

JUDICIAL AND LEGISLATIVE CONSIDERATIONS IN THE TAXATION OF COMPENSATION RECEIPTS: AN INTERNATIONAL COMPARISON

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In 1995, the Federal Commissioner of Taxation released Taxation Ruling TR 95/35 in an attempt to comprehensively address the appropriate capital gains tax treatment of a receipt of compensation, awarded either by the courts or via a settlement. The ruling was in response to the numerous, somewhat contradictory, court decisions of the early 1990s. Despite the release of TR 95/35, there still appears to be a lack of consensus as to the appropriate treatment of such awards. It has been suggested that the only way a taxpayer can, with any certainty, determine their liability is to obtain a private binding ruling, a far from satisfactory situation. In an attempt to clarify what the capital gains tax consequences of a compensation receipt should be, this article examines the Australian position and explores the comparative jurisprudence of the United Kingdom and Canada to ascertain whether the Australian attitude is consistent with these international jurisdictions. This article concludes that while the jurisdictions, through differing approaches, achieve a similar result, there is still a need to address the uncertainties that remain.

1. INTRODUCTION

The general principle relating to the taxation of a compensation receipt is simple. A compensation receipt takes on the character of

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the item it replaces.¹ If an amount replaces what would have been income it will be assessable as income. Likewise, if an amount replaces capital, the compensation receipt will be assessable under the capital gains tax ("CGT") regime. As such, the process is twofold in addressing the question of the tax consequences, as they relate to a particular receipt. First, the question of whether the receipt is income or capital must be asked, and to this extent, there have been numerous cases dealing with the distinction between income and capital in the context of a compensation receipt. Second, the application of the relevant provisions of the legislation must be considered in order to determine how the receipt is then taxed. Within the context of the second question, the complexities in recent years have tended to centre on the application of the CGT provisions of the income tax legislation.² As such, this article will concentrate primarily on the CGT consequences of a receipt of compensation.

While this article concentrates on CGT consequences, it is recognised that there are significant goods and services tax ("GST") issues which may also arise in relation to compensation received by way of court order or an out of court settlement. While these issues are outside the scope of this article, it should be noted that *GST Ruling* GSTR 2001/14 was released on 20 June 2001, dealing with the GST consequences of such a receipt. This ruling considers the GST consequences resulting from court orders and out of court settlements. It explains how a payment (or act or forbearance) that is made in compliance with a court order or out of court settlement should be treated for the purposes of *A New Tax System (Goods and Services Tax) Act 1999* (Cth).³

In 1995, the Federal Commissioner of Taxation released *Taxation Ruling* TR 95/35 ("TR 95/35"), in an attempt to comprehensively address the appropriate CGT treatment of the receipt of

¹ *C of T (NSW) v Meeks* (1915) 19 CLR 568, 580 (per Griffith CJ) ("Meeks").

² The cases decided were based on the *Income Tax Assessment Act 1936* (Cth) ("ITAA36") (now Pts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (Cth) ("ITAA97")).

³ *GST Ruling* GSTR 2001/14, para 1.

compensation, awarded either by the courts or via a settlement. The ruling was in response to the numerous, somewhat contradictory, court decisions of the early 1990s. Despite this ruling, there still appears to be a lack of consensus as to the appropriate treatment of such awards. It has been suggested that the only way a taxpayer can, with any certainty, determine their liability is to obtain a private binding ruling.⁴ This is a far from satisfactory situation.

Australia is not the only country to be faced with the issue of the appropriate taxation consequences of a compensation receipt. This question has also been considered in the United Kingdom and Canadian jurisdictions.⁵ In an attempt to clarify what should be the tax consequences of a compensation receipt, this article examines the Australian position and explores the comparative jurisprudence of the UK and Canada to ascertain whether the Australian attitude is consistent with these international jurisdictions. This article will examine the Australian position first, followed by a discussion of the principles adopted in the UK and Canada. Finally, it will undertake a reconciliation of the jurisdictions.

2. THE CURRENT AUSTRALIAN POSITION

The early part of the 1990s saw a series of Australian cases dealing with the taxation consequences of compensation receipts.

⁴ Editorial Note, "Compensation Payments: Some CGT Issues" (2001) 35(6) *Taxation in Australia* 289, 291.

⁵ Administratively, both countries have addressed the issue in a similar manner to Australia. On 19 December 1988, the UK Inland Revenue Commission released *Extra-Statutory Concession D33* ("D33") entitled "Capital Gains Tax on Compensation and Damages: *Zim Properties Ltd* – Compensation and Damages" to specifically deal with the circumstances that arose in the 1985 case of *Zim Properties Ltd v Proctor* (1984) 58 TC 371 ("*Zim Properties*"). Revenue Canada's policy, contained in *Interpretation Bulletin IT-365R2* ("IT-365R2") entitled "Damages, Settlements and Similar Receipts", was issued on 8 May 1987. Australia was the last to follow suit, with the Commissioner of Taxation, on 6 December 1995, handing down *Taxation Ruling TR 95/35* entitled "Income Tax: capital gains: treatment of compensation receipts".

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Principally these cases were concerned with the CGT consequences.⁶ Before this issue, the main concern was whether the compensation receipt was of a capital or income nature. As already stated, in determining the taxation consequences of a compensation receipt, a twofold process must be adopted. While the emphasis of this article is on the CGT consequences of such a receipt, it is necessary to consider the distinction between income and capital at the outset. Each issue will be examined in turn.

2.1 Income or Capital

The threshold question of whether the compensation receipt is income or capital is asked in all three jurisdictions being examined. The basic principle is that if the compensation received replaces lost income (for eg, trading receipts) it will be classified as income and taxed as such.⁷ Conversely, if the receipt replaces capital, it is classified as such and will be subject to the CGT regime. The distinction is of concern because the tax payable varies between the two. Further, not all compensation receipts of a capital nature are subject to tax. In essence, the taxation consequences of the classification is that an amount replacing income will be assessable under s 6-5 of the *Income Tax Assessment Act 1997* (Cth) ("ITAA97") while an amount replacing capital may be subject to CGT pursuant to the CGT provisions in Pts 3-1 and 3-3 of the ITAA97. While this basic proposition dates back nearly a hundred years in Australian tax law, it has been recently emphasised in two compensation cases - *Liftronic Pty Ltd v FC of T* ("*Liftronic*")⁸ and *Whitaker v FC of T* ("*Whitaker*").⁹

Liftronic, a case dealing with loss of business profits, demonstrated the difficulty in determining whether compensation

⁶ Although more recently, the applicability of ordinary principles of income tax has arisen in relation to interest received in relation to a compensation receipt. See *Whitaker v FC of T* 96 ATC 4823; (1998) 38 ATR 219.

⁷ *Scott v FC of T* (1966) 117 CLR 514; and *Meeks* (1915) 19 CLR 568.

⁸ 96 ATC 4425, 4440 (per Foster J).

