

TAXATION OF DAMAGES

By Andrew Rider

Two key tax issues arise in relation to the award of damages in litigation: (a) whether the award is liable to tax; and (b) whether the award should be adjusted to take tax into account.

This article examines the above issues primarily in the context of the *Income Tax Assessment Act 1997* (Cth) (ITAA), with some brief discussion about the impact (if any) of the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act).

CHARACTERISATION OF DAMAGES – INCOME OR CAPITAL?

The taxation treatment of an award of damages under the ITAA depends, among other things, on the nature of the receipt in the hands of the recipient.¹ The key question, therefore, is ‘what were the damages paid for?’

Income

Where damages are paid for something pertaining to income,² the payments may be assessable under the ordinary income provisions in ss6-5 of the ITAA. By way of example, the following payments have been held to be assessable as income:

- (a) compensation paid to a farmer for lost trading income (*Gill v Australian Wheat Board*);³
- (b) damages awarded to a landlord for lost rental income (*Raja's Commercial College v Gian Singh & Co*);⁴
- (c) damages for lost company profits (*Liftronic Pty Ltd v FCT*);⁵ and
- (d) pre-judgment interest awarded in settlement of underpaid wages.⁶

Capital

Where damages are paid for something on capital account, they may be taxable as net capital gains under Chapter 3 of the ITAA (CGT provisions). By way of example, the following payments have been held to be receipts of capital:

- (a) damages paid for the loss of a taxpayer's profit-making structure;⁷
- (b) payments received by a person for loss of earning capacity,⁸ or in consideration of restrictions on his/her future income-earning capacity;⁹ and
- (c) lump-sum damages received in settlement of an unliquidated claim covering both income and capital elements, which cannot be dissected into those elements.¹⁰

APPORTIONMENT OF DAMAGES

In the typical case, a single receipt of mixed capital and income nature may be apportioned between capital and ordinary income respectively.¹¹ However, such an apportionment cannot be made in respect of the payment of lump sum damages received in settlement of an unliquidated claim.¹²

In general, the Commissioner will not allow a taxpayer to claim the benefit of an exemption if it applies only to part of an award of damages, where the damages cannot be relevantly apportioned.

In terms of the apportionment of receipts for CGT purposes, the Federal Court recently held in *Gerard Cassegrain & Co Pty Ltd v FCT*¹³ that a \$9.5m settlement payment subject to CGT should have been apportioned in some manner between the taxpayer and its managing director, in view of various rights they both surrendered under the deed of settlement that gave rise to the payment.

TAXATION TREATMENT OF PARTICULAR DAMAGES AWARDS

The ITAA and/or the common law provides for the following taxation treatment of the damages awards set out below.

Compensation for lost wages

Payments received as compensation for lost wages under equal opportunity, sex discrimination or workers' compensation laws are taxable as ordinary income under the ordinary income provisions in s6-5 of the ITAA.

In relation to payments for workers' compensation, the relevant legislation provides for the repayment of the gross amount of statutory benefits received by the employee to the employer or statutory fund in order for the employee to bring a claim outside the statute.¹⁴ Because it can be reasonably foreseen that it is the gross income replacement benefits that have to be reimbursed, although the worker receives only the net after-tax amount of each statutory payment, the claimant receives an extra component in damages, called the *Fox v Wood*¹⁵ component. It is an amount equal to the tax earlier paid in respect of workers' compensation benefits.

Compensation for personal injury

A lump-sum award of damages for personal injuries is not treated as assessable income, even when received in instalments.¹⁶ Further, neither the pre- nor post-judgment interest components of damages awarded for a taxpayer's personal injuries are assessable.

However, the award of damages for loss of income-earning capacity is calculated on the plaintiff's post-tax (that is, net) income.¹⁷

The CGT provisions expressly provide that no capital gain arises where a taxpayer receives compensation or damages for any wrong, injury or illness suffered personally by a taxpayer or a relative, or for any wrong or injury suffered by a taxpayer at work.¹⁸

Compensation for non-personal wrong or injury

The CGT consequences of compensation payments for wrongs or injuries that are not of a personal nature are generally as follows:¹⁹

