms:

"We had to create a scheme which left the pool interesting for the existing partners and the new partners and a reward, I know that is a word I use a lot, but a payment for partners that we would like to take VPR because of their age to make room for the new guys on the expansion of the practice and for that payment they give up their legal right and entitlement to their share of profit for three or five years depending when they opted for VPR.

(b) It was not in dispute between the parties that ABC could appoint more partners and Mr ZZ explains the difficulty was the diluting effect on profits for the partners:

"Apart from the fact it wouldn't make any commercial or financial sense I personally, we never tried it but I could never see the existing partners voting for that because they were going to diminish their income and the people coming in, their expectation was unfulfilled because the income and the quality of the income, would you do it again the next time, if I were so facetious years

later. It didn't form a solution, it formed a short term keep the profit but it didn't do anything else."

(c) The benefit of the VPR scheme was its effect on profits available for the continuing partners:

"In two ways …. the quality of our profits have not decreased, in fact they have increased slightly if we just even stagnate from the previous three years. We now have room to get better guys up the ladder or units and at capacity without denigrating to any great degree the profit of the existing partners, bring in new partners who can replace the people who have taken VPR because we have quality profit which is now available."

(d) The VPR scheme was a trade-off between different elements and different interests in ABC but that all had core interests in profit.

(e) The focus on profits was clear in Mr ZZ's evidence and for example he refers to "*pot*" in the context of profits, "*average profit left behind*", "*quality profit which is now available*" and "*apparatus is circular*"

(f) The retiring partners are paid for "*average profit left behind*" and "*quality profit which is now available*" in the profit "*pot*" and so it was a "*win-win*" once profits were increasing so that there was more left in the "*profit pool*". The VPR payment was then made out of this "*profit pool*"

"*The practice was probably making …..70:30 against the retiring partner on the worst days" and explained "That there was €70 left in the profit pool of the partnership and €30 went out to reward the retiring partner for giving up his profit, legal profit share right. That is actually what it means. It was working because of the increasing profits."*

(g) It was accepted by Mr ZZ that a retiring partner was entitled to profit up to retirement and that entitlement comes from the partnership agreement which he referred to as the partner's "*accession agreement with the practice*". He continued "*…you buy out my legal profit share entitlement and what would you give me for it. That was VPR*."

(h) Mr ZZ accepted that the payments were made *qua* partner and that the VPR was effectively splitting the profit between the retiring partner and the continuing partners.

(i) The VPR scheme got the balance right and allowed retiring partners "*to access VPR as the next part of [the retiring partner's] lifestyle*".

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(j) The VPR was very attractive for the retiring partner:

(k) It was important that the retiring partners were incentivised to take up the scheme that it was "*attractive enough to the guy to come to the counter and ask*".

(l) The evidence of Mr ZZ was that the VPR payments were payable out of profits. In addition to the extracts from evidence above, Mr ZZ in giving evidence on the cost projections prepared by him for the VPR scheme, by reference to the appendices to his memo dated 15 April 2003, stated as follows:

> *"So every year you will have a charge really against your profits of these figures annually and continued by explaining that the continuing partners needed to generate enough profit to cover the VPR liability. In his words "you better beat this in terms of your profit projections"*

(m) In reference to 'phantom unit allocation', he acknowledged that the VPR payments as an allocation of the profit to a partner:

> *"When I wrote the partner reward system in 2001 I provided a clause in it which said that 10% of the profit before any allocation to any partner other than VPR because we had a legal obligation to that, came into my domain and I could allocate it for abnormal performance among any partner."*

(n) The VPR formula was driven by historical profits. It was described as having been designed for the greater good of the partners both continuing and retiring in the scheme documentation. Mr ZZ's evidence was consistent in terms of it being "*a win-win…that as long as the profits were increasing there were no losers in VPR*"

(o) The evidence was that the scheme was designed to allow suspension of the payments depending on the economic conditions or specifically "*practice profitability*" and that the payments could be and in fact were rescheduled over a longer period of time. Mr ZZ said the VPR formula was pitched to the partners in the following terms:

> *"… where we can make it really attractive as far as is conceivably possible for the partner who is going to come and seek VPR and at the same time not leave the practice at a loss and hope our profits expand and we will be at a profit. That is how we actually pitched it."*

(p) The evidence was that the Appellants considered a policy of provisioning or creating a profit reserve for the advance funding of future VPR payments. Mr ZZ explained in his direct evidence that this policy was not adopted. It was submitted the payment of VPR was dependent on practice profitability and on generating new profits out of which the VPR payments could be made.