⁹ ATC 4823; (1998) 38 ATR 219.

was for loss of profits, or loss of goodwill or reputation. In this case, consistent with UK decisions¹⁰ considered later in this article, emphasis was placed on whether capital assets were permanently incapacitated. Similarly, in other types of actions, emphasis will be placed on the nature of the compensation in the hands of the recipient. For example, where a contract entered into in the ordinary course of business is breached, any compensation awarded will be regarded as income and taxed accordingly.¹¹ Conversely, where the breach of contract affects the capital structure of a taxpayer's assets any compensation received will be regarded as consideration on disposal of part of the entire asset.¹²

The distinction between income and capital compensation receipts was also raised in the Full Federal Court decision of *Whitaker*. In that case, the Commissioner sought to tax both pre-judgment and post-judgment interest on the basis that the amounts were income according to ordinary concepts. The taxpayer had received an award of damages resulting from a medical negligence claim that included the interest. The taxpayer argued that the amounts were capital in nature as the true character of the interest was to be found in the nature of the claim brought. In the alternative, the taxpayer argued that the interest was part of the whole judgment and could not be separated out. The Court held that pre-judgment interest on personal injury damages was not subject to tax but post-judgment interest was taxable.¹³

The Full Federal Court unanimously concluded that pre-judgment interest was a capital receipt and, as such, not taxable as ordinary income. Black CJ held that the pre-judgment interest component

¹⁰ For eg. *The Glenboig Union Fireclay Co v IRC* (1922) 21 TC 427 ("Glenboig"); and *London and Thames Haven Oil Wharves Ltd v Attwooll (Inspector of Taxes)* ("Attwooll") (1966) 43 TC 491.

¹¹ *Short Bros Ltd v IRC* (1927) 12 TC 955; and *Heavy Minerals Pty Ltd v FC of T* (1966) 115 CLR 512.

¹² *Case Y24 91 ATC* 268.

¹³ At first instance, Hill J held that both pre-judgment and post-judgment interest was subject to income tax. The taxpayer appealed.

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took its character from the award of damages and as such was a capital receipt. Lockhart and Burchett JJ both held that the interest was merely one component of the total award. The Full Federal Court agreed with the decision at first instance in relation to the post-judgment interest and unanimously held that this component was taxable as ordinary income. As a response to *Whitaker*, s 51-55(1) of the ITAA97¹⁴ was introduced with the effect that an amount paid by way of interest on a judgment debt, whether payable under a law of the Commonwealth, a State or Territory, or otherwise is exempt from income tax where certain conditions are met.¹⁵

As evidenced, difficulties primarily arise with the distinction between capital and income where a compensation receipt is made up of several components. This is exacerbated where the compensation receipt relates to a settled claim and there is no evidence of how the amount is arrived at. It is unclear in Australia whether a single receipt of a composite nature can be dissected into component parts. The High Court has indicated that in certain circumstances it may be permissible. In *McLaurin v FC of T*,¹⁶ the High Court cited the situation "where the payment or receipt is in settlement of distinct claims of which some at least are liquidated ... or are otherwise ascertainable by calculation"¹⁷ as an example of when the apportionment of a lump sum is permissible. However, the Court continued by saying that if "the payment or receipt is in respect of a claim or claims for unliquidated damages only and is made or accepted under a compromise which treats it as a single,

¹⁴ Section 51-55 was inserted by Act No 58 of 2000.

¹⁵ First, the debt arose from a judgment (the original judgment) given by, or entered in, a court for an award of damages for personal injury. Second, the amount is in respect of the whole or any part of the period beginning at the time of the original judgment or, if the judgment debt is taken to have arisen at an earlier time, at that earlier time and ending when the original judgment is finalised. At first instance, Hill J held that both pre and post-judgment interest was subject to income tax. The taxpayer appealed.

¹⁶ (1961) 104 CLR 381.

¹⁷ *Ibid* 391.

undissected amount of damages",¹⁸ apportionment is not appropriate.

The High Court reached a similar conclusion in *Allsop v FC of T*¹⁹ and, despite criticism, both of these cases were applied in *FC of T v Spedley Securities Ltd.*²⁰

The culmination of these cases was best summarised by Davies J in *FC of T v Northumberland Development Co*²¹ when he said:²²

It is not in dispute that a sum or sums received as compensation for the compulsory acquisition of property can be dissected or apportioned into capital and income elements if there is an appropriate basis for doing so.

The Commissioner is of the view that it will be possible to dissect a lump sum payment using such devices as evidence presented before the court or statements of claim as the appropriate basis.²³

The equivocal nature of current judicial guidance on the dissection of lump sum compensation payments into their income and capital components suggests that private rulings would be required in the majority of cases. To alleviate this administrative burden, it is suggested that the Australian Tax Office ("ATO") issue a taxation ruling clarifying what are the appropriate bases on which to apportion single compensation payments. Based on precedent, it is suggested that a lump sum can be apportioned between its capital and income components if:

- the out of court settlement is accompanied by an express breakdown of the various components of the lump sum according to their nature as either capital or income;

¹⁸ *Ibid.*

¹⁹ (1965) 113 CLR 341.

²⁰ 88 ATC 4126.

²¹ 95 ATC 4483.

²² *Ibid* 4486.

²³ *Taxation Ruling TR 95/35*, paras 188-209.

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- the out of court settlement expressly states that it is in satisfaction of all of the damages claimed thus allowing for the pro-rata apportionment of the lump sum based on the original claim; or
- there is a court order that clarifies the nature of the component parts of the compensation receipt.

By providing these stringent guidelines, not only will it facilitate a clear determination as to the nature of the components of a lump sum payment, it will also encourage parties to an action to clarify exactly what they are receiving compensation for.

2.2 The Taxation of a Receipt of Capital

The taxation of personal injury²⁴ awards has never been in dispute due to the exemption provided in the ITAA97, s 118-37²⁵ and previously in the *Income Tax Assessment Act 1936* (Cth) ("ITAA36"), s 160ZB.²⁶ However, compensation awarded for other types of disputes has been contentious.

In TR 95/35, the Commissioner addressed compensation received for non-personal injury or wrong after a series of contradictory cases. The most well known of the taxation of compensation receipt cases

²⁴ "Personal injury" has been defined in *Taxation Ruling* TR 99/D1 to mean an injury to the person as opposed to an injury to the person's property, character or reputation. This will cover both physical and mental injury. The meaning of "injury" for the purposes of s 118-37, as defined in TR 95/35, may extend this definition.

²⁵ Section 118-37 provides:

A capital gain or capital loss you make from a CGT event relating directly to any of these is disregarded:

- (a) compensation or damages you receive for any wrong or injury you suffer in your occupation;
- (b) compensation or damages you receive for any wrong, injury or illness you or your relative suffers personally.

²⁶ Section 160ZB provides that "a capital gain shall not be taken to have accrued to a taxpayer by reason of the taxpayer having obtained a sum by way of compensation or damages for any wrong or injury suffered by the taxpayer to his or her person or in his or her profession or vocation and no such wrong or injury shall be taken to have resulted in the taxpayer having incurred a capital loss".

being *Provan v HCL Real Estate Ltd*,²⁷ *Tuite v Exelby*,²⁸ *Carborundum Realty v RAIA Archicentre Pty Ltd*,²⁹ *Namol Pty Ltd and Anor v AW Baulderstone Pty Ltd and Ors*,³⁰ *Re Portman Place Building Units Plan No 4313*,³¹ *Rabelais Pty Ltd v Cameron and Ors*,³² and *Turner v TR Nominees Pty Ltd*.³³ These cases illustrate the confusion surrounding the application of the CGT provisions of the ITAA36 to compensation receipts, exacerbated by the fact that the Commissioner was not a party in any of these cases. TR 95/35 is an attempt by the Commissioner to simplify, or at least clarify, the application of the CGT provisions to the award of compensation.³⁴

At the outset, the term "compensation receipt" is comprehensively defined to include any amount (whether money or other property) received by a taxpayer in respect of a right to seek compensation or a cause of action, or any proceeding instituted by the taxpayer in respect of that right or cause of action, whether or not in relation to any underlying asset, arising out of court proceedings, or made up of dissected amounts.³⁵ Clearly, the ruling is intended to apply to compensation awards received by way of a court award or an out of court settlement. The ruling goes on to adopt an approach of outlining a number of different scenarios to determine the CGT implications of such awards, and when each is considered to apply.

TR 95/35 suggests that a compensation receipt will fall within one of three categories. First, the compensation receipt may relate to an underlying asset. Second, the compensation receipt may relate to the disposal of the right to seek compensation. Finally, and least

²⁷ 92 ATC 4644.

²⁸ 93 ATC 4293. See also *Exelby v Tuite* (Unreported, Queensland Court of Appeal, 28 November 1994).

²⁹ 93 ATC 4418.

³⁰ 93 ATC 5101.

³¹ 94 ATC 4346.

³² 95 ATC 4552.

³³ Unreported, Supreme Court of New South Wales (Equity Division), 3 November 1995.

³⁴ The ruling does not consider the application of the ordinary income provisions.

³⁵ TR 95/35, para 3.

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likely, the compensation receipt may arise from the disposal of a notional asset.

The first scenario, the indirect or underlying asset approach, is considered the most appropriate basis of determining the CGT consequences of a compensation receipt.³⁶ Using this approach, not directly adopted by the courts in the decisions referred to earlier, the nature of the compensation receipt and what gave rise to the entitlement to receive it are examined. Where the amount was received in relation to an underlying asset, which may have been acquired, disposed of, damaged, reduced in value or otherwise affected, the compensation receipt is attributed to that asset.

The effect of the underlying asset approach is to treat the compensation receipt as a recoupment of part or the entire cost base of the underlying asset. Examples include cases where excessive consideration has been paid for the asset, or where the asset has been permanently damaged or reduced in value or alternatively as part of the consideration on disposal of the asset. For example, this will apply where the claim for damages has arisen out of the actual disposal of the underlying asset and because insufficient consideration was received for the disposal. In a practical sense this approach, where available, is to be preferred to its alternative, the direct approach where the right of action or right to seek compensation is treated as the relevant asset.

The underlying asset approach seeks to identify the most relevant underlying asset(s) in the particular transaction. TR 95/35, however, states that the taxpayer must be able to show a "direct and substantial link with" the underlying asset and goes further to seemingly limit the types of situations where the Commissioner will accept use of the underlying asset approach. The ruling provides that the taxpayer will not be able to demonstrate the link where the asset has not been disposed of and has not been permanently damaged or permanently reduced in value by the happening or event which generated the

³⁶ Ibid para 70.

amount of compensation.³⁷ Generally, where a taxpayer is unable to demonstrate a direct and substantial link with the underlying asset the court will treat the right to seek compensation as the underlying asset and apply the direct approach.

In situations where there is an underlying asset, and the compensation receipt has arisen in relation to a transaction where that asset has actually been disposed of, the Commissioner considers that the compensation receipt forms part of the consideration on disposal of that asset, and is not related to any other asset such as a right to seek compensation. The consequence of this treatment is that if the underlying asset is exempt from CGT, such as a main residence, or if the underlying asset was acquired prior to 20 September 1985, no capital gain or loss will arise on the disposal. If the asset is subject to the CGT regime, ordinary CGT implications arise on the disposal.³⁸

Alternatively, where the underlying asset has not been disposed of, but rather has sustained permanent damage to or a permanent reduction in its value, the Commissioner considers that the compensation receipt is treated as a recoupment of the cost base of the asset. Again, no amount is treated as being in respect of the disposal of the right to seek compensation. Where there is permanent damage to or a reduction in value of the asset, the total acquisition costs of the asset are reduced by the amount recouped.³⁹ Furthermore, where the compensation receipt exceeds the cost base of the underlying asset, the excess is not subject to CGT.⁴⁰

TR 95/35 focuses on the relevance of determining exactly what part of the cost base of an asset is being recouped in determining the CGT consequences.⁴¹ It is contemplated that situations may arise

³⁷ Ibid para 82.

³⁸ Ibid para 145.

³⁹ Ibid paras 131 and 152.

⁴⁰ Ibid paras 7 and 133.

⁴¹ For example, it is stated in para 135 that if a taxpayer is compensated for the costs of repairing an asset, but chooses not to incur the repair costs, the compensation

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where the most relevant asset or cost base element will not be known until disposal of the underlying asset.

The second scenario addressed by TR 95/35 arises where there is no disposal, permanent damage to or permanent reduction in value of the underlying asset in respect of which the compensation is received. In this situation, the direct approach is applied which considers that the compensation receipt relates to the disposal of the right to seek compensation.³⁸ The Commissioner considers that such a right comes within the definition of "asset". Where the right to seek compensation is the relevant asset, the amount received will form the consideration on disposal of that right.

The specification of an "asset" as the "right to seek compensation" to some extent addresses the confusion encountered by the High Court in *Hepples v FC of T* ("*Hepples*").⁴³ *Hepples* involved a payment of \$40,000 to the taxpayer as consideration for compliance with a two year restrictive covenant by which the taxpayer agreed not to divulge the trade secrets of his former employer. The issue on trial was whether the compensation received was for the "disposal of an asset" within the meaning of ss 160M(6) and 160M(7) of the ITAA36, the asset being the disposal of the respondent's right to engage in certain trading activities. Although a majority of the High Court judges considered the sum should be a capital gain, in accordance with widely accepted legal opinion,⁴⁴ they could not agree as to which of the possible provisions correctly classified the compensation as a capital gain. Therefore, due to the ambiguity of the previous legislative provisions, the compensation was not classified as a capital gain and therefore not included in the

receipt is then attributable in the right to seek compensation.

⁴² Note that the Commissioner rejects a "bundle of rights" approach as being overly legalistic (TR 95/35, para 64). Where there are separate causes of action but all are "related", the right to seek compensation is treated as a single asset. Where separate causes of action are unrelated, separate assets are considered to exist (TR 95/35, para 89).

⁴³ 91 ATC 4808.

⁴⁴ *Higgs v Olivier* [1951] Ch 899.

respondent's assessable income for taxation purposes. Consequently, Pt IIIA underwent considerable amendments to address this ambiguity and the Commissioner, in TR 95/35, specifically includes consideration received for entering into a restrictive covenant as capital.

Although the inclusion of this second scenario in TR 95/35 is partially in response to the equivocal nature of the relevant ITAA36 provisions at the time, its failure to unequivocally include the forfeiting of rights under a restrictive covenant within the "right to seek compensation" asset class is unfortunate. Given the extensive rationalisation in the ruling that a right to seek compensation is an asset for CGT purposes⁴⁵ and the extensive discussion of the *Hepples* decision,⁴⁶ a more complete drafting would have stipulated the inclusion of restrictive covenants within the transactions covered by the second scenario.

Furthermore, there is significantly greater scope to reduce the CGT consequences of compensation receipts for loss or damage suffered, with the ability in certain cases to include in the cost base of the right to seek compensation the "damage" which gave rise to the right in the first place. Expenditure or an outgoing forms part of the cost base of the right to seek compensation if there is a "direct and substantial link" between the outgoing and the right.⁴⁷ The final ruling stops short of stating that the disposal of a right to seek compensation can never result in a capital gain, even where such compensation is only intended to rectify damage or loss suffered.

The third scenario considers that the compensation relates to the disposal of a notional asset. A notional asset is defined as an asset

⁴⁵ TR 95/35, paras 32-65.

⁴⁶ *Ibid* paras 39-47.

⁴⁷ *Ibid* para 103. Paragraph 104 goes on to state that where a taxpayer suffers monetary loss giving rise to the right to seek compensation, that loss is included in the cost base of the right. The same approach is to be applied where the insured party under an insurance policy pays a claimant and then seeks reimbursement from the insurer.

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which is created upon its disposal according to s 160M(7) and for which a capital gain arises on the disposal of the notional asset. TR 95/35 itself recognises that the scope for the notional asset provisions is limited and it is considered that there is limited scope for application of the third scenario. It is difficult to determine a situation where such an approach would apply.

Although TR 95/35 provides three collectively exhaustive scenarios so as to address the CGT consequences of all possible compensation receipts, it is argued that a substantial amount of ambiguity still remains. The primary difficulty is that there is no unequivocal distinction between when to treat the compensation as relating to an underlying asset and when to treat the compensation as relating to the disposal of a right to seek compensation. Indeed the ruling itself contemplates that compensation may relate to both an underlying asset and a right to sue and therefore should be apportioned accordingly.⁴³ Possibly, the issuance of a further taxation ruling with some practical examples of the application of TR 95/35 would allay some of the confusion in practical application.

In summary, the Australian approach requires an initial consideration of the indirect approach and failing its suitability, the application of either the direct approach or the notional asset approach.

3. UNITED KINGDOM

As expected, of the three jurisdictions the UK has the longer history of cases dealing with the taxation of compensation receipts. The UK has been at the forefront of distinguishing between income and capital. The Inland Revenue has also released a policy document, *Extra-Statutory Concession D33* ("D33"), stating their position in respect of the CGT consequences of compensation receipts.

⁴⁸ Ibid paras 172-175.

3.1 Income or Capital

Like other jurisdictions, whether the compensation receipt is income or capital depends on its character in the hands of the recipient and, generally, will take on the character of the item it replaces. In determining whether a sum is income or capital a long line of decided cases may be consulted including the leading case of *Glenboig Union Fireclay Co Ltd v IRC* ("*Glenboig*"),⁴⁹ which has often been referred to within both the Canadian and Australian courts.

In *Glenboig*, the taxpayer owned fireclay pits that ran underneath a railway line. Steps were taken by the Railway Company to prevent Glenboig from mining in the area and ultimately compensation for £15,316 was paid for the loss of the right to work the offending pit. A question arose as to whether the sum of money was income or capital in nature. It was held by the House of Lords that the compensation amount was capital in nature as it related to the complete sterilisation of a company asset. The result was the same as it would have been had the pit been sold. In his judgment, Lord Buckmaster stated:

In truth the sum of money is the sum paid to prevent the taxpayer obtaining the full benefit of the capital value of that part of the mines which they were prevented from working by the railway company. It appears to me to make no difference whether it be regarded as a sale of the asset out and out, or whether it be treated merely as a means of preventing the acquisition of profit that would otherwise be gained. In either case the capital asset of the company has been sterilised and destroyed, and it is in respect of that action that the sum of £15,316 was paid.⁵⁰

The same principle was applied nearly half a century later in *London and Thames Haven Oil Wharves Ltd v Attwooll*

⁴⁹ (1922) 12 TC 427 (affirmed [1922] SC 112 (HC); 12 TC 461 (HL)).

⁵⁰ *Glenboig* (1922) 12 TC 461, 463.

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(*Attwooll*),⁵¹ In this case, the taxpayer was compensated for damage, caused by a customer, to one of its jetties. Based on the grounds that the sum represented lost profits, the Inland Revenue sought to assess the £21,404 received by the taxpayer as income. The taxpayer argued that the amount was of a capital nature. The Court of Appeal found for Inland Revenue. Lord Diplock indicated that:

Where pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits arising in any year from the trade carried on by him at the time when the compensation is so received, the compensation is to be treated for income purposes in the same way as that sum of money would have been treated as if it had been received instead of compensation. The rule is applicable whatever the source of the legal right of the trader to recover the compensation. It may arise from a primary obligation under a contract, such as a contract of insurance, from a secondary obligation arising out of non-performance of a contract, such as a right of damages, ... from an obligation to pay damages in tort ... from a statutory obligation, or in any other way in which legal obligations arise.⁵²

The courts in the UK have also recognised that the method adopted to determine the quantum of the compensation receipt is not conclusive of the character of the payment. This issue arose in *Glenboig*, as the amount of compensation was determined by reference to lost profits. Lord Buckmaster said:

It is unsound to consider the fact that the measure, adopted for the purpose of seeing what the total amount should be, was based on considering what are the profits that would have been earned ... There is no relation between the measure that is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of the application of the test.⁵³

⁵¹ (1966) 43 TC 506 (CA).

⁵² *Ibid* 515.

⁵³ *Glenboig* (1922) 12 TC 461, 463.

Where it is determined that the receipt is income in nature it will be taxed according to the ordinary principles of income tax. Likewise, where it is determined that a compensation receipt is capital in nature it is necessary to consider the CGT consequences and the application of s 22 of the *Taxation of Chargeable Gains Act 1992* ("TCGA").⁵⁴ In order to aid in the application of the CGT provisions to compensation receipts the Inland Revenue has released D33.

3.2 The Taxation of a Receipt of Capital

D33, entitled "Capital Gains Tax on Compensation and Damages: *Zim Properties Ltd - Compensation and Damages*", was introduced to deal with the circumstances that occurred in *Zim Properties Ltd v Proctor* ("*Zim Properties*").⁵⁵

In *Zim Properties*, the taxpayer entered into a contract for the sale of investment properties for £175,000, settlement to be 12 months from the date of contract, which was 12 July 1973. The taxpayer was unable to complete the contract because it failed to show good title to one of the properties. Despite the solicitors being aware that the title deeds to one of the properties were "lost" they still included a "time is of the essence" clause in the contract which was used by the purchaser to terminate dealings. The taxpayer issued a writ against their solicitors claiming negligence and breach of contract. The matter was eventually settled, with the solicitors paying £60,000 in February 1976 and £9,000 in April 1976 by way of compensation. In the accounting period ending 31 March 1976, the taxpayer was assessed by the Commissioner as owing £15,000 in respect of the chargeable gain arising out of the disposal of a chose in action.

The taxpayer appealed the assessment claiming that there was no asset from which the £60,000 could be said to have been derived. Further, the taxpayer argued that if there was an asset from which the

⁵⁴ Formerly *Capital Gains Tax Act 1979*, s 20 ("CGTA").

⁵⁵ (1984) 58 TC 371.

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money was derived, it was the property in the contract of sale. The second argument would allow a deduction for the acquisition costs, thereby reducing the tax payable on the capital gains. The Special Commissioners determined that the chose in action was an asset within the definition of s 22(1) of the *Finance Act 1965* ("FA") and that the money was a result of the disposal of that asset. They also concluded that the cost of acquisition was, pursuant to s 22(4) of the FA, the market value at the date the taxpayer's right arose. Both parties appealed. The taxpayer raised the same arguments, while the Crown argued that the Special Commissioners had incorrectly applied s 22(4).

The High Court of Justice (Chancery Division) dismissed both the taxpayer's appeal and the Crown's cross-appeal. In his judgment, Warner J stated that the sum received by the taxpayer was a "capital sum" derived from "an asset" under the FA and therefore was a chargeable capital gain. Relying on the House of Lord's decision in *O'Brien v Benson's Hosiery (Holdings) Ltd*,⁵⁶ his Honour held that the taxpayer's right to legal action constituted an asset for the purposes of the Act. He stated that in his view:

[it would be] inconsistent with the decision in *O'Brien v Benson's Hosiery (Holdings) Ltd* ... to hold that a right to bring an action to seek to enforce a claim that was not frivolous or vexatious, which right could be turned to account by negotiating a compromise yielding a substantial capital sum, could not be an "asset" within the meaning of that term in the capital gains tax legislation.⁵⁷

In rejecting the taxpayer's contention that the asset to which the compensation was attributed was the underlying property, Warner J stated that it was necessary to search for the "reality of the matter" and, in this case, the reality was that the sum was derived from the right to sue. His Honour found that it was not contrary to business

⁵⁶ *O'Brien v Benson's Hosiery (Holdings) Ltd* [1979] 3 All ER 652.

⁵⁷ *Zim Properties* (1984) 58 TC 371, 390.

sense to treat the compensation as a gain, as the taxpayer still owned the properties unaffected and unimpaired by the fate of the contract.⁵⁸

In response to *Zim Properties* the Inland Revenue released D33 which adopted the approach taken by the Court in that case. It provides:

[a] person who receives a capital sum derived from an asset is treated for the purposes of capital gains tax as disposing of that asset. The case of *Zim Properties Ltd v Proctor* ([1985] STC 90; 58 TC 371) has established that the right to take court action for compensation or damages is an asset for capital gains tax purposes. It follows that a person who receives compensation or damages, whether by court order or arbitration or by negotiated settlement as a result of a cause of action may be regarded as disposing of the right of action. A capital gain may accrue as a result.⁵⁹

D33 adopts the position that a capital gain will accrue if the capital sum received as compensation exceeds the amount which may be deducted as the cost of acquiring the right of action. It further provides that a right of action will almost invariably be acquired otherwise than by way of a bargain made at arm's length and, as a result, special rules will apply in determining the cost base. D33 provides:

[w]here the right of action was acquired on or before 9 March 1981, it is deemed to have been acquired for a sum equal to its market value on the date of acquisition. Where it is acquired on or after 10 March 1981 and there was no disposal of the right of action corresponding to the claimant's acquisition of it, then where - as is usually the case - the taxpayer gave no consideration to acquire it is treated as having been acquired without cost.⁶⁰

The date of acquisition of the asset will be the date that the right of action accrues to the taxpayer and it will be disposed of when

⁵⁸ Ibid 389.

⁵⁹ D33, para 1.

⁶⁰ Ibid para 2.

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compensation is received.⁶¹ D33 also provides that a deduction may be made for any legal and professional fees incurred in pursuing the claim and, where the claim fails or expenses exceed compensation, a capital loss may accrue.⁶²

After establishing the general principles relating to the CGT consequences of compensation receipts, D33 goes on to provide relief and exemptions in specific circumstances, despite the decision in *Zim Properties*. A major exception to this statement is the clear provision that:

other statutory reliefs and exemptions are not available where the receipt of the compensation is regarded as giving rise to a disposal of the right of action, not of any underlying asset to which the relief or exemption might apply.⁶³

The principal concession is the treatment of the disposal of the chose in action as compensation received for the disposal of an underlying asset where there is an underlying asset for CGT purposes. The chose in action can arise either through the total or partial loss or destruction of or damage to property. The result of this treatment is that it allows for a cost base upon disposal.⁶⁴ D33 goes on to provide relief where relief was or would have been available on the disposal of the relevant underlying asset.⁶⁵ Private residence relief, retirement relief and rollover relief will fall within this

⁶¹ Ibid paras 4-5.

⁶² Ibid para 2.

⁶³ Ibid para 7. These include deferment relief for compensation applied in restoring or replacing an asset, rollover relief for the replacement of business assets, retirement relief and private residence relief.

⁶⁴ Ibid para 9. Paragraph 9 provides the example that if compensation is paid by an estate agent because his negligence led to the sale of a building falling through, an appropriate part of the cost of the building may be deducted in computing any gain on the disposal of the right of action.

⁶⁵ Ibid para 10. Paragraph 10 provides the example that if compensation is derived from a cause of action in respect of damage to a building suffered by reason of professional negligence and the compensation is applied in restoring the building, deferment relief under TCGA, s 23 (CGTA, s 21) will be available as if the compensation derives from the building itself and not from the right of action.

exemption. Further, if the right of action relates to an asset that is specifically exempt from CGT, such as a motor car, D33 provides that any gain on the disposal of the right of action may be treated as exempt.⁶⁶ Similarly, where an action is brought in relation to private or domestic matters and it does not concern loss of or damage to or loss in connection with a form of property which is an asset for CGT purposes, any gain accruing on the disposal of the right of action will be exempt from CGT.⁶⁷

Both legislation and D33 specifically exclude personal compensation or damages from CGT consequences. The TCGA, s 51(2)⁶⁸ provides that "sums obtained by way of compensation or damages for any wrong or injury suffered by an individual in his person or his profession or vocation" are not chargeable to CGT. Inland Revenue has defined the words "wrong or injury" to include breaches of contractual duties and torts. Further, if the exemption would have applies to damages received for any wrong or injury, it also applies to any compensation for professional negligence in relation to an action in respect of that wrong or injury.⁶⁹

This exemption is further clarified by D33 which goes on to provide that:

[t]he words "in his person" are to be read in distinction to "in his finances" but they embrace more than physical injury so that distress, embarrassment, loss of reputation or dignity may all be suffered "in the person". Compensation or damages for unfair or unlawful discrimination suffered "in the person" and for libel or slander would thus be included. Similarly the words "in his profession or vocation" refer to compensation or damages suffered by an individual in his professional capacity such as unfair discrimination, libel or slander as distinct from "in his finances". If

⁶⁶ D33, para 10.

⁶⁷ Ibid para 11.

⁶⁸ Formerly, s 19(5) of the CGTA declared that "sums obtained by way of compensation or damages for any wrong or injury suffered by an individual in his person or on his profession or vocation are not chargeable gains".

⁶⁹ D33, para 12.

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the compensation is received by the members of a partnership, each member is treated as receiving a share of the compensation. The exemption is extended by concession to such compensation received by an individual in his trade or employment. The exemption also extends to compensation received by a person other than the individual who suffered the wrong or injury, such as relatives or personal representatives of a deceased person. It also extends to compensation for emotional distress caused by the death of another person, and compensation for loss of financial support.⁷⁰

Therefore, D33 confirms the Court's views in *Zim Properties* that a right to take court action for compensation or damages is an asset for CGT purposes. After allowing for the deduction of legal fees accrued in the process of pursuing the right, the compensation is treated as a capital gain for taxation purposes. Alternatively, if the taxpayer can establish that it is the disposal or damage to an underlying asset that gave rise to the right to compensation, the capital gain will be reduced by an appropriate amount of the cost base of the asset. As the majority of cases operate on the latter basis, it is suggested that a more practicable framework would initially consider whether there was an underlying asset. If this were then implemented, further guidance would be required as to when the compensation attaches to an underlying asset and how to calculate the appropriate cost base. Also, the distinction between no damage or loss of asset (in which case the compensation is received for the disposal of a right to sue) and damage, loss or disposal of asset (in which case the compensation is received for the damage or loss to the underlying asset) must be highlighted.

It is important to note that Extra-Statutory Concessions do not necessarily bind the Crown.⁷¹ However, D33 will cover the majority of situations that arise in the future and it will be applied. Failure to apply the Extra-Statutory Concession will result in the application of the rules as developed by the cases.

⁷⁰ Ibid. The exemption only applies to individuals.

⁷¹ *R v IRC Fulford Dobson* [1987] STC 344.

4. CANADA

Consistent with the Australian and UK jurisdictions, Canada's *Income Tax Act 1952* ("Canada's ITA") does not specifically provide for the taxation consequences of a receipt of compensation. In order to determine such consequences, it is necessary to apply the ordinary principles of taxation found in Canada's ITA, as interpreted by the courts. To aid in this application, Revenue Canada has released a policy document, entitled "Damages, Settlements and Similar Receipts".⁷² *Interpretation Bulletin IT-365R2* ("IT-365R2"), dated 8 May 1987, details Revenue Canada's views on the treatment of amounts received out of claims for damages for personal injury or death, as compensation for loss of property or income, as crime compensation awards, or on termination of employment.⁷³ While IT-365R2 deals with the common cases of compensation awards, it does not deal with all possibilities. As with UK and Australian courts, Canadian courts have delivered a variety of judgments in the matter, with the income tax treatment of damages ranging from the compensation award being fully taxable to non-taxable.

4.1 Income or Capital

For the purposes of determining the treatment of compensation received, the receipt of damages is treated either as ordinary damages or as a capital receipt, which can then be an eligible capital amount, a capital gain or a windfall. In Canada, only three-quarters of the capital gain is taxable, whether accrued to an individual or entity.⁷⁴ The "eligible capital amount", which arises from the sale of specific business assets, is similarly taxed at three-quarters of the amount.

⁷² An Interpretation Bulletin does not have the force of law. Rather, it represents Revenue Canada's administrative interpretation of the law, resulting in the uniform and consistent application of the law within the various offices. While it does provide a useful guide to the taxpayer in determining the views of Revenue Canada, any statement made in the Interpretation Bulletin does not bind the department.

⁷³ IT-365R2, para 1.

⁷⁴ Canada's ITA, s 40(1)(a).

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Courts have applied the basic rules of distinction between income and capital. That is, "the receipt of damages will be ordinary income if it compensates for loss of a sum that would have been income" while "a receipt of damages that compensates for loss of, or damage to, a capital asset will be a capital receipt."⁷⁵ Canadian courts have adopted the approach taken by the British courts in looking to the origin of the claim in determining the compensatory nature of the damages rather than focusing on the legal right of the taxpayer to recover compensation.⁷⁶ For example, in *The Queen v Manley*,⁷⁷ the Court held that damages resulting out of a claim based on agency constituted income because the origin of the claim was an agreement that would have resulted in income being earned. There have been two notable cases of relevance in the 1990s on the capital or income question in relation to compensation receipts - *Mohawk Oil Co v R ("Mohawk")*⁷⁸ and *Murray Barrett Ltd v Minister of National Revenue ("Murray Barrett")*.⁷⁹

In *Mohawk*, the taxpayer entered into a contract for the construction of a waste oil processing plant. After unsuccessful attempts to make the plant work, it was taken out of action and a lawsuit ensued. The claim was eventually settled for \$6 million with the taxpayer claiming this amount was not taxable, as it was "akin to a windfall". The Minister contended that the amount was partially attributable to income and partially attributable to capital. The trial judge agreed with the taxpayer and the Minister appealed. On appeal, it was held that in determining the character of the payment, regard must be had to the significance of the payment in the hands of the recipient rather than the payer. In this case, the payment was for lost income and the loss of a capital asset. Therefore, the compensation receipt was held to be partially income and partially capital.

⁷⁵ SJ Hugo and LA Rautenberg, "Damages and Settlements: Taxation of the Recipient" (1993) 41 *Canadian Tax Journal* 5.

⁷⁶ See, for instance, *Commissioners of Inland Revenue v Fleming & Co (Machinery) Ltd* (1952) 33 TC 57; and *Attwooll* (1966) 43 TC 491.

⁷⁷ (1985) 85 DTC 5150 (FCA).

⁷⁸ (1992) 92 DTC 6135.

⁷⁹ (1994) 94 DTC 1886.

In *Murray Barrett*, the appellant received moneys pursuant to the settlement of a claim against the developers of a property. While the case involved complex dealings and poor draftsmanship, ultimately the tenant defaulted, the property was sold at a loss and the appellant lost a substantial sum of money. The settlement resulted in the appellant receiving \$23,589 and the question arose as to whether it was income or a non-taxable capital receipt. Allowing the appeal, the Court held that the sum was capital in nature due to the reduction in value of what would have been a sound capital investment.

While other jurisdictions have left the income-capital distinction to the courts, Revenue Canada have chosen to address the issue in IT-365R2 and, as such, this threshold test will be discussed in further detail below.

4.2 The Taxation of a Receipt of Capital

The approach adopted by Revenue Canada in its policy document is very different to that of the ATO and of the UK Inland Revenue. Rather than provide a general principle and then give concessions and exemptions, Revenue Canada has opted to discuss the various common heads of damage and the consequences of each. The five heads of damages addressed by IT-365R2 are damages for personal injury, damages for non-performance of a business contract, damages for loss of business income or loss of business properties, crime compensation awards and termination of employment payments.

Any amounts received by a taxpayer or the taxpayer's dependant that fall within the first category, damages for personal injury or death, are specifically excluded from taxable income by IT-365R2.⁸⁰ IT-365R2 divides damages for personal injury or death into two categories. The first category covers special damages such as out-of-pocket expenses for medical and hospital expenses and accrued or future loss of earnings. The second category covers general damages such as pain and suffering, the loss of amenities of life, the loss of

⁸⁰ IT-365R2, para 2.

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earning capacity, the shortened expectation of life and the loss of financial support caused by the death of the supporting individual. Any damages falling within these categories will be exempt from taxation despite the fact that damages may have been determined by reference to loss of earnings. Any amount that can reasonably be considered income from employment will be subject to taxation under the ordinary provisions of Canada's ITA. Further, any amount received by virtue of employees or worker's compensation is required to be included in a taxpayer's assessable income.⁸¹

The taxation consequences of an interest component in the compensation receipt are also dealt with in IT-365R2. It provides that any interest included in the award of damages or settlement amount will not be included as income in the hands of the taxpayer despite the amount being referred to as interest in the court order or settlement agreement. Any interest paid on moneys held after the court order or settlement agreement will however be subject to income tax unless the taxpayer qualifies for an exemption. An exemption, provided for in ss 81(1)(g1) and (g2) of Canada's ITA, may be applicable where the taxpayer is less than 21 years of age and the income is derived from property received as an award of damages in respect of the taxpayer's physical or mental injury.⁸² Revenue Canada has made it clear that an amount received for personal injury will normally be free from taxation consequences.

The second category of compensation discussed in IT-365R2 is an amount received to settle a dispute relating to a business contract. In determining the taxation consequences, the real issue will be whether the compensation receipt is of an income or a capital nature. IT-365R2 states that a receipt which relates to the loss of an income-producing asset will constitute a capital receipt, while compensation for loss of income will constitute business income. The distinction between capital and income in this circumstance will be a question of fact, taking into account three factors:

⁸¹ *Interpretation Bulletin* IT-202R2 "Employees' or Workers' Compensation".

⁸² IT-365R2, para 6.

- where compensation is received for the failure to receive a sum of money, and that sum of money would have constituted an income item, the compensation will constitute an income item;
- "where for example, the structure of the recipient's business is so fashioned as to absorb the shock as one of the normal incidents to be looked for and where it appears that the compensation received is no more than a surrogatum for the future profits surrendered, the compensation received is in use to be treated as a revenue receipt and not a capital receipt";⁸³ and
- "when the rights and advantages surrendered on cancellation are such as to destroy or materially to cripple the whole structure of the recipient's profit-making apparatus, involving the serious dislocation of the normal commercial organisation and resulting perhaps in the cutting down of the staff previously required, the recipient of the compensation may properly affirm that the compensation represents the price paid for the loss or sterilisation of a capital asset and is therefore a capital and not a revenue receipt."⁸⁴

While it may appear from IT-365R2 that the distinction is clear, quite often the distinction is difficult to draw on the facts. In *Canadian National Railway v Minister of National Revenue*,⁸⁵ the Court stated, "the essential question is to determine what the compensation – whether paid pursuant to a contract, a court award of damages, or otherwise – is intended to replace. ... [W]hatever the source of the legal right to compensation, be it the contract or the law of damages, the substantive issue is: what is the amount intended to replace?"⁸⁶ The fact that damages are measured according to lost income can also prove to be deceiving. It is necessary to draw a distinction "between damages measured by lost income and damages that compensate for lost income".⁸⁷ For

⁸³ Ibid para 8 quotes directly from *Commissioner of Inland Revenue v Fleming and Co (Machinery) Ltd* (1952) 33 TC 57 (House of Lords).

⁸⁴ Ibid.

⁸⁵ (1988) 88 DTC 6340 (FCTD).

⁸⁶ Ibid 6342-6343.

⁸⁷ Hugo and Rautenberg, above n 75, 9.

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example, an asset may be lost by the taxpayer but the compensation is determined with reference to the income producing capabilities of the asset. In this circumstance, the compensation receipt will relate to the underlying asset and, therefore, be capital in the hands of the recipient.⁸⁸

Where it is concluded that a compensation receipt is of a capital nature it may be taxed as a capital gain, an eligible capital amount, or treated as a windfall and therefore not taxed at all. While capital gains arise from the disposition of an asset, an eligible capital amount may arise without such a disposition. As to what constitutes an eligible capital amount, Canada's ITA defines an eligible capital expenditure as a capital payment which is not for tangible property, intangible depreciable property or property for which the expenditure is deductible. An eligible capital amount is an amount that would have been an eligible capital expenditure if the taxpayer had paid it.⁸⁹ For example, compensation which relates to the whole profit-making apparatus of the taxpayer's business is an eligible capital amount.⁹⁰ The tax treatment of these two categories varies.

The first category of compensation is taxed in the same manner as in Australia. That is, the proceeds from the disposition are reduced by the adjusted cost base and any expenses upon disposition to determine the capital gain. It is provided that where the compensation received relates to a particular asset, whether sold, destroyed, or abandoned, then that compensation will be considered part of the proceeds of disposition. Similarly, if the compensation receipt relates to an asset not disposed of, the cost base of the asset will be reduced by the amount received.⁹¹ On the other hand, where there is an eligible capital amount a pool concept is used. In this circumstance, there is no cost base. Rather, eligible capital expenditures are added and eligible capital amounts are deducted

⁸⁸ Case examples include *Glenboig* (1922) 12 TC 427; and *Courier MH Inc v The Queen* (1976) 76 DTC 6331.

⁸⁹ Canada's ITA, s 14.

⁹⁰ IT-365R2, para 9.

⁹¹ *Ibid.*

from the cumulative eligible capital pool. When the pool becomes negative, that amount is added to taxable income.

While it appears that a complex problem arises out of compensation receipts of a capital nature relating to the termination of a contract, it has been suggested that:

it appears unlikely that the eligible capital rules will apply when a taxpayer receives an amount on the termination of a contract that forms part of the capital structure of the taxpayer's business ... The eligible capital rules will have potential application only where the payer receives something in addition to the settlement, such as the regaining of the right to trade.⁹²

Where there is a capital receipt that is not an eligible capital gain, there may be CGT consequences. As with other jurisdictions, the issue has arisen as to whether the chose in action is "property". Pursuant to Canada's ITA, property is defined in s 248(1) as:

Property of any kind whatever, whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes:

(a) a right of any kind whatever, a share or a chose in action ...

Canadian courts have clearly and concisely dealt with the issue of the chose in action being the property disposed of. In *Zygocki v The Queen*,⁹³ the taxpayer sued a purchaser of land inventory who refused to complete the sale. The taxpayer argued that the judgment gave rise to a capital gain rather than income as the settlement resulted in proceeds from the disposal of the judgment. The Court rejected this argument and went behind the chose in action to consider the origin of the claim. On this basis, the compensation receipt was held to be income.

⁹² Hugo and Rautenberg, above n 75, 15.

⁹³ (1984) 84 DTC 6283 (FCTD).

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Canadian courts have also considered whether a compensation receipt constitutes a disposition. A disposition has been defined in s 54(c) of Canada's ITA to include:

- (i) any transaction or event entitling a taxpayer to proceeds of disposition of property,
- (ii) any transaction or event by which ...

(B) any debt owing to a taxpayer or any other right of a taxpayer to receive an amount is settled or cancelled.

As to what constitutes a "disposition" of property the Court in *Victory Hotels Ltd v Minister of National Revenue*⁹⁴ adopted a wide meaning of the term and approved the definition given by the Australian High Court in *Hetley House Pty Ltd v FC of T.*⁹⁵ Canadian commentators have argued that, despite the broad definition, the receipt of damages may not constitute the proceeds of disposition as the claim is not transferred to the defendant.⁹⁶ This argument is based on the fact that when an action is settled, the right to sue still exists, with the settlement agreement being a defence to any continued action. The payment of a court judgment, under this analysis, does constitute a disposal.

If a capital receipt is neither a capital gain nor an eligible capital amount, it may be considered a "windfall" gain. Typically, these amounts are paid gratuitously where no commercial relationship exists. For example, in *Federal Farms Ltd v Minister of National Revenue*⁹⁷ the Court held that amounts paid to compensate Federal Farms for crops destroyed by a hurricane were a gift and therefore not taxable. The Court reached this conclusion on the basis that there was no legal obligation to make the payment, nor was there any connection between the taxpayer's business and the payment.

⁹⁴ (1962) 62 DTC 1378.

⁹⁵ (1953) 88 CLR 141.

⁹⁶ Hugo and Rautenberg, above n 75, 23.

⁹⁷ (1959) 59 DTC 1050.

The third category of compensation receipts considered in IT-365R2 is compensation for loss of business income or business properties. A receipt of this nature will fall into one of several categories - a non-taxable receipt, an income receipt, a receipt resulting from the disposition of a capital property or an eligible capital amount.⁹⁸ The consequences of each will be the same as already discussed. *Interpretation Bulletin* IT-182, entitled "Compensation for loss of business income, or of property used in a business", provides that it must be determined whether the compensation is a voluntary payment or a payment to which the taxpayer was entitled. An amount to which the taxpayer has no legal right, but rather is a voluntary payment (for example, out of a relief fund for disaster victims), will not be income or proceeds of disposition of the property in the hands of the taxpayer. On the other hand, if the taxpayer is legally entitled to the funds, through statute law or some other means, compensation paid due to the disposition of property will be considered to be proceeds received in relation to that disposition. Likewise, compensation for loss of income will be considered taxable as income in the hands of the taxpayer.⁹⁹

Finally, IT-365R2 clarifies the taxation of crime compensation awards and amounts received on termination of employment. It provides that crime compensation awards or amounts of a similar nature will normally be considered a non-taxable receipt. This will be the case whether the authority of criminal-injury compensation laws pays the compensation or any other source, provided the amount is not in excess of a fair valuation of the damages suffered.¹⁰⁰ In circumstances where a person receives an amount on termination of employment, that amount will be included as assessable income.¹⁰¹

⁹⁸ IT-365R2, para 10.

⁹⁹ IT-182, paras 2-4.

¹⁰⁰ IT-365R2, paras 11-12.

¹⁰¹ *Ibid* paras 14-15.

5. A RECONCILIATION OF JURISDICTIONS

In determining the taxation consequences of a compensation receipt in each of the three jurisdictions, a similar result ensues. Although all three jurisdictions adopt a two-fold approach, the method for arriving at that result varies somewhat.

The first issue that must be dealt with is the "income or capital" question. While each jurisdiction has approached this issue from a slightly different perspective, the result would appear to be the same. UK courts consider that the essential question is "always whether the taxpayer has received compensation in connection with the deprivation of a capital asset ... or in connection with lost trading profits".¹⁰² Courts have applied this principle in cases such as *Glenboig* and *Attwooll* which, in turn, have been cited by the Canadian and Australian courts.

Canada has applied a similar rule in that "the receipt of damages will be ordinary income if it compensates for loss of a sum that would have been income ... while a receipt of damages that compensates for loss of, or damage to, a capital asset will be a capital receipt."¹⁰³ Revenue Canada has, however, gone one step further than other jurisdictions by stating the distinguishing principles between income and capital with respect to a compensation receipt within its Interpretation Bulletin. In cases since that Bulletin, the emphasis has again been placed on what the compensation receipt is intended to replace.

Australia has also been, and continues to be, faced with the problem of the income and capital distinction. Again, while Australia has adopted the same principles as the UK and Canada, recent cases such as *Liftronic* and *Whitaker* demonstrate the practical difficulty in applying these principles. Furthermore, recent Australian cases also

¹⁰² A Shipwright and JW Price, "Damages, Compensation Payments, UK Taxation and Intellectual Property" (1992) 4 *European Intellectual Property Review* 121, 122.

¹⁰³ Hugo and Rautenberg, above n 75, 5.

demonstrate the difficulties in apportioning a lump sum payment between income and capital, despite the view of the Commissioner that this can be done in all cases.

Therefore, despite adopting a similar view to that of the UK and Canadian courts on the preliminary income and capital distinction, it appears that cases will continue to arise in Australia. This level of uncertainty is far from satisfactory and, to this extent, the ATO may wish to consider adopting the Canadian approach of dealing with the issue by way of a taxation ruling.¹⁰⁴ This should decrease the uncertainty, thereby minimise the taxpayer's need for either a private ruling or litigation. Indeed, the need for a private ruling or litigation may be circumvented altogether if legislative provisions are implemented to clarify, first, the correct basis for distinguishing between income and capital and, second, an appropriate basis for apportionment of lump sums. As suggested earlier, the latter provision could be effected by requiring parties to a compensation dispute to comply with one of the sanctioned methods for apportioning the lump sum.

After considering the income and capital distinction, each of the respective taxing bodies has addressed the second issue, the CGT consequences of a compensation receipt. Again, each jurisdiction has taken a different approach to effectively reach the same conclusion with the exception that all jurisdictions do expressly provide for the exemption of compensation for personal injuries from CGT. The UK does this in both its legislation and D33. In Canada, IT-365R2 provides for the concession, while in Australia, s 118-37 of the ITAA97 states that any compensation for personal injury is not included in a taxpayer's net capital gain or loss.

In considering the CGT consequences of a compensation receipt that is not for personal injury, the UK Inland Revenue Commission policy statement D33 adopts an approach that is in stark contrast

¹⁰⁴ Note that TR 95/35 only addresses the second issue, CGT consequences of compensation receipts, not the preliminary income or capital question.

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to Australia's TR 95/35. It provides that the general rule is that the asset disposed of is the chose in action and the underlying asset approach is a concession to the general principle. Essentially, this approach is the complete opposite of TR 95/35, which requires the underlying asset approach to be applied first and, only if this is unsuitable, the direct approach is to be used. The result, however, would appear to be the same due to the UK concession.

In contrast to the UK and Australian approaches, Revenue Canada has chosen to consider the various possible heads of damages that may be received, rather than adopt broad-based principles. This segmented approach appears to leave gaps in the Canadian policy, thereby increasing the likelihood that taxpayers will be forced to return to the courts for a decisive answer.

The resounding result of this analysis is that clear, legislative guidance is needed to address both the income and capital distinction and the CGT consequences of a compensation receipt. In particular, the latter issue requires clarification as to the timing of the "CGT event" and the relevant cost base. Practical difficulties associated with the Canadian policy suggest that a segmented approach, which operates on the basis of specific types of compensation receipts, is not ideal and rather a broad based approach such as that adopted by the Commissioner in TR 95/35 is preferable. Furthermore, stipulating the underlying asset approach as the default method would appear to be preferable to the UK default method of the direct approach (based on the chose in action), as the majority of cases fall under the former.

Given the comparative strength of the Australian approach, there are some useful conclusions to be drawn from this tri-jurisdictional study. First, in an overwhelming majority of situations where this matter arises, the policy outlined by the respective taxing bodies in their rulings or equivalent will cover the issues that arise. Second, where the policies are not applicable, for whatever reason, there will be a dearth of case law, albeit somewhat unclear. Finally, there seems to be no dispute that a right to a sum of money is a chose in action and capable of being an asset for CGT purposes.

In conclusion, it is observed that although the methods of the three jurisdictions produce similar results, the current Australian approach is practically preferred. It is suggested, however, that clear legislative intervention is required to clarify the taxation consequences of a compensation receipt. The current situation is thus far from conclusive.