- (a) if a CGT event has happened to an underlying asset,²⁰ the compensation is treated as capital proceeds. So, if the asset was a pre-CGT asset, or is otherwise exempt (such as the family home), the compensation generally has no CGT consequences. If the asset was a post-CGT asset, a capital gain (or loss) may arise from the CGT event;
- (b) if the CGT event does not happen to the asset, but the asset has been permanently damaged or reduced in value,²¹ the compensation is treated as a recoupment of all or part of the total acquisition costs of the asset. So, if the asset was a pre-CGT asset, or is otherwise exempt, the compensation generally has no CGT consequences. If it is a post-CGT asset, its cost base and reduced cost base are decreased by the amount of the recoupment;
- (c) if there is no underlying asset, the compensation is generally treated as capital proceeds from a CGT event which happens in relation to an asset, being the right to seek compensation;²²
- (d) where the compensation does not relate either to an underlying asset or the disposal of a right to seek compensation, CGT event H2²³ may happen in relation to the amount received as compensation; and
- (e) if the compensation amount relates to a number of heads of claim and cannot be allocated on any reasonable basis between those heads of claim, the whole amount is taken to relate to the disposal of the taxpayer's right to seek compensation.²⁴ If one of the undissected components relates, for example, to the personal injury of the taxpayer, the exemption that may otherwise be available (see above) does not apply.

ADJUSTMENT OF DAMAGES FOR TAX

As discussed above, the common law provides for the calculation of damages for loss of earning capacity on a post-tax basis²⁵ and for the grossing up of worker's compensation awards for the tax deducted on compensation payments made to injured workers.²⁶

However, in terms of the position at common law regarding the adjustment of damages payments for the incidence of CGT, the cases are somewhat mixed.

For example, in the following cases, the courts have been prepared to make orders to accommodate the incidence of CGT on the damages awarded:

- (a) in *Provan v HCL Real Estate Ltd & Ors*,²⁷ the court ordered the defendant to indemnify the plaintiff for any liability to pay CGT on the judgment;
- (b) in *Tuite v Exelby & Ors*,²⁸ the court increased the award for the reduction in the capital value of the plaintiff's shares by way of a CGT indemnity, with the plaintiff giving an undertaking to refund the amount to the defendants if CGT was not assessed;
- (c) in *Rabelais v Cameron*,²⁹ the court reserved leave to the

plaintiff to apply for additional damages on a separate occasion on account of any CGT payable on damages awarded for losses suffered as a result of the defendant failing to complete a contract;

- (d) in *Duke Group Ltd v Pilmer*,³⁰ the court approved a conditional order for the defendant to indemnify the plaintiff for any CGT payable on damages awarded for losses suffered as a result of the defendant's breach of contractual and common law duties of care; and
- (e) in *Inglebrae Coal Pty Limited v New South Wales Coal Compensation Board & Anor*,³¹ the court awarded the appellant further compensation under the relevant statutory compensation scheme for its CGT liability, which arose when it received compensation for the vesting of its coal title in the Crown.

However, in contrast to the above cases, the courts were not prepared to make orders to accommodate the incidence of CGT on the damages awarded in the following cases:

- (a) in *Carborundum Realty v RAlA Archicentre Pty Ltd & Anor*,³² the court refused the plaintiff leave to amend its statement of claim to cover an anticipated CGT liability, based on the court's view that the damages awarded did not give rise to a real gain in the hands of the plaintiff and that parliament did not intend to impose CGT where the compensation merely put the plaintiff back to where he was before the defendant intervened; >>

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- (b) in *Fedorovitch v St Aubins Pty Ltd (No. 2)*,³³ the court declined to make such an order on the basis that the sale of the shares simply brought forward the liability to CGT;
- (c) similarly, in *Joondalup Gate Pty Ltd v the Minister for Lands as delegate for the Minister for Works*,³⁴ in denying compensation for any CGT liability, the court recognised that any future sale of the land would have been subject to CGT;
- (d) in *Namol v A W Boulderstone (No. 2)*,³⁵ the court held that it was not inconsistent with the award for compensation to accept that the plaintiff should pay CGT on that award, nor was it unjust for the plaintiff to pay CGT on the punitive damages awarded; and
- (e) in *Osric Investments Pty Ltd v Woburn Downs Pastoral Pty Ltd*,³⁶ the court followed the judgment in *Namol* and refused to allow any increase in damages for a potential CGT liability. The court also referred to the difficulty in making an assessment of damages for a CGT liability and pointed to the evidentiary onus on the plaintiff.

APPROACH TO CASES WHERE TAX ADJUSTMENT IS AN ISSUE

Evidence

The cases suggest that in order to recover additional damages for CGT, the plaintiff must prove that it is more likely than not that the plaintiff's loss and damage will include a liability to CGT.³⁷

In *Namol*, the court also expressed the view that, if CGT is to be taken into account, there should at least be an opinion from an experienced tax practitioner as to the likely tax consequences of the judgment, and the basis on which such an opinion is held.

Remedy or relief

In the various cases cited where the courts have made orders to accommodate a potential CGT liability, they have granted the plaintiff an indemnity or reserved liberty to apply for further damages on account of such a CGT liability. The difficulty with seeking such relief is that it offends the principle that damages are to be assessed once and for all.