103. The evidence of the current partner, Mr XX, accorded with that of the retired partner. Mr XX confirmed that it was possible to appoint new partners but that dilution of earnings was the reason that ABC did not.

104. The payments under the VPR scheme was "*a delicate balancing act*" thus clearly acknowledging that the VPR scheme was to deal with both the continuing partners and the retiring partners' interests.

Conclusion

105. The VPR payment was made pursuant to a written legal agreement between ABC and ZZ dated 1st June 200x. The VPR scheme was an alteration or amendment to the partnership agreement and expressly so provides "*these provisions are incorporated into a new partnership agreement*" but even absent this clause it was self-evidently so. The recitals and terms of the VPR agreement demonstrated that it was negotiated and agreed while the retiring partner was still a partner and, in that capacity, and provide for the retirement of the partner notwithstanding the provisions of the partnership agreement (Clause 1).

106. The terms acknowledge that the retiring partner may still be affected by future events and makes provision for future sales and recognises the role of the retiring partner in building up the business and also allows the retiring partner to avail of any improved VPR terms in the future (Clauses 2.4 and 2.5). The Agreement refers to the payment of the retiring partner's average profit by his monthly instalment percentage (Clause 3.1). The retiring partner was paid his total profit percentage of up to 260% of his average historic profits. (at Clause 3.4).

107. Even if the payments are found to meet the wholly and exclusively test in TCA, section 81(2)(a) (which is denied, see duality above); it cannot automatically follow that TCA, section 81(2)(l) TCA is satisfied as the Appellant asserted. It cannot be so as such a reading would render TCA, section 81(2)(l) redundant. The structure of the legislation is clear and it was not in dispute between the parties that TCA, sections 81(2)(a) and 81(2)(l) are stand-alone and not sequential so for example, the question could be posed by reference to TCA, section 81(2)(l) before proceeding to TCA, section 81(2)(a). TCA, section 1088(1)(b) also expressly denies a deduction for certain annual payments payable out of profits without any reference to a "*wholly and exclusively*" purpose test for deductibility. It is illogical that a test on the purpose of incurring an expense could determine whether that expense is an annual payment and if it is payable out of profits.

108. In the taxation of partnerships, TCA, section 1008 provides for the proportional split of annual payments between the individual partners which was predicated on the basis that those annual payments are payable out of profits and are not deductible expenses in arriving at profits.

109. This interpretation is consonant with the scheme of the legislation where there are examples of charges that while wholly and exclusively incurred for the purposes of the trade are not deductible. For example, certain wholly and exclusively incurred payments treated as trade charges are not automatically deductible in computing trading profits for corporation tax purposes such as TCA, section 243A. Another example is the express provision to allow loss relief for payments assessed under TCA, section 238 incurred wholly and exclusively for trading purposes (TCA, section 390) which would not otherwise be required on the Appellant's view of the legislation.

110. TCA, section 81(2)(l) denies a trading deduction for annual payments "*payable out of the profits or gains*". It is not circumscribed in the manner suggested by the Appellant namely, annual payments payable out of the profits or gains to be charged to tax. The latter language is used in TCA, sections 237 and 238 in the context of withholding tax from annual payments. It was not in dispute between the parties that the collection mechanism does not drive the question of deductibility for tax purposes. This was clear because the collection mechanism is an event that happens after the amount of profits charged to tax has been computed. The mechanism adopted by the Appellant itself could not be relevant to the determination of the issue in any event. The collection mechanism for withholding tax on annual payments was not relevant to the matter in issue, being the deductibility or not of a payment in computing profits to be charged to tax.

Analysis

111. The primary issue in this appeal is to determine whether the VPR payments made by the Appellants to retired partners were deductible expenses for the purposes of calculating profits assessable to income tax or whether such payments were charges deductible in computing total income.

112. The significance of the distinction argued by the parties is that if the VPR payments were considered to be made out of profits or gains brought into charge to tax, an exposure to PRSI, USC and levies would arise for the continuing partners. However, if such payments were expenses incurred '*wholly and exclusively'* for the purposes of the trade, assessable taxable income on the continuing partners would reduce for the purposes of calculating PRSI, USC and levies.

113. However, and notwithstanding the purported inequity identified by the Appellants that the failure of the Respondent to allow a deduction for the VPR payments for the purposes of calculating PRSI, USC and levies imposes a liability on such payments on both the Appellants and the VPR recipients with reference to the same income, the jurisdiction of the Tax Appeals Commission does not extend to a consideration of equity.

Findings of Fact

114. The following are material findings of fact:

(a) Following the completion of a number of amalgamations and mergers of the various firms in 1993 to become ABC, Mr ZZ became concerned with the over preponderance of older partners, the surplus capacity at partner level, the overlapping specialisms, the lack of opportunities for the younger talent to progress to partnership level and the inevitable loss of competitiveness, all of which would jeopardise the retention of the 'ABC' international franchise. Therefore, to ensure that ABC was creating the necessary opportunities for talented people progressing through the firm, Mr ZZ and his colleagues devised an early retirement opportunity for older partners which he described as the VPR scheme. As explained by Mr ZZ, the concept of the VPR scheme was "*the answer to the thing that is going to crucify us and choke us like a viper*."

(b) However, the VPR scheme had to be carefully implemented as ABC required a certain number of partners in each of the disciplines of the practice not only to ensure that the firm was properly covered but also to develop people progressing through the firm. If the standard deteriorated or where there was an inadequate number of partners to deal with the expanding business, ABC's professional insurance would also be called into question.

(c) Therefore, to ensure that ABC was only creating opportunities which were necessary for the right people coming through the ranks, certain older partners were encouraged to retire early. This process ensured that there was a smooth transition whereby industry knowledge was shared and personal contact with clients maintained.

(d) By implementing the VPR scheme, potential VPR candidates were offered a financial incentive to give up the legal right to retire at 65 or indeed 62 where appropriate and the associated entitlement to the share of profits. The VPR calculation was based on a formula calculated with reference to historic profits.

(e) The objectives, rationale and operation of the scheme were driven solely by the interests of the business and not by the needs, requirements or desires of any individual partners. Therefore, while the VPR programme could not be so generous as to jeopardise the wellbeing and fabric of the practice going forward, it had to offer some incentive to the retiring partner to leave ABC.

(f) While the VPR arrangement was beneficial to the retiring partners, the practice benefited to a more substantial degree.

(g) The evidence of Mr XX was that the retirement of a VPR partner freed up capacity to bring through one or more partners. Effectively two younger partners had more energy and were eager to get out in the marketplace and grow their portfolios than an older incumbent partner. As the younger partners were getting a smaller share of the profits, there was an incentive for them to drive the profits forward. Furthermore, the appointment of younger partners who were more active in the market had the effect of generating additional revenues due to increased activity.

(h) The VPR scheme also enabled ABC to appoint specialists in areas where it did not previously have a business or offer a service and consequently that contributed to the growth through expansion of their services.

(i) Mr XX also confirmed that there would have been a significant dilution of earnings if the partners were appointed in the absence of a commercial basis and therefore talented people would leave to join competitor firms.

(j) The VPR payments were calculated with reference to figures for past performance and therefore did not constitute a further share of past profits of the partnership nor a share of the partnership profits after the VPR individual had retired from the partnership. The VPR recipients had no entitlement to any partnership profits after retirement. Therefore, when an individual partner retired, that partner ceased to conduct the partnership business and as a result no longer contributed to the profits of the partnership. Moreover, that individual ceased to be entitled to a share in the partnership profits.

Wholly & Exclusively Test

115. TCA, section 81(2) sets out the '*wholly and exclusively'* test whereby a tax deduction is not allowed if a disbursement or expense is not wholly and exclusively incurred for the purpose of the trade or profession and provides, *inter alia*:

"Subject to the Tax Acts, in computing the amount of the profits or gains to be charged to tax under Case I or II of Schedule D, no sum shall be deducted in respect of:

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

(b) …"

116. While the test is expressed in the negative, with positive inversion, a deduction is permitted in respect of any disbursement or expense that is wholly and exclusively laid out or expended for the purposes of the trade or profession.

117. Furthermore, both parties relied on *Strong v Woodifield* 5 TC 215 where at p.219 Lord Davey determined that the meaning of "*for the purpose of the trade*" meant:

"for the purpose of enabling a person to carry on and earn profits in the trade, etc. I think the disbursements permitted are such as are made for that purpose. 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 profits".

118. As discerned from the parties' submissions, the interpretation and application of the phrase '*wholly and exclusively laid out or expended for the purposes of the trade or profession*' is not without its difficulties. In resolving such difficulties, significant reliance can be placed on the decision of Budd J. in *MacAonghusa v Ringmahon* VI ITR 327, a case in which the both High Court and the Supreme Court considered the issue of tax deductible trading expenses and the application of the general principles as set out in the English authorities.

119. In *Ringmahon*, the respondent company had taken out a term loan in 1991, which was applied to redeem preference share capital. It sought to deduct the interest payable in respect of the loan as an expense incurred wholly and exclusively for the purposes of its trade. Revenue took the view that the loan was raised for the purpose of a share restructuring, which was capital in nature, rather than for the company's trade and refused to allow the deduction.

120. In deriving assistance from the judgement in *Vodafone Cellular Limited and Ors v Shaw (Inspector of Taxes)* [1997] STC 734 which had considered previous relevant authorities specifically *Mallalieu v Drummond* and *MacKinlay*, Budd J. in the High Court, at page 25, relied on the following passage of Millett LJ in espousing the useful principles in determining whether a payment was made '*wholly and exclusively*' for the purposes of the taxpayer company's trade:

"From these cases the following propositions may be derived.

1. *The words for the purposes of the trade mean to serve the purposes of the trade. They do not mean for the purposes of the taxpayer but for the purposes of the trade, which is a different concept. A fortiori they do not mean for the benefit of the taxpayer.*

2. *To ascertain whether the payment was made for the purposes of the taxpayer's trade it is necessary to discover his object in making the payment. Save in obvious cases which speak for themselves, this involves an inquiry into the taxpayer's subjective intentions at the time of the payment.*

3. *The object of the taxpayer in making the payment must be distinguished from the effect of the payment. A payment may be made exclusively for the purposes of the trade even though it also secures a private benefit. This will be the case if the securing of the private benefit was not the object of the payment but merely a consequential and incidental effect of the payment.*

4. *Although the taxpayer's subjective intentions are determinative, these are not limited to the conscious motives which were in his mind at the time of the payment. Some consequences are so inevitably and inextricably involved in the payment that unless merely incidental they must be taken to be a purpose for which the payment was made.*

To these propositions I would add one more. The question does not involve an inquiry of the taxpayer whether he consciously intended to obtain a trade or personal advantage by the payment. The primary inquiry is to ascertain what was the particular object of the taxpayer in making the payment. Once that is ascertained, its *characterisation as a trade or private purpose is in my opinion a matter for the commissioners, not for the taxpayer. Thus in Mallalieu v Drummond (Inspector of Taxes) the primary question was not whether Miss Mallalieu intended her expenditure on clothes to serve exclusively a professional purpose or partly a professional and partly a private purpose, but whether it was intended not only to enable her to comply with the requirements of the Bar Council when appearing as a barrister in court but also to preserve warmth and decency*."

121. In *Gresham Life Assurances v Styles* (1892) 3 TC 185, which predates 1922 and therefore forms part of law in this State, Lord Halsbury LC in his speech to the House of Lords focused on the precise terms of the statutory antecedent of TCA, section 81(2)(l) when stating at p.315:

"Now to my mind it is very clear what is the intuitus, both from the enactment and from the rules under which the duties are to be ascertained. The thing to be taxed is the amount of profits and gains. The word "profits" I think is to be understood in its natural and proper sense-in a sense which no commercial man would misunderstand. But when once an individual or a company has in that proper sense ascertained what are the profits of his business or his trade, the destination of those profits, or the charge which has been made on those profits by previous agreement or otherwise, is perfectly immaterial. The tax is payable upon the profits realized, and the meaning to my mind is rendered plain by the words "payable out of profits."

122. As such, based on my findings of fact, I am satisfied that the object of the initial phase of the VPR scheme was to encourage the disproportionate number of older partners to retire and to facilitate the appointment of younger partners. By pursing such a policy, the firm could retain and promote talented people by providing a suitable platform to join the partnership, generate business activity and increase profits. The continuation of the VPR scheme not only provided opportunities to appoint younger partners but enabled the firm to headhunt key individuals and to diversify its services.

123. While there is no doubt that that there was a significant financial advantage to the retiring partner in receiving the VPR payments, I am satisfied that the object of the Appellants in making the VPR payment was to drive the business forward by removing the less productive partners and the appointment of a greater number of partners who were not only younger and more dynamic but a had a greater desire to increase the partnership profits and benefit accordingly. The aspiration to increase profits was not an end in itself but the means by which ABC could drive its business forward by retaining and attracting partner talent. I am satisfied that ABC needed to offer sufficient financial reward to new partners in order to make partnership in ABC an attractive proposition and that a dilution of the profits would have had a detrimental effect on their ability to retain partners and as a consequence the business itself.

124. Therefore, the VPR scheme allowed ABC to entice one high earning partner to retire early so that it could free up an element of the profit-share in order to bring two young and enthusiastic individuals through to partnership. This approach was a factor which has led to the significant success and growth of the business.

125. I have also concluded that while the benefit to the retiring partner was merely incidental as the rationale for the payment was to improve efficiencies in the Appellant's practice, remain competitive in a demanding market and retain the lucrative international franchise all of which had the effect of increasing profitability.

126. Therefore, in line with principles espoused in *Ringmahon*, I am satisfied, that the VPR payments were made to serve the purposes of the trade. It is clear from Mr ZZ's evidence that the failure to address the significant commercial impediments, prompted in the main by the over preponderance of older partners and the lack of opportunities for younger talent would have had significant adverse ramifications for the Appellants' business.

127. I derive further fortification in my interpretation and application of the law from the following passage of Budd J in *Ringmahon* at page at p. 20:

> *"To ascertain whether the payment was made for the purposes of the taxpayer's trade it is necessary to discover his object in making the payment. Save in obvious cases, which speak for themselves, this involves an inquiry into the taxpayer's subjective intentions at the time of the payment."*

128. Therefore, based on the submissions and a consideration of the evidence, I have determined that the object of making the VPR payments was to encourage older and indeed less productive partners give up their legal entitlement to the future profits of the firm and to promote younger more dynamic and highly skilled individuals to partnership. While the effect of the VPR payments increased profits, I have found, in line with the principles espoused in *Ringmahon*, that the object of the VPR payments was to serve the purposes of the trade. As such, the VPR payments were made "*wholly and exclusively*" to serve the purpose of the trade and such should be allowed as deductions in the calculation of the Appellants' taxable profits.

129. Furthermore, I agree with the Appellants' submission that the VPR payment was an expense in calculating taxable profit and therefore could not be considered to be an *"annuity or other annual payment …. <u>payable out of the profits or gains</u>"* [Emphasis added]. Therefore, an annuity or payment cannot be "*payable out of the profits or gains*" if it has already been included in the arriving at the firm's taxable profits. The prohibition in TCA, section 81(2)(l) is not against a deduction in respect of annuities or annual payments, *per se*, but only such payments made out of the profits or gains.

Payments Qua Partner

130. There is no dispute between the parties that the VPR agreement was negotiated and made at a time when the retiring partner was still a partner in ABC. However, the Respondent argued that the payments flowed from a partner's rights under the partnership agreement as the retiring partner agreed with the other partners to vary the partnership agreement by changing the date of his retirement which would otherwise apply. Therefore, the purpose of the VPR payments was to deal with the division of the profit pool so that changes to the partnership do not cause a dilution of profit for the continuing partners. As a consequence, the Respondent asserted that there was an allocation or appropriation out of remaining partner's profit pot, whereby the existing partners had agreed that their profit pot would be charged with the legal obligation to pay to the retired partner. As such payments were not trade expenses because the justification for the payments was based on the partner relationship between the continuing partners and the retiring partner and therefore not wholly and exclusively for the purpose of the trade.

131. In support of its position, the Respondent placed significant reliance on joined cases *Morgan and Self* a decision of the UK First Tier Tax Tribunal in which two partners in a large firm of chartered accountants were asked to withdraw from the partnership. In addition to their profit shares, the outgoing partners each received a further payment from the firm. The tribunal concluded on the facts that the further payments were made to the individuals in their capacity as partners and held that they were payments of profits. In dismissing the appeals, the FTT held at paragraph 63:

> *"I agree that the division of the profits of the firm was a matter for the Executive and profits were usually divided by reference to the points basis. However, the constitutional documents also make it clear that additional payments could be made out of profits before the balance of the profits were allocated under the points basis. Although the departure letters of 14 December 2000 and 31 October 2001 did not refer to the further payments as special allocations of profit the whole context within which the payments were made indicate that they were special allocations of profit."*

132. Therefore, unlike in this appeal, in *Mr Morgan and Mrs Self* there was an explicit finding of fact that both individuals received a share of the special allocation of the firm's profits.

133. It is also necessary to consider the divergence in the parties' submissions in the interpretation of the judgment of House of Lords in *MacKinlay* in which it was held that sums contributed by a large professional partnership towards the relocation expenses of individual partners who moved at the firm's request were not deductible in computing the partnership's taxable profits. However and as observed by the Appellants, *MacKinlay* can be distinguished as in that case the House of Lords considered that in deciding whether payments made by a partnership to an individual partner are profits of the firm, or expenditure which should be deducted from the profits, it is necessary to decide

whether the payments were received by the individual partner acting in his capacity as a partner in the firm and the extent to which that position was "*the very justification for the receipt*". However, in this appeal, the VPR payments were made to the recipients to relinquish their positions as partners and therefore could not be received in consideration for acting in a capacity of a partner. In effect the VPR payment was made in consideration for not being a partner.

134. It is also relevant that the VPR recipients did not earn the VPR payments which they received as they had retired from the partnership and were no longer carrying on the partnership business and therefore not entitled to a share in the partnership profits.

135. Both *MacKinlay* and *Morgan and Self* can be distinguished on the basis of my findings that the purpose of the VPR payment was to reduce the over preponderance of older partners and thereby provide opportunities for the younger talent to progress to partnership level, improve competitiveness, enhance the skills and knowledge base, retain the international franchise and reduce the exposure to litigation. Accordingly, such payments were not payable out of the partnership profits and therefore could not be an allocation of profits and therefore not made *qua* partner.

136. Furthermore the Respondent's reliance on such cases to assert there was an allocation or appropriation of profit to the VPR recipients *qua* partner or in their capacity as partner undermines the Respondent's argument as such an allocation would reduce the continuing partner's profits with a corresponding reduction in income liable to PRSI, USC and levies.

Determination

137. I am satisfied that the object of the initial phase of the VPR scheme was to encourage the disproportionate number of older partners to retire and to facilitate the appointment of younger partners. By pursing such a policy, the firm could retain and promote talented people by providing a suitable platform to join the partnership, generate business activity and increase profits. The continuation of the VPR scheme not only provided opportunities to appoint younger, better educated and more dynamic partners but also enabled the firm to headhunt key individuals and to diversify its services. On this basis, I can only conclude that the VPR payments were incurred "*wholly and exclusively*" for the purpose of the Appellants' trade/profession.

138. Based on such findings, the Appellants' assessments should be reduced or indeed refunds made to reflect that the VPR payments were trading expenses incurred wholly and exclusively for the purposes of the Appellants' trade/profession.

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Conor Kennedy
Appeal Commissioner
21st May 2020

The Tax Appeals Commission has been requested by the Respondent to state and sign a case for the opinion of the High Court in respect of this determination, pursuant to the provisions of Chapter 6 of Part 40A of the Taxes Consolidation Act 1997 as amended.