However, where a plaintiff is seeking an increase in damages to cover any CGT liability, it may be prudent for the plaintiff to apply for an indemnity and security as well.

Joinder of Commissioner

There is authority that the Commissioner cannot be joined as a party merely on the grounds that tax adjustment of damages is in issue.³⁸ In some cases, it may be possible to overcome this problem by approaching the Commissioner for agreement to be bound by the result in the case and by offering him, as a condition of agreeing to do so, the opportunity of making submissions *amicus curiae*. Another option may be to seek a private ruling from the Commissioner in relation to the CGT liability of the damages award.

GST

The payment of liquidated damages is outside the scope of GST.³⁹ However, rather than damages being outside the scope of GST because they are compensation, the Commissioner's view is that it is the absence of a 'supply' (as defined in the GST Act) which has this effect.⁴⁰

In Practice Statement PS LA 2008/16, the Commissioner states that GST does not apply to the recovery of legal costs (arising from either a court award or an agreed settlement between the parties in dispute). This is because the party being reimbursed has not made a 'supply' in consideration of the payment. The Commissioner also states that the amount of legal costs a party may recover should take into account the party's entitlement to input tax credits, in circumstances where costs are assessed on a 'party/party' basis, and not by reference to a fixed scale, or on a 'solicitor and client' basis, or an 'indemnity basis', or where disbursements are reimbursed. ■

Notes: **1** See, for example, *Carapark Holdings Ltd v Commissioner of Taxation (Cth)* (1966) 115 CLR 653 at 663. **2** For example, lost wages or profits. **3** [1982] NSWLR 795. **4** [1976] 2 All ER 801. **5** 96 ATC 4425. **6** See ATO Interpretative Decision ID 2003/404. **7** See, for example, *Case Y24*, 91 ATC 268. **8** See, for example, *Atlas Tiles v Briers* (1978) 144 CLR 202. **9** See, for example, *Higgs v Olivier* (1952) TC 137. **10** See, for example, *McLaurin v FCT* (1961) 104 CLR 381. **11** Sections 118-20 of the ITAA provide relief from CGT if a gain is subject to ordinary income tax. To the extent that the gain is subject to income tax, the gain from the CGT event is reduced. An award of damages that is pure income will be taxed under ordinary concepts and no CGT liability will arise. In the case of awards of mixed character, without apportionment, the capital nature of the award will prevent ordinary income tax from applying. In the absence of an exemption, the award will be liable to CGT. **12** *Ibid.* **13** [2007] FCA 415. **14** See s151Z of the *Workers' Compensation Act 1987* (NSW). **15** (1981) 148 CLR 438. **16** See *Atlas Tiles* at 209, 224. Also, in *Commissioner of Taxation v Sydney Refractive Surgery Centre Pty Limited* [2008] FCAFC 190 (18 December 2008), the court held at [16] that an award of damages for defamation did not constitute income within the meaning of section 6-5 of the ITAA, notwithstanding that the amount was calculated solely by reference to lost profits. **17** See *Cullen v Trappell* (1980) 146 CLR 1. **18** See subsection 118-37(1) of the ITAA. **19** See *Taxation Ruling* TR 95/35. **20** Such as the disposal of an asset – CGT event A1 (ss104-10 of the ITAA). **21** CGT event C1 (ss104-20 of the ITAA). **22** CGT event C2 (ss104-25 of the ITAA) – the Commissioner's view is that the relevant causes of action are acquired at the time of the first actionable wrong – see *Taxation Ruling* TR 95/35. **23** See ss104-155 of the ITAA. **24** There are significant limitations on the elements of the cost base of the cause of action – see subsections 110-25(1) to (3) of the ITAA. **25** See *Cullen v Trappell* (1980) 146 CLR 1. **26** See *Fox v Wood* (1981) 148 CLR 438. **27** (1992) 92 ATC 4644. **28** (1992) 93 ATC 4293. **29** (1995) 95 ATC 4552. **30** (1999) 73 SASR 64. **31** (2003) 58 NSWLR 362. **32** (1993) 93 ATC 4418. **33** (1999) 17 ACLC 1558. **34** (1996) 33 ATR 327. **35** (1993) 47 FCR 388. **36** (2002) 20 ACLC 1. **37** See *Tuite v Exelby & Ors* (1992) 93 ATC 4293 at 4303 and *Osric Investments Pty Ltd v Woburn Downs Pastoral Pty Ltd* (2002) 20 ACLC 1. **38** See *Provan v HCL Real Estate Ltd & Ors* (1992) 92 ATC 4644 at 4645. **39** See para 109 of GSTR 2006/2. **40** See paras 110 and 111 of GSTR 2001/4.